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Article

Equity Crowdfunding: A Market for Lemons?

Darian M. Ibrahim[†]

INTRODUCTION

Everything is online now—the way we connect with others, the way we shop, even some forms of education. We keep up with friends on Facebook we cannot see in person, buy light bulbs from Amazon rather than making a trip to the hardware store,¹ and obtain an MBA at night on our computers from the comfort of our own home after the kids have gone to bed.² One area that has initially resisted the move to cyberspace, however—eschewing the virtual world for the real one—is entrepreneurial finance.

Venture capitalists (VCs) and angel investors have long valued close networks and personal relationships when selecting which entrepreneurs to fund, and they closely monitor their investments in person after they fund.³ These practices lead to intense *locality* in funding—i.e., investors funding entrepre-

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1. See Trefis Team, *Amazon Crumbles Brick and Mortar Stores, Stock Primed for Move to \$233*, FORBES (Dec. 9, 2011, 1:49 PM), <http://www.forbes.com/sites/greatspeculations/2011/12/09/amazon-crumbles-brick-and-mortar-stores-stock-primed-for-move-to-233>.

2. See AUBURN UNIVERSITY MASTER OF BUSINESS ADMINISTRATION ONLINE, <http://harbert.auburn.edu/academics/online-programs/mba-online> (last visited Nov. 2, 2015); THE JOHN MARSHALL LAW SCHOOL JD LAW COURSES ONLINE, <http://www.jmls.edu/academics/jd/jd-online.php> (last visited Nov. 2, 2015); KELLEY SCHOOL OF BUSINESS ONLINE MBA, <http://kelley.iu.edu/onlineMBA/Online/MBA/page36790.cfm> (last visited Nov. 2, 2015); OPEN YALE COURSES, <http://oyc.yale.edu> (last visited Nov. 2, 2015).

3. See *infra* Part II.

neurs in their own communities. But with everything else in society moving online, why not entrepreneurial finance? Can online platforms successfully match entrepreneurs and investors from different communities? Why does a Midwestern entrepreneur need to convince investors in Chicago to fund her startup when there are substantially more investors across the nation who may be interested? And on the flip side, the Internet democratizes investing by allowing the majority of those without connections to angels or VCs the possibility of getting rich funding the next Facebook or Twitter.⁴

Public opinion—and now the law—is highly supportive of the online “crowdfunding” trend. In an age where bipartisan support for anything in Congress is uncommon, allowing entrepreneurs to use the Internet to raise money is a rarity: everyone seems to like it.⁵ The Jumpstart Our Businesses Startups (JOBS) Act⁶ passed with bipartisan support.⁷ The JOBS Act allows general solicitation of accredited investors, a move that makes online matchmaking and investing legally possible in a way that it was not before.⁸ The Capital Raising Online While Deterring Fraud and Unethical Non-Disclosures (CROWDFUND) Act—part of the JOBS Act—goes even further and allows even *unaccredited* investors to invest in startups without the safeguards that have always been provided to unaccredited investors under the securities laws.⁹ Crowdfunding is thought

4. See Jean Eaglesham, *Crowdfunding Efforts Draw Suspicion*, WALL ST. J., Jan. 18, 2013, at C1 (quoting President Obama as calling crowdfunding a “game changer” that allows “ordinary Americans . . . to go online and invest in entrepreneurs they believe in”).

5. See Tanya Prive, *Inside the JOBS Act: Equity Crowdfunding*, FORBES (Nov. 6, 2012, 11:57 AM), <http://www.forbes.com/sites/tanyaprive/2012/11/06/inside-the-jobs-act-equity-crowdfunding-2> (“The issue is entrepreneurs find it very difficult to access financing. . . . These portals could serve as a great vehicle for investing in small businesses, which are accountable for creating 65% of the net new jobs over the past 17 years.”).

6. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 301–305, 126 Stat. 307, 315–323 (2012) (codified in 15 U.S.C. §§ 77a–77r, 78a–78o (2012)).

7. See Leigh Ann Caldwell, *Obama Signs “JOBS Act” into Law, Calls It a “Game-Changer,”* CBS NEWS (Apr. 5, 2012, 3:55 PM), <http://www.cbsnews.com/news/obama-signs-jobs-act-into-law-calls-it-a-game-changer> (“The bill passed Congress with bipartisan support. Republican lawmakers, including House Majority Leader Eric Cantor, stood directly behind the president during the signing ceremony. ‘By increasing access to capital and reducing onerous regulations, entrepreneurs and small business owners will have more ability to take risks, grow and create jobs,’ Cantor said in a statement.”).

8. See *infra* Part I.B.1.

9. See *infra* Part I.B.2.

to fill a funding gap for startups that cannot attract other financing, or are too early in their life cycles to attract angels and VCs.¹⁰

This Article examines the progression in entrepreneurial finance from: (1) traditional angel/VC operations through personal networks; to (2) online soliciting of accredited investors (JOBS Act Title II); to (3) full-blown crowdfunding to anyone who wishes to invest in a startup (JOBS Act Title III).¹¹ *This Article's first main contribution is to show that Title II sites are succeeding, and to explain why. Its second main contribution is to theorize about how Title III might play out when implemented, and to suggest legal reforms to increase its chances for success.*

The Article begins by defining “crowdfunding” and distinguishing its two main types. Crowdfunding can be *equity*-based, meaning investors receive stock in a business in exchange for their money, or it can be *non-equity* based, when people either donate funds or obtain rewards in exchange for their contributions.¹² From a legal perspective, equity crowdfunding is the far more interesting of the two types and is the type of crowdfunding that this Article focuses on.¹³

10. See C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 101 (2012) (noting the “unavailability of traditional sources of small business financing” for new startups); Thomas G. James, *Far from the Maddening Crowd: Does the JOBS Act Provide Meaningful Redress to Small Investors for Securities Fraud in Connection with Crowdfunding Offerings?*, 54 B.C. L. REV. 1767, 1787 (2013) (“[C]rowdfunding fills a necessary funding gap for startups seeking needed capital . . .”). *But see* Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 63 (1998) (“The inability of small businesses to find adequate capital may not indicate a market failure, however. The high failure rate of small businesses demonstrates the risky nature of small business investment . . .”).

11. In my estimation, which is consistent with the nomenclature in the JOBS Act, Title II is a step toward crowdfunding but is not actually crowdfunding. Title III, on the other hand, is crowdfunding and is the more controversial and problematic of the JOBS Act changes. See Kendall Almerico, *Want To Make Equity Crowdfunding Legal? 3 Experts Sound Off*, ENTREPRENEUR (Sept. 4, 2014), <http://www.entrepreneur.com/article/237000> (contending that as of late 2014, without Title III's implementation, “equity crowdfunding” has not yet been made legal).

12. Alan R. Palmiter, *Pricing Disclosure: Crowdfunding's Curious Conundrum*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 373, 375 (2012) (noting that crowdfunding originated in the U.S. on the non-equity side); Chance Barnett, *Crowdfunding Sites in 2014*, FORBES (Aug. 29, 2014, 6:11 PM), <http://www.forbes.com/sites/chancebarnett/2014/08/29/crowdfunding-sites-in-2014>.

13. There are other ways to break down and define the various types of crowdfunding. Bradford, *supra* note 10, at 14–27 (offering a fuller taxonomy of

With some understanding of our eventual target—equity crowdfunding—in mind, the Article then peers back to the time before online investing took hold. Expert angels and VCs operating in tight geographic networks, most notably Silicon Valley, have funded and advised Apple, Google, Facebook, Twitter, Tesla Motors and virtually every other software, social media, and biotech company you can think of. What explains this success? One answer is that intense geographic locality in traditional entrepreneurial finance mitigates investor risk both pre- and post-investment. *It follows, then, that a major concern with crowdfunding is that the very thing touted about it—the democratization of investing through the Internet—eliminates the tight knit communities that have made entrepreneurial finance successful to date.*

Despite this foundational concern, entrepreneurial finance's move to cyberspace is inevitable. As startups need less money to ramp up,¹⁴ and because it is cheaper and more efficient to raise money online than in person,¹⁵ startups will likely raise an increasingly large percentage of funds over the Internet. This Article asks the normative question of whether this trend toward online fundraising is desirable, completing our progression from traditional investing to online investing by examining Titles II and III of the JOBS Act in turn. Do these laws adequately balance the SEC's twin goals of raising capital and investor protection, or do they skew too heavily toward the former?¹⁶ More pointedly, will Title III crowdfunding—the end goal of the legislation—turn into a market for “lemons,”¹⁷ existing only for low-quality startups and foolish investors?

the various strains of crowdfunding). For my purposes, because equity crowdfunding invokes the securities laws while other types do not, the non-equity types of crowdfunding are lumped together and not analyzed further. 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, 1737 (2012) (“Unlike raising money for charities or other nonprofit ventures, a business seeking investors through crowdfunding implicates the securities laws . . .”).

14. See *infra* notes 99–104 and accompanying text.

15. See Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1471 (2013) (discussing the low promotion costs of online offerings).

16. See Hazen, *supra* note 13, at 1767 (“Exposing unsophisticated investors to risky investments without adequate disclosure unduly sacrifices investor-protection goals to the perceived need to lower the disclosure barriers for small businesses and crowdfunding techniques.”).

17. See generally George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (discussing how the market for “lemons” problem intersects with quality differences and

Before reaching the more difficult question posed by Title III, I reveal that the less-radical Title II,¹⁸ which allows general solicitation of accredited investors, seems to have proven successful for entrepreneurs and investors in its first year of operation. Online platforms such as AngelList, FundersClub, and CircleUp have successfully matched entrepreneurs and accredited investors and raised significant cash for startups. This is somewhat surprising, at least in the first analysis, considering: (1) that moving operations online would appear to weaken the close networks and geographic locality that explain traditional angel/VC success; and (2) that the first Internet matching service for startups and accredited investors, ACE-Net, failed miserably over a decade ago.¹⁹

I contend that, upon closer examination, Title II's success should not come as a surprise after all. The Title II sites that have been successful more closely resemble traditional angel investing rather than some new paradigm of entrepreneurial finance. AngelList, FundersClub, and Circle Up operate like traditional angels, they just do so online instead of in person. *Title II platforms are simply taking advantage of the Internet to reduce the transaction costs of traditional angel and VC operations and add passive angels to their networks at a low cost.* The key network players on Title II platforms are the same angels and VCs who invest offline, and the “new” accredited investors being solicited are piggybacking on a select group's expertise. I show that ACE-Net failed because, even though it was limited to accredited investors, it more closely resembled a new network without strong intermediaries and established players than the current Title II platforms. Conversely, Title II is succeeding because it is only a modest change in current practice.

The analysis changes when we reach Title III, however. Title III allows *unaccredited investors* to invest through online

uncertainty).

18. This is not to say that Title II is without its concerns. See Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 *FORDHAM L. REV.* 3389, 3422–25 (2013) (highlighting concerns with equating wealth and sophistication under the accredited investors rule); Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 *CORNELL L. REV.* 1573, 1578 (2013) (expressing concerns about allowing general solicitation of accredited investors when their sophistication is in doubt given the ease of satisfying the accredited investor criteria). Despite concerns, Title II has gotten far less attention and criticism than Title III.

19. See *infra* notes 105–13 and accompanying text for a discussion of ACE-Net.

platforms without the traditional protections of the securities laws. While Title III is still in a holding pattern waiting for SEC rules to implement it,²⁰ Title III represents a true equity crowdfunding situation and a paradigm shift in entrepreneurial finance. Title III crowdfunding is significantly different than Title II for three reasons: (1) Title III is more than moving existing networks online; unaccredited investors are not part of existing angel/VC networks, and thus their inclusion would form new networks of players unknown to each other; (2) given the sheer numbers of unaccredited vs. accredited investors, this would more closely resemble a non-expert based, “wisdom of the crowds” situation than piggybacking on expert investors; and (3) given the foregoing, the identity and quality of the entrepreneurs, investors, and matchmaking sites under Title III might be different. Due to Title III’s extreme departure from traditional entrepreneurial finance, there is a significant risk that it will fail as ACE-Net did.

I argue that any such projections about Title III require more careful analysis. First, there are reasons to believe some high-quality entrepreneurs and investors will use Title III once it is implemented. Namely, some startups will be too early-stage to seek financing from traditional angels or under Title II, and they might prefer Title III over bootstrapping or “friends and family” money. Another subset of high-quality startups might choose to unbundle the traditional investor’s cash and value-added services (e.g., advice connections) and seek only cash under Title III without paying a premium for value-added services. Second, there is the related question of whether those high-quality Title III startups will be outnumbered by low-quality startups with no good way for unaccredited investors to distinguish between them. Should that happen, high-quality startups would not be valued appropriately, resulting in their exit from Title III, leaving only “lemons” remaining.²¹ I argue that the wisdom of crowds and strong intermediation are two potential ways to solve the lemons problem under Title III.

20. Press Release, Congressman Jared Polis, Polis Issa Lead 26 Members of Congress in Letter Urging SEC to Implement Crowdfunding Rules (Aug. 12 2014), <http://polis.house.gov/news/documentsingle.aspx?DocumentID=390763> (“[A] bipartisan group of twenty-six colleagues, today sent a letter to Securities and Exchange Commission (SEC) Chair Mary Jo White urging her to complete the ‘crowdfunding’ rulemaking process . . .”).

21. See *infra* notes 155–56 and accompanying text for a discussion of the “lemons” problem.

This Article proceeds as follows. Part I defines crowdfunding and discusses changes in the JOBS Act that make it legally possible. Part II peers back to the time before online investing to discuss why traditional angel and VC financing has been so successful. Part III uses the analytical framework developed in the previous Part to analyze Title II of the JOBS Act, which allows for general solicitation of accredited investors over the Internet. I conclude that, while puzzling on the surface, Title II is proving successful with good reason—Title II sites are really just existing angel and VC networks moved online to reduce the transaction costs of operation and add passive angels at a low cost. Part IV then analyzes Title III of the JOBS Act, the more radical crowdfunding provisions. I suggest that Title III might—but doesn't need to—turn into a market for lemons. I conclude by offering changes to Title III that could help avoid the lemons problem.

I. CROWDFUNDING DEFINED AND MADE LEGAL

“Crowdfunding” may be commonly thought of as using the Internet to raise money for a product or cause. Businesses, political campaigns, and charitable organizations all use the Internet to raise money. Crowdfunding adds a financing element to its precursor, “crowdsourcing.”²² Wikipedia and Yelp! are both crowdsourced projects.²³ For both crowdsourcing and now crowdfunding, the “crowd” part of the word implies using the wisdom of crowds as opposed to reliance on experts.²⁴ This bottom-up approach brings to mind prediction markets such as the Iowa prediction market.²⁵ President Barack Obama successful-

22. See Schwartz, *supra* note 15, at 1459 (“[C]rowdfunding has its origins in ‘crowdsourcing,’ which is ‘a type of participative online activity in which an individual, an institution, a non-profit organization, or company proposes to a group of individuals . . . via a flexible open call, the voluntary undertaking of a task.’” (quoting Enrique Estellés-Arolas & Fernando González-Ladrón-de-Guevara, *Towards an Integrated Crowdsourcing Definition*, 38 J. INFO. SCI. 189, 197 (2012))). Another precursor is microlending (or microfinance). Bradford, *supra* note 10, at 28.

23. Schwartz, *supra* note 15, at 1459.

24. See JAMES SUROWIECKI, *THE WISDOM OF CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS, ECONOMICS, SOCIETIES, AND NATIONS* 5–22 (2004) (discussing different ways of utilizing collective wisdom).

25. See *Iowa Electronic Markets*, UNIV. OF IOWA COLL. OF BUS., <http://tippie.uiowa.edu/iem/markets> (last visited Nov. 2, 2015); see also Michael Abramowicz & M. Todd Henderson, *Prediction Markets for Corporate Governance*, 82 NOTRE DAME L. REV. 1343, 1346–49 (2007) (applying the idea of prediction markets to corporate governance).

ly used the Internet to raise record sums for his 2008 campaign, an early example of a successful crowdfunding campaign.²⁶

For purposes of this Article, I differentiate two main types of crowdfunding: non-equity based and equity-based. This Part will explore those two crowdfunding variations in turn, explain why equity crowdfunding is far more interesting from a legal perspective, and detail changes in the JOBS Act that have made equity crowdfunding legal.

A. NON-EQUITY VS. EQUITY CROWDFUNDING

Non-equity crowdfunding is when people donate money online or purchase products or experiences in exchange for contributions to a project.²⁷ For example, “The Veronica Mars Movie Project” provided different prizes based on the amount of money a person donated, including t-shirts, a personalized video greeting from a cast member, tickets to the movie premiere, or being an extra in the movie.²⁸ Importantly, none of the backers of a rewards crowdfunding project receive an interest (such as a share of the profits) in the project’s later success.²⁹

Kickstarter and Indiegogo are two of the most popular non-equity crowdfunding platforms. Kickstarter, the platform for the Veronica Mars movie, follows an “all-or-nothing” funding approach, meaning that a project only gets funded if it raises all of the funds sought.³⁰ Kickstarter is emphatic that it does

26. See Michael Luo, *Small Online Contributions Add Up to Huge Fundraising Edge for Obama*, N.Y. TIMES (Feb. 20, 2008), <http://www.nytimes.com/2008/02/20/us/politics/20obama.html> (ironically describing Obama’s campaign headquarters as having “the feel of an Internet start-up”).

27. See Barnett, *supra* note 12.

28. *The Veronica Mars Movie Project*, KICKSTARTER, <http://www.kickstarter.com/projects/559914737/the-veronica-mars-movie-project/posts/427900> (last visited Nov. 2, 2015).

29. Barnett, *supra* note 12. Despite the lack of a profit’s share in the movie’s eventual success, the Veronica Mars project raised its \$2 million goal in just 11 hours. Erin Strecker, “*Veronica Mars*” *Movie Is a Go*, ENT. WKLY. (Mar. 13, 2013, 8:55 PM), <http://www.ew.com/article/2013/03/13/veronica-mars-movie-is-a-go-kickstarter>. The project ultimately raised over \$5.7 million and became the fifth highest grossing rewards crowdfunding project. Matthew Toren, *10 Crowdfunding Success Stories To Love*, ENTREPRENEUR (Mar. 18, 2014), <http://www.entrepreneur.com/article/232234>.

30. Kickstarter’s success rate is just under 40%, with a majority of projects receiving less than 20% of their funding goal. *Stats*, KICKSTARTER <http://www.kickstarter.com/help/stats?ref=footer> (last visited Nov. 2, 2015). Through Kickstarter, 95,092 projects totaling \$2.05 billion have been successfully funded. See *id.*

not engage in equity crowdfunding,³¹ nor does it allow charitable campaigns.³² Indiegogo is different in a couple of important respects. First, it allows projects to raise less than the full amount sought.³³ Second, Indiegogo encourages charitable campaigning and offers a 25% discount to registered 501(c)(3) nonprofits.³⁴

Equity crowdfunding is different than non-equity crowdfunding in a key way. In equity crowdfunding, investors contribute money in exchange for a tangible interest in the venture they are funding, most often stock.³⁵ Unlike traditional entrepreneurial finance, where startups may be screened in person at a monthly meeting of angels, equity crowdfunding uses a virtual platform to match investors and entrepreneurs. Because investors receive equity in exchange for their funds, they are purchasing “securities,” and thus the securities laws regulate the transaction.³⁶

B. LEGAL CHANGES IN THE JOBS ACT THAT FACILITATE EQUITY CROWDFUNDING

Harnessing the power of the Internet to raise capital for small businesses drove the bi-partisan support and easy pas-

31. *Our Rules*, KICKSTARTER, <http://www.kickstarter.com/rules> (last visited Nov. 2, 2015); *Seven Things To Know About Kickstarter*, KICKSTARTER, <http://www.kickstarter.com/hello> (last visited Nov. 2, 2015) (“Creators keep 100% ownership of their work. Backers are supporting projects to help them come to life, not to profit financially.”).

32. *Our Rules*, *supra* note 31.

33. INDIEGOGO, <http://support.indiegogo.com/hc/en-us> (last visited Nov. 2, 2015). Indiegogo allows either “Flexible” or “Fixed” Funding. Under the “Fixed Funding” model, project creators must raise the full amount sought to keep any of the funds, like Kickstarter. Under the “Flexible Funding” model, project creators can raise and keep less than the full amount sought. *See How Much Does Indiegogo Cost? Fees & Pricing*, INDIEGOGO, <https://support.indiegogo.com/hc/en-us/articles/204456408-Fees-Pricing> (last visited Nov. 2, 2015).

34. *Id.*

35. Equity crowdfunding is the focus of this Article, although “debt crowdfunding” may not be far behind. *See Amy Cortese, The Crowdfunding Crowd Is Anxious*, N.Y. TIMES (Jan. 5, 2013), <http://www.nytimes.com/2013/01/06/business/crowdfunding-for-small-business-is-still-an-unclear-path.html> (“Much of the crowdfunding focus has been on equity—selling shares in startups—but SoMoLend is betting that loans to expanding small businesses are a bigger opportunity. Equity crowdfunding will be ‘minuscule compared to the impact crowdfunding will have on debt financing,’ says Candace Klein, SoMoLend’s founder and C.E.O. ‘We think this is literally going to change the banking system.’”). Debt financing is not to be confused with microlending, which does not implicate the securities laws.

36. *See supra* note 13 and accompanying text.

sage of the JOBS Act.³⁷ Prior to the JOBS Act, the securities laws contained two main roadblocks to equity crowdfunding: the ban on general solicitation in Rule 506 private offerings and the strict rules for selling to unaccredited investors in such offerings.

1. Title II: Allowing General Solicitation of Accredited Investors

First, while Regulation D³⁸ and Rule 506³⁹ promulgated under the Securities Act of 1933 allow startups to raise money in private offerings without SEC registration, they do not allow startups to seek potential investors through “general solicitation or general advertising.”⁴⁰ “To avoid making a general solicitation, [an entrepreneur] must have a preexisting, substantive relationship with the potential investor.”⁴¹

It is easy to see how the general solicitation ban would present a problem when the Internet is involved. How can an entrepreneur have a preexisting relationship with every angel or VC who might view his information online? The short answer is that he cannot. As a 2006 report on Rule 506 and general solicitation noted, the ban on general solicitation “prohibits issuers from taking advantage of the tremendous efficiencies and reach of the Internet to communicate with potential investors.”⁴²

Title II of the JOBS Act solves the general solicitation problem, which has long been seen as a hindrance to small

37. The initial form of the JOBS Act bill was passed by the House of Representatives after only one day of consideration. 158 CONG. REC. H1275 (daily ed. Mar. 8, 2012) (indicating H.R. 3606 was passed 390-23 on March 8, with consideration beginning on March 7).

38. 17 C.F.R. §§ 230.501–.506 (2014).

39. *Id.* § 230.506; see also Abraham J. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 132 (2010) (“The exemption from registration that most startup companies rely on is Rule 506 of Regulation D . . .”).

40. 17 C.F.R. § 230.506.

41. Darian M. Ibrahim, *Financing the Next Silicon Valley*, 87 WASH. U. L. REV. 717, 756 (2010); see also Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of “Technological Disintermediation” for Unregistered Offerings of Securities*, 2 J. SMALL & EMERGING BUS. L. 1, 6 (1998) (commenting on general solicitation that “there has consistently been a dominant message: the ‘pre-existing relationship’ test is the key”).

42. ADVISORY COMM. ON SMALLER PUB. COS., FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 75 (Apr. 23, 2006), <http://www.sec.gov/info/smallbus/aspc/acspc-finalreport.pdf>.

businesses raising capital.⁴³ Title II removes the ban on general solicitation in 506 offerings provided only accredited investors are solicited, and that there are “reasonable steps to verify” the accredited status of the investors.⁴⁴ By removing Rule 506’s ban on general solicitation, online investing in limited form (due to the accredited investor restriction) became possible.⁴⁵

2. Title III: Easing Sales to Unaccredited Investors

To obtain a true equity crowdfunding situation, the majority of us *unaccredited* investors must be allowed to participate in startup offerings. The Internet can be a powerful tool to use the wisdom of crowds to identify and fund the next big idea, but a true crowd-based approach requires opening up the process to more than accredited investors. Currently most Rule 506 offerings, and virtually all startups’ sales to angels and VCs, are limited to accredited investors due to the disclosure and other requirements involved when bringing unaccredited investors into the mix.⁴⁶ While accredited investors are thought to be

43. See, e.g., William K. Sjostrom, Jr., *Relaxing the Ban: It’s Time To Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1 (2004); JD Alois, *CircleUp: 40 Companies and \$40 Million Funded*, CROWDFUND INSIDER (Sept. 26, 2014), <http://www.crowdfundinsider.com/2014/09/50858-circleup-40-companies-40-million> (noting that Title II of the JOBS Act allowance of general solicitation “was an incredibly important change that finally allowed online investment crowdfunding portals to truly come to life”).

44. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 309 (2012) (codified at 15 U.S.C. § 77d) (instructing the SEC to remove the “prohibition against general solicitation or general advertising” under Rule 506). Another change is enhancing the issuer’s belief that an investor is accredited, which the issuer must now take “reasonable steps to verify.” Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 77 Fed. Reg. 55,464, 54,467 (Sept. 5, 2012) (to be codified at 17 C.F.R. pts. 230, 239) (“[R]easonable steps . . . [is] an objective determination, based on the particular facts and circumstances of each transaction. . . . [F]actors include: [1.] the nature of the purchaser and the type of accredited investor that the purchaser claims to be; [2.] the amount and type of information that the issuer has about the purchaser; and [3.] the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.” (bullet points omitted)).

45. See 17 C.F.R. § 230.506 (2014).

46. Even before the JOBS Act, startups did not have to make disclosures to accredited investors. 17 C.F.R. § 230.502(b)(1) (2014); Interpretative Release on Regulation D, 48 Fed. Reg. 10,045, 10,045 (Mar. 10, 1983) (to be codified at 17 C.F.R. pt. 231) (“[I]f accredited investors are the only purchasers in offerings under Rules 505 and 506, Regulation D does not require delivery of specific disclosure”); see also Rodrigues, *supra* note 18, at 3394 (“U.S. securities law has *always* allowed wealthy investors to enter certain markets

able to fend for themselves, unaccredited investors are not, and that is the basis for their differing legal treatment.⁴⁷

Title III of the JOBS Act would make it possible, for the first time, for unaccredited investors to purchase equity in nascent startups through the Internet. Title III directs the SEC to promulgate rules to implement this broad and significant change, although no rules have yet been made.⁴⁸ Title III permits limited deregulated offerings by reducing the issuer disclosures that Rule 506 has long required.⁴⁹ This sweeping change in unaccredited investor protection has led to fears that unaccredited investors will supply “dumb money” into low-quality or fraudulent startups.⁵⁰ Such fears explain the holdup in the SEC passing rules to implement Title III.⁵¹

Title III attempts to limit the downside for unaccredited investors in a novel way—by specifying how much they can purchase in Title III startups in any given year. For investors with annual incomes below \$100,000, that cap is \$2000 or 5% of their income, whichever is greater.⁵² Investors with annual incomes over \$100,000 can invest the greater of \$10,000 or 10% of their income.⁵³ While the final result on Title III is unclear at the current time, and provisions may be subject to change,⁵⁴ al-

(including not only the market for private company investments . . . while cordoning off average (retail) investors from the same opportunities.”).

47. SEC v. Ralston Purina Co., 346 U.S. 119, 124–25 (1953); Rodrigues, *supra* note 18, at 3417–22 (tracing the history of the accredited investor exemption in private placements).

48. Palmiter, *supra* note 12, at 394 n.78 (“The SEC has been charged with drafting regulations to enact the crowdfunding provisions . . .”). Just before the publication of this Article, the SEC released final rules to permit crowdfunding, however these rules had not yet been published in the *Federal Register*. See SEC, Crowdfunding Final Rule (Oct. 30, 2015), <http://www.sec.gov/rules/final/2015/33-9974.pdf>.

49. See *infra* notes 163–65 and accompanying text.

50. Hazen, *supra* note 13, at 1766 (“[T]he solicitation of small investors is likely to attract unsophisticated investors who are in need of the investor protection provisions generally found in the securities laws.”).

51. There is a risk of fraud in Title III, especially considering that “[t]he JOBS Act exemptions bear some resemblance to the old Rule 504, which allowed ‘non-reporting issuers to offer and sell securities to an unlimited number of persons without regard to their sophistication or experience and without delivery of any specified information.’ The old Rule 504 enabled widespread fraud . . .” Sherief Morsy, Note, *The JOBS Act and Crowdfunding: How Narrowing the Secondary Market Handicaps Fraud Plaintiffs*, 79 BROOK. L. REV. 1373, 1380 (2014).

52. 15 U.S.C. § 77d(a)(6)(B) (2012).

53. *Id.*

54. See Equity Crowdfunding Improvement Act of 2014, H.R. 4564, 113th Cong. (2014), <http://www.opencongress.org/bill/hr4564-113/text> (last visited

lowing unaccredited investors to participate in a meaningful way in online investing is a necessary step to achieving true equity crowdfunding.

II. TRADITIONAL ANGEL AND VC INVESTING

Having described equity crowdfunding and the legal changes under the JOBS Act that are making it possible, this Article now shifts its focus to the normative question of whether equity crowdfunding is *desirable*. The analytical framework used to evaluate this normative question is that of traditional entrepreneurial finance. Why is startup investing so difficult, and what made angels and VCs so successful before online platforms came into existence?

Part A discusses the significant risks involved in funding early-stage startups. Without being able to manage these risks, rational investors would not fund these businesses. Part B explains how VCs have managed these risks through the use of detailed investment contracts. Part C explains how, in contrast, angel investors use informal means to manage the same risks.

A. THE TRIO OF RISKS IN FUNDING STARTUPS

As Ronald Gilson was the first to explain, early-stage startups present extreme levels of uncertainty, information asymmetry, and agency costs.⁵⁵ Startups present uncertainty both because they are new, and thus have no track records, and because they are often high-tech, which adds the element of technological uncertainty.⁵⁶ There is information asymmetry, meaning the entrepreneur knows more than his investors, again due to the lack of a track record and perhaps a new technology.⁵⁷ While uncertainty and information asymmetry are *ex ante* (or pre-) investment problems, agency costs present themselves *ex post* (or post-) investment. Agency costs are the fear that post-investment, the entrepreneur will act (with the investors' money) in a way that benefits himself and not the inves-

Nov. 2, 2015); see also Samuel Guzik, *JOBS Act 2.0: Congressman McHenry's Cure for the "Six Deadly Sins" of Crowdfunding Regulation*, CROWDFUNDING INSIDER (May 5, 2014, 7:30 AM), <http://www.crowdfundinsider.com/2014/05/37673-jobs-act-2-0-congressman-mchenrys-cure-six-deadly-sins-crowdfunding-regulation>.

55. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1076 (2003).

56. *Id.* at 1076–77.

57. *Id.* at 1077.

tors.⁵⁸ Of course all investors face these problems, but startup investors face them in spades due to the unique nature of startups.

B. HOW VCS MITIGATE THE RISKS OF STARTUP INVESTMENTS

VCS mitigate these extreme risks in startup investing through the use of detailed investment contracts. Staged financing, or releasing money over time once a startup achieves certain pre-set milestones, makes the startup's prospects clearer before subsequent funds are released and reduces the entrepreneur's informational advantage.⁵⁹ Staged financing also incentivizes the entrepreneur to succeed in order to receive more funds, therefore also reducing agency costs.⁶⁰ Staged financing is thus a powerful tool VCS use for mitigating risk in startup funding.⁶¹

In addition to staged financing, VCS take preferred stock with liquidation preferences in exchange for their investments, which signals the entrepreneur's belief that the startup will be worth more than these preferences.⁶² VCS also contract for board representation that likely exceeds the number of directors they could elect by voting their shares.⁶³ Due to the preeminence of the board in corporate governance, the VCS

58. *Id.*

59. *Id.* at 1078–79; see also Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 304 (2003) (discussing VCS' use of staged financing).

60. Gilson, *supra* note 55, at 1079–80.

61. Michael Klausner and Kate Litvak describe staged financing as the “[m]ost important” of all the VC's risk-reduction techniques. Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, in BRIDGING THE ENTREPRENEURIAL FINANCING GAP 54, 56 (Michael J. Whincop ed., 2001) (“Most important among these contract terms is the staged nature of the venture capital investment.”); see also Fisch, *supra* note 10, at 61 (“Active involvement together with staged financing allows venture capitalists to address the information and agency problems of the small business better than public equity.”).

62. Klausner & Litvak, *supra* note 61.

63. Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 988–89 (2006) (arguing that so-called “independent” directors on startup boards are often chosen by the VC and are likely to side with the VC in any contested board vote, giving the VC control of the board in more cases than it would otherwise appear); cf. Brian J. Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH L. REV. 461, 462–63 (2010) (showing that VCS have less control over the appointment of independent directors than is commonly thought).

board control also reduces agency costs.⁶⁴ VCs also employ other formal mechanisms, such as protective provisions that allow them to control exit decisions, which likewise mitigate the trio of investment problems that would otherwise make startup investments undesirable.⁶⁵

C. HOW ANGELS MITIGATE THE RISKS OF STARTUP INVESTMENTS

As I have previously written, angel investors fund startups that are even earlier stage and thus present even higher degrees of uncertainty, information asymmetry, and agency costs.⁶⁶ Yet angels use none of the VC's contractual protections to guard their investments.⁶⁷ This is, in important part, because angels use informal means of reducing investment risks.⁶⁸

First, *ex ante*, angels generally invest only in technical areas with which they are familiar, thus reducing uncertainty and the entrepreneur's informal advantage.⁶⁹ Angels are experts in the technical fields they invest in, usually having made their investment capital from a successful exit in their own startup.⁷⁰ Angels also get their deal flow from a network of trusted advisors. This network "serves an important screening and sorting function by funneling high-quality deals to angels while exclud-

64. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 559 n.65 (2003).

65. Gilson, *supra* note 55, at 1084–85.

66. See Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1420 (2008) ("[B]ecause angels invest at an earlier stage than venture capitalists, when a start-up has no operating history whatsoever, [this trio of] problems [is] even more acute than at the time venture capitalists invest.").

67. See *id.* at 1421 ("[T]he investment contracts used by traditional angels differ dramatically from those used by venture capitalists because they provide far less investor protection.").

68. Angels eschew detailed investment contracts for other reasons, too, including that aggressive contracts could hinder follow-on VC investments and because angel investments are too small to justify elaborate protective devices. See *id.* at 1428–31 (discussing the need for follow-on VC funding); *id.* at 1433–35 (discussing the cost of contracting).

69. See *id.* at 1431–32; see also Fisch, *supra* note 10, at 86 ("[A]ngels frequently have substantial expertise in the industry in which they invest.").

70. Ibrahim, *supra* note 66, at 1419 ("Most angels are ex-entrepreneurs themselves . . ."). Compare that with VCs, who are usually finance types rather than ex-entrepreneurs. MARK VAN OSNABRUGGE & ROBERT J. ROBINSON, ANGEL INVESTING 109 (Jossey-Bass Inc. 2000) (observing that "venture capitalists for the most part have little entrepreneurial experience" and are instead "financial MBA-types").

ing low-quality deals.”⁷¹ Angels also screen startups in-person (perhaps several times).⁷²

Second, *ex post*, angels routinely visit and engage with the entrepreneurs they fund, which reduces agency costs.⁷³ As Andrew Wong has noted, angels invest no more than a two-hour drive from their investments,⁷⁴ and this creates a “localized bond of trust [that makes] formal control mechanisms unnecessary.”⁷⁵ Importantly, entrepreneurs have traditionally *wanted* angel participation (and VC participation through the board).⁷⁶ The value-added services angels and VCs provide through their advice, experiences, connections, and empathy are said to be as important to entrepreneurs as the investors’ money.⁷⁷ The need for value-added services from investors becomes important to our story later.⁷⁸

III. WHY TITLE II SITES ARE SUCCEEDING

The previous Part explained why traditional angel and VC investing has worked so well prior to the rise of online platforms for startup investing. However, any realist must acknowledge that entrepreneurial finance’s move to cyberspace is inevitable.⁷⁹ As it becomes possible to fund startups with less cash, the VC’s deep pockets are no longer necessary. Furthermore, it is cheaper and more efficient to raise money online, thus allowing entrepreneurs to spend less time fundraising and more time developing their businesses. But despite these advantages, will Title II work without following the traditional Silicon-Valley blueprint? This Part discusses Title II’s success

71. Ibrahim, *supra* note 66, at 1432.

72. *Id.* at 1444.

73. *Id.* at 1433.

74. MIT ENTREPRENEURSHIP CTR., VENTURE SUPPORT SYSTEMS PROJECT: ANGEL INVESTORS 32 (Feb. 2000), <http://ocw.mit.edu/courses/sloan-school-of-management/15-975-special-seminar-in-management-the-nuts-and-bolts-of-business-plans-january-iap-2005/readings/angelreport.pdf> (“Most active angels will not invest in opportunities outside a 1-2 hour driving range.”).

75. Andrew Wong, *Angel Finance: The Other Venture Capital*, in VENTURE CAPITAL: INVESTMENT STRATEGIES, STRUCTURES, AND POLICIES 347–64 (Douglas Cumming ed., 2010).

76. Gilson, *supra* note 55, at 1075 (“[T]he venture capital fund’s noncash contributions have special value to early stage companies.”).

77. *Id.*

78. See *infra* notes 145–52 and accompanying text.

79. See Sean M. O’Connor, *Crowdfunding’s Impact on Start-Up IP Strategy*, 21 GEO. MASON L. REV. 895, 896 (2014) (“Notwithstanding . . . criticisms, enterprise crowdfunding will become a reality sooner rather than later, and tech start-ups will be among the first to explore using it.”).

so far and contends that on close examination it is not all that surprising.

A. TITLE II SITES SUCCESS SO FAR

Several Title II sites have come into existence since the JOBS Act was passed. By any measure, including funds raised by these sites for their own operations and startups using these sites to successfully raise funds, these Title II sites are off to a promising start. According to one observer, “investments made through crowdfunding platforms have grown each quarter and will continue to grow.”⁸⁰ The most notable of these sites include AngelList, FundersClub, and CircleUp.

AngelList has an interesting history. Naval Ravikant, the co-founder, originally “co-founded Epinions, an early online reviews site, but felt cheated out of proceeds from the company’s sale to EBay.”⁸¹ After a lawsuit against their VC backers in Epinions, “Ravikant channeled his disappointment into a blog called Venture Hacks . . . [which] offered dealmaking tips to startups.”⁸² In 2010 VentureHacks became AngelList, which went from widely distributed e-mail to a networking website.⁸³ In 2013 alone, “500 startups raised \$125 million” through AngelList, according to Ravikant.⁸⁴ AngelList has rivals, such as Gust, but “so far, no one has replicated the appeal of AngelList.”⁸⁵

FundersClub bills itself as an online venture capital firm. By mid-2013, FundersClub (accelerated through the well-known Y Combinator out of Silicon Valley⁸⁶) had “raised \$6.5 million for itself” and “also collected \$7.2 million for its 31 port-

80. Kay Koplovitz, *Equity Crowdfunding at Year One, What’s the Impact?*, FORBES (Sept. 26, 2014), <http://www.forbes.com/sites/kaykoplovitz/2014/09/26/equity-crowdfunding-at-year-one-whats-the-impact> (quoting Luan Cox, co-founder and CEO of Crowdnetic).

81. Brad Stone, *AngelList, the Social Network for Startups*, BLOOMBERG BUS. (Jan. 16, 2014), <http://www.bloomberg.com/bw/articles/2014-01-16/angel-list-the-social-network-for-startups>.

82. *Id.*

83. *See id.*

84. *Id.*

85. Andrew Davidson, *Follow the Money: AngelList Has Blown Open Early-Stage Investments*, WIRED (May 17, 2013), <http://www.wired.co.uk/magazine/archive/2013/05/features/follow-the-money>.

86. For a history of Y Combinator, see RANDALL STROSS, *THE LAUNCH PAD: INSIDE Y COMBINATOR, SILICON VALLEY’S MOST EXCLUSIVE SCHOOL FOR STARTUPS* (2012).

folio companies from its crowd of 6,700 investors.”⁸⁷ “In February [2014], the company released its first prediction of return on investment for funders on the platform—41.2%.”⁸⁸

CircleUp, itself a successful startup (also accelerated through Y Combinator),⁸⁹ claims that since its launch in 2012 it has raised over \$40 million for 40 startups.⁹⁰ CircleUp does not raise money for tech-based companies, instead focusing on consumer products companies,⁹¹ but, importantly, it still caters to growth startups as opposed to lifestyle firms. As CircleUp’s co-founder explains, “[w]e don’t have any companies on the site who are looking at it as a lifestyle business,” noting that “typically these companies will exit to a private equity fund or strategic acquisition.”⁹²

Several other Title II platforms join AngelList, FundersClub, and CircleUp as innovators in this space. For example, Microventures, described as “an online venture capital platform,”⁹³ had raised over \$50 million for its portfolio compa-

87. Josh Constine, *FundersClub Ditches Dumb Money by Going Invite-Only*, TECH CRUNCH (Aug. 16, 2013), <http://techcrunch.com/2013/08/16/fundersclub-invite-only>.

88. Laura Baverman, *FundersClub Fills Void for Start-Up Investors*, USA TODAY (Mar. 17, 2014), <http://www.usatoday.com/story/money/business/2014/03/17/baverman-funders-club-online-venture-fund/6291007>.

89. See Lora Kolodny, *CircleUp Raises \$14M To Crowdfund Anything but Tech*, WALL ST. J.: VENTURE CAPITAL DISPATCH (Mar. 26, 2014), <http://blogs.wsj.com/venturecapital/2014/03/26/circleup-raises-14m-to-crowdfund-anything-but-tech> (noting the \$14M Series B financing CircleUp raised from Canaan Partners and others, including previous backers “Google Ventures, Union Square Ventures, Maveron and Rose Park Advisors”); Lora Kolodny, *Johnson & Johnson Partners with CircleUp for Early Look at Startups*, WALL ST. J.: VENTURE CAPITAL DISPATCH (July 31, 2014), <http://blogs.wsj.com/venturecapital/2014/07/31/johnson-johnson-partners-with-circleup-for-early-look-at-startups> (noting that 4,000 startups have applied to raise funds on CircleUp as of mid-2014, and that CircleUp has partnered with consumer products giant Johnson & Johnson).

90. Alois, *supra* note 43.

91. See Lora Kolodny, *Collaborative Fund, CircleUp Partner To Invest \$4 Million in B Corps*, WALL ST. J.: VENTURE CAPITAL DISPATCH (Aug. 18, 2014), <http://blogs.wsj.com/venturecapital/2014/08/18/collaborative-fund-circleup-partner-to-invest-4-million-in-b-corps> (describing CircleUp as “the fundraising platform for ‘anything but tech’ startups”).

92. Christine Lagorio-Chafkin, *CircleUp Draws More Investors as Equity Crowdfunding Gains Ground*, INC.COM (Mar. 26, 2014), <http://www.inc.com/christine-lagorio/circleup-bright-spot-crowdfunding.html>.

93. JD Alois, *Microventures Claims \$50 Million Equity Crowdfunding Milestone*, CROWDFUND INSIDER (Sept. 17, 2014), <http://www.crowdfundinsider.com/2014/09/49869-microventures-claims-50-million-equity-crowdfunding-milestone>.

nies as of September 2014.⁹⁴ Other Title II sites include We Are Crowdfunding,⁹⁵ WeFunder,⁹⁶ and EarlyShares⁹⁷ who have all enjoyed early success.

B. THE PUZZLE: SUCCEEDING YET NOT FOLLOWING THE BLUEPRINT

The success of Title II is somewhat surprising, at least on first analysis. It would appear that moving operations online would weaken the close networks and geographic locality that explain traditional angel/VC success. If an angel investor from Virginia funds a startup in Silicon Valley—the very geographic dispersion the Internet is meant to foster—the angel can no longer use traditional pre- and post-investment risk-reducing mechanisms. Relatedly, history is not on the side of Title II. The first attempt at an Internet matching service for entrepreneurs and angels, ACE-Net, failed miserably over a decade ago.⁹⁸

To tie back into our discussion in the previous Part, consider the inapplicability of the VC model to Title II funded startups. Title II sites are catering to the modern startup—the “capital-efficient” startup.⁹⁹ It is now the case that many startups need less money to launch and grow.¹⁰⁰ For example,

94. *Id.*

95. Janet Levaux, *RCAP's Crowdfunding Site: A Smart Move?*, THINKADVISOR (Sept. 8, 2014), <http://www.thinkadvisor.com/2014/09/08/rcaps-crowdfunding-site-a-smart-move> (“We Are Crowdfunding . . . lets accredited investors and others buy public and private offerings online by pooling their resources.”).

96. Ryan Lawler, *Y Combinator-Backed WeFunder Launches To Bring Crowdfunding Startups to the Masses*, TECH CRUNCH (Mar. 19, 2013), <http://techcrunch.com/2013/03/19/wefunder-launch>.

97. Samantha Hurst, *Electric Vehicle Technology Company Brammo Chooses Equity Crowdfunding Platform EarlyShares for Its \$3 Million Capital Raise*, CROWD FUND INSIDER (Sept. 25, 2014), <http://www.crowdfundinsider.com/2014/09/50820-electric-vehicle-technology-company-brammo-chooses-equity-crowdfunding-platform-earlyshares-3-million-capital-raise>.

98. See *infra* notes 108–11 and accompanying text.

99. Another way of describing these startups is “lean.” The “lean startup” develops a base product then adapts the product quickly based on consumer feedback. See ERIC REIS, *THE LEAN STARTUP: HOW TODAY'S ENTREPRENEURS USE CONTINUOUS INNOVATION TO CREATE RADICALLY SUCCESSFUL BUSINESSES* 8–11 (2011) (summarizing the lean startup method). See generally Darian M. Ibrahim, *Should Angel-Backed Startups Reject Venture Capital?*, 3 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 251, 256–57 (2013) (noting “capital-efficient” startups are the new reality and that deep pockets are no longer necessary).

100. Many startups may be able to “bootstrap” their way to profitability,

the cost of launching a software startup has diminished greatly over the past decade.¹⁰¹ One important driver is the advent of cloud computing, which allows startups to avoid purchasing expensive servers and to “manage various functions in a cost-efficient way.”¹⁰² Also, the hottest sector these days, social media and entertainment (including app development), requires little capital to launch compared to “capital-intensive” sectors such as biotech and clean technology.¹⁰³ For these technologies, incubators and accelerators like Y Combinator are also helping to fast-track startup development.¹⁰⁴

The VC model does not work well for cash-efficient startups. VCs have historically not invested in a Series A round¹⁰⁵ for less than \$5 million due to the returns they seek and human capital (e.g., board representation) required for each investment.¹⁰⁶ Recall that once they invest, VCs rely on detailed investment contracts whose most important protection

even if it is a slower climb. According to one author, “[t]he most dangerous and insidious thing that’s happening with our entrepreneurs today is that they come out of school and believe that they cannot build a business without [debt or venture] capital.” Gwen Moran, *Go It Alone*, ENTREPRENEUR MAG., Aug. 2012, at 66–67 (quoting author Dileep Rao); see Kelvin W. Willoughby, *How Do Entrepreneurial Technology Firms Really Get Financed, and What Difference Does It Make?*, 5 INT’L. J. INNOVATION & TECH. MGMT. 1, 6 (2008) (arguing that unorthodox bootstrap financing is the leading type of entrepreneurial finance for tech firms).

101. Ibrahim, *supra* note 99, at 256; see also Abraham J.B. Cable, *Incubator Cities: Tomorrow’s Economy, Yesterday’s Start-ups*, 2 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 195, 227 (2013) (“The most notable lean-start-up successes are Internet-related companies. But the principles are intended to be more generally applicable.”).

102. John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 156 (2014); see also Cable, *supra* note 101, at 226 (“The wide availability of cloud computing services from large vendors like Amazon can eliminate the need to obtain and maintain expensive equipment.”).

103. See Ibrahim, *supra* note 99, at 257.

104. See KEVIN LAWTON & DAN MAROM, THE CROWDFUNDING REVOLUTION: SOCIAL NETWORKING MEETS VENTURE FINANCING 57 (2010) (“Have you noticed that of recent, incubator-style funding mechanisms are popping up everywhere like weeds?”).

105. The “Series A” round is typically the first round of serious capital from professional investors.

106. Robert P. Bartlett, III, *Venture Capital, Agency Costs, and False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 98 n.225 (2006) (“For instance, for all of the primary VC investment sectors, the average size of a first-round equity financing increased from approximately \$1 million in 1980 to over \$5.2 million in 2003 in inflation-adjusted dollars.”). Of course early-stage VCs who act more like angel groups will have a lower minimum investment.

may be staged financing.¹⁰⁷ If a startup requires less than the VC's first-round investment for its entire life cycle, the VC's detailed contracts and staged financing do not work.

Now consider the seeming inapplicability of the angels' model to Title II startups. *Ex ante*, angels rely on personal connections and networks of trust to screen investments. The Internet, however, is impersonal and negates the traditional intimacy in angel deal flow. *Ex post*, angels routinely participate in venture development, visiting the startup frequently and talking through problems with entrepreneurs. Again, the lack of locality brought on by the Internet makes such participation impossible, thus removing another informal means of risk reduction available to the online investor.

Indeed, this analysis explains why ACE-Net, the first Internet matching service for entrepreneurs and angels, failed. ACE-Net was launched over fifteen years ago and was made possible even before Title II under a no-action letter from the SEC.¹⁰⁸ ACE-Net was described as a "cross between a blind-dating service and an initial public offering."¹⁰⁹ It was a joint project of several government agencies (although driven by the Small Business Administration) and was limited to accredited investors.¹¹⁰ Yet ACE-Net died a slow death.¹¹¹ The postmortem was summed up nicely by securities lawyer Mark Hiraide, who noted that "[W]ithout an active connection between entrepreneurs and the investment community, deals did not get

107. See *supra* notes 59–65 and accompanying text.

108. Angel Capital Electronic Network, SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,305, at ¶ 77,516 (Oct. 25, 1996).

109. Dennis Berman, *ACE-Net: A Tough Way To Find an Angel*, BUS. WK. (Aug. 13, 1998), <http://www.businessweek.com/smallbiz/news/date/9808/e980813a.htm>.

110. Zoltan J. Acs & Fred A. Tarpley Jr., *The Angel Capital Electronic Network (ACE-Net)*, 22 J. BANKING & FIN. 793, 795 (1998) ("ACE-Net is a partnership between the Office of Advocacy, the US Small Business Administration, and US Department of Defense, in collaboration with the [SEC and state securities administrations.]; Fisch, *supra* note 10, at 64 ("ACE-Net, the Small Business Administration's Internet-based matching service, was developed . . . to facilitate the matching of angel investors with small businesses seeking capital.").

111. David Worrell, *Guardian Angels*, ENTREPRENEUR (Feb. 28, 2005), <http://www.entrepreneur.com/article/76266> ("After the SBA gave up its central role in the organization in 2000, the ACE-Net website seemed to be more or less abandoned and neglected."); see *id.* (noting that a second attempt was made when ACE-Net was revamped as "Active Capital" with a new web address). When I checked on November 2, 2015, that website no longer existed.

done.”¹¹² This would seem to confirm the necessity of close networks for entrepreneurial finance’s success. ACE-Net will be discussed again in more depth later.¹¹³

C. THE SOLUTION: WHY TITLE II SITES ARE SUCCEEDING

Despite the seeming divergence between traditional angel/VC models of risk reduction and Title II, I revealed that Title II sites appear to be succeeding. What explains this success? My argument is that on closer examination, Title II sites are still acting under the traditional angel model in important respects, even if there are differences.¹¹⁴ Title II sites could fairly be described as traditional angel networks that have migrated online for two reasons: 1) to reduce the transaction costs of operations; and 2) to add new, passive angels at a low cost.

1. Title II Sites Are Really the Same As Traditional Entrepreneurial Finance

Title II sites are replicating angel risk-reduction mechanisms in an online setting. First, consider the angel’s traditional means of reducing uncertainty and information asymmetry pre-investment. Angels rely on networks of trusted associates and their own expertise to find high-quality deal flow. How is this replicated online? To answer, we must first understand the difference between “active” and “passive” angels. Angels have always invested in small groups, or syndicates, that include a mix of active angels and passive angels.¹¹⁵ Active angels are the lead investors—they likely have expertise in the technology at hand, conduct the due diligence, and negotiate the terms of the investment. Passive angels, on the other hand, are along for the ride, contributing their cash but piggybacking on the active angel’s expertise and reputations.¹¹⁶

112. *Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Sec., Ins., and Inv. of the Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. 12 (2011) (statement of Mark T. Hiraide, Partner, Petillon, Hiraide & Loomis, LLP).

113. See *infra* notes 214–16 and accompanying text.

114. It makes sense that the angel model would translate better to Title II. As Paul Graham, founder of Y Combinator, notes, “Venture capitalists are fast followers . . . [who] don’t try to predict what will win. They just try to notice quickly when something is already winning. But angels have to be able to predict.” STROSS, *supra* note 86, at 86–87.

115. Ibrahim, *supra* note 66, at 1424 (“Angels have long syndicated their investments with angel investment teams comprised of anywhere from six to twelve ‘active’ and ‘passive’ angels.”).

116. See Fisch, *supra* note 10, at 62 (“Angels range from financially sophis-

Applying this to Title II sites, what we find is that our hypothetical Virginia investor is likely a passive angel who is contributing cash but nothing else. *Ex ante*, an active angel (or equivalent) is doing the screening and selecting of the startup. Consider FundersClub as an example. FundersClub has an “Investment Committee” that prescreens startups that wish to list on the site.¹¹⁷ In fact, that Investment Committee accepts less than two percent of startups that seek to list on FundersClub’s site.¹¹⁸ In addition to its own expertise, FundersClub’s Investment Committee is relying on its own network of trust. So far, it has only listed startups that have graduated from a top accelerator.¹¹⁹ This process of obtaining high-quality deal flow from a trusted source, coupled with the investor’s own expertise, is highly reminiscent of pre-Internet angel practice.¹²⁰

AngelList filters its investments differently. Rather than prescreen startups that can list on the site, AngelList has a

ticated investors who take an active monitoring approach to relatively unsophisticated and passive investors.”).

117. Matthew Zeitlin, *FundersClub Takes Crowdsourcing Approach to Early-Stage Venture Capital*, DAILY BEAST (Mar. 3, 2013, 5:45 AM), <http://www.thedailybeast.com/articles/2013/03/03/fundersclub-takes-crowdsourcing-approach-to-early-stage-venture-capital.html> (“[A]n investing committee for the company screens startups that could be hosted on the platform. FundersClub then hosts a few at a time . . .”).

118. Baverman, *supra* note 88 (“FundersClub acts like a traditional venture capital fund in some ways, screening thousands of start-ups and funding 1.8% of applicants.”). CircleUp accepts less than two percent of companies hoping to be listed on its website. Ryan Caldbeck, *Why We Are Picky: The Importance of Curation in Crowdfunding*, FORBES (Nov. 20, 2012), <http://www.forbes.com/sites/ryancaldbeck/2012/11/20/why-we-are-picky-the-importance-of-curation-in-crowdfunding>; cf. William Alden, *Crowdfunding Site CircleUp Raises \$14 Million*, N.Y. TIMES (Mar. 26, 2014, 7:31 AM), <http://dealbook.nytimes.com/2014/03/26/crowdfunding-site-circleup-raises-14-million> (“CircleUp offers investors equity in small consumer and retail companies, which are vetted to weed out potential duds.”).

119. Zeitlin, *supra* note 117 (“FundersClub so far has hosted only companies that have come out of the startup accelerators 500 Startups and Y Combinator (FundersClub itself is a Y Combinator alumnus).”).

120. See Caldbeck, *supra* note 118; *How FundersClub Selects Companies*, FUNDERSCLUB.COM, <https://fundersclub.com/vetting> (last visited Nov. 2, 2015) (describing a process that closely resembles a traditional VC or angel screening process). MicroVentures follows a similar process, and claims they review potential listings with the “same level of rigor as traditional Venture Capital companies.” *Investors*, MICROVENTURES.COM, <https://microventures.com/investors> (last visited Nov. 2, 2015). EarlyShares also conducts due diligence to decide whether a startup should be listed on its site. *Frequently Asked Questions*, EARLYSHARES.COM, <http://www.earlyshares.com/learn-more/how-it-works/frequently-asked-questions> (last visited Nov. 2, 2015).

more open listing policy. However, investors still receive signals of startup quality through the concept of “social proof.”¹²¹ Social proof works by showing new investors which startups other investors, including prominent investors, are funding. As one former AngelList investor writes, “Nearly every email [AngelList] send[s] includes names of people or firms who’ve committed to invest.”¹²² Top angels, by followers, on AngelList are household names: Reid Hoffman (founder of LinkedIn), Marissa Mayer (CEO of Yahoo), and the actor Ashton Kutcher.¹²³ In mid-May 2013, Hoffman “was the most tracked investor on AngelList with 21,558 followers.”¹²⁴ AngelList makes it possible for new passive angels to piggyback on Hoffman’s (and others’) expertise when selecting which startups to fund.¹²⁵ Indeed, AngelList has a function called “syndicate,” which operates in exactly the same way as a traditional angel syndicate, except online.¹²⁶ New investors are passive and turn over decision-making to an active angel.

The preceding examples show that, on the *ex ante* side, traditional screening mechanisms of expert angels and means of obtaining high-quality deal flow are alive and well on the Internet under Title II. What about *ex post* investment, where routine participation in a venture’s development reduces the angel’s agency costs? This does not seem possible given the geographic dispersion of investors over the Internet.

On closer examination, however, the most successful Title II sites seek to screen not only startups, but also *investors*, making sure to attract those investors who can contribute value-added services. FundersClub is an invitation-only site on the investor side too.¹²⁷ FundersClub is wary of the “potential for equity crowdfunders to only provide . . . ‘dumb money’” with-

121. *Why I Deleted My AngelList Account*, BRYCE DOT VC, <http://bryce.vc/post/3520840379/why-i-deleted-my-angellist-account> (last visited Nov. 2, 2015) (discussing AngelList’s use of “social proof”).

122. *Id.*

123. Davidson, *supra* note 85.

124. *Id.*

125. WeFunder uses something similar called the “haystack.” The haystack is “a tool that allows [investors] to quickly flip through new companies and rate them.” *Common Questions*, WEFUNDER.COM, https://wefunder.com/faq/common_questions (last visited Nov. 2, 2015). Once a startup’s profile earns a positive rating, it is promoted out of the haystack and onto WeFunder’s “Top Startups” page. *Id.*

126. Stone, *supra* note 81 (“[S]yndicates lets users pool their money alongside a single well-connected angel.”).

127. Constine, *supra* note 87.

out value-added services.¹²⁸ Similarly, AngelList “only allows accredited investors who can help a startup in tangible ways, not just those who provide capital.”¹²⁹ Despite these statements, it is difficult to believe that, with the expanded reach of Title II, there are not plenty of investors on Title II sites who do not contribute value-added services. That should not be a problem so long as there are active angels who *do* provide these services, with new investors in a passive role. The leading investors on AngelList and FundersClub are likely closely monitoring their startups post-investment.¹³⁰ Further, the ease of adding passive angels who do not contribute value-added services is one of the benefits of Title II, as explained below.

2. Title II Sites Reduce Transaction Costs and Add Passive Angels at Low Cost

If Title II sites are the functional equivalent of traditional entrepreneurial finance, why not just stick with traditional entrepreneurial finance? Why would angels or VCs use the Internet? My answer is twofold: (1) the Internet reduces the transaction costs of angel/VC operations; and (2) the Internet is a cheap way to add new, passive angels to existing networks.

First, I argue that the Internet is beneficial to angels and VCs because it reduces the transaction costs of their operations. That the Internet can reduce the transaction costs of group organization is nothing new.¹³¹ “Cyberlaw theorists have pointed to network effects and lower transaction costs as contributing factors for increased online production.”¹³² Another

128. *Id.* Indeed, as FundersClub’s co-founder notes: “We’re not trying to democratize access to start-up investing . . . We’re trying to democratize access to investing in the highest-promise start-ups.” Baverman, *supra* note 88.

129. Tomio Geron, *The Most Influential Angel Investors on AngelList*, FORBES (May 1, 2012, 3:50 PM), <http://www.forbes.com/sites/tomiogeron/2012/05/01/the-most-influential-angel-investors-on-angellist>.

130. Unfortunately I have no evidence at this early stage in the life of Title II of the extent to which investors are interacting with entrepreneurs post-investment.

131. See Nathaniel J. Gleicher, *Moneybombs and Democratic Participation: Regulating Fundraising by Online Intermediaries*, 70 MD. L. REV. 750, 766 (2011) (“Online organizations radically reduce [transaction] costs by using e-mail instead of traditional mail and by relying on the Internet to connect with and organize their members.”). See generally CLAY SHIRKY, *HERE COMES EVERYBODY: THE POWER OF ORGANIZING WITHOUT ORGANIZATIONS* (2008) (discussing the ways in which groups have effectively used the Internet to organize).

132. Salil K. Mehra, *Paradise Is a Walled Garden? Trust, Antitrust, and User Dynamism*, 18 GEO. MASON L. REV. 889, 900 (2011) (citing YOCHAI

commentator observed that “the Internet is a perfect medium for eliminating the middleman and transaction costs stemming from organizational structure.”¹³³ For example, Title II sites are attempting to make the process of investing more like one-click shopping on Amazon.¹³⁴ Angel investors easily sharing best practices online is another example of the Internet reducing transaction costs.¹³⁵

Second, angels and VCs are using Title II to attract more sources of funding at a low cost. More investors tagging along to Reid Hoffman’s investments simply allows Hoffman to fund more, and larger, startups. His transaction costs of finding this new money are extremely low. As one commentator put it: “AngelList has done for deal flow what Facebook did for keeping up with your friends. The site has transformed deal flow from an activity requiring active intention into one where you can sit back and let the cash come to you.”¹³⁶ Further, the money comes with no strings, as the anonymity and geographic spread of the Internet allows Hoffman to advise and monitor the startup without co-investor interference.

Here we return again to ACE-Net (and not for the last time). One important reason that ACE-Net failed was that it did not replicate offline angel operations. There was no screening of startups prior to listing on ACE-Net or “social proof” type concepts after listing. ACE-Net was a completely hands-off intermediary.¹³⁷ We shall see that other than its accredited-

BENKLER, *THE WEALTH OF NETWORKS: HOW SOCIAL PRODUCTION TRANSFORMS MARKETS AND FREEDOM* 3–5 (2006)).

133. Jyh-An Lee, *Organizing the Unorganized: The Role of Nonprofit Organizations in the Commons Communities*, 50 *JURIMETRICS* 275, 324 (2010).

134. *What is AngelList?*, *THE SECRET OF RAISING MONEY* (Feb. 17, 2014), <http://blog.theseecretofraisingmoney.com/whatisangellist> (AngelList uses Invest Online, where “funding is now just a couple clicks away” and which is “akin [to] shopping on Amazon”); cf. Colleen Taylor, *Backed with \$1.5M, CircleUp Aims To Be the AngelList for Consumer and Retail Startups*, *TECHCRUNCH* (Apr. 18, 2012), <http://techcrunch.com/2012/04/18/circleup> (“CircleUp also serves as a broker-dealer to allow the funding transactions to take place via the site.”).

135. *Best Practices for Angel Investors and Entrepreneurs*, *ANGELBLOG*, <http://www.angelblog.net> (last visited Nov. 2, 2015) (“Angel investing will get to the same state of development [as VCs] even faster because we can now exchange and develop ideas on the internet.”).

136. Evan Burfield, *The Changing Nature of Angel Investing*, 1776 (May 16, 2014), <http://www.1776.vc/insights/the-changing-nature-of-angel-investing>.

137. Acs & Tarpley, *supra* note 110, at 796 (describing the myriad of restrictions on ACE-Net’s involvement with companies and transactions imposed by the SEC No-Action letter that based ACE-Net possible before JOBS Act Title II).

investor-only limitation, ACE-Net more closely resembles a Title III site than a Title II site. Why it was not successful as a Title III-type site is an important part of the next Part's discussion.

IV. TITLE III AND EQUITY CROWDFUNDING: A LEMONS PROBLEM?

The previous Part argued that Title II sites are not equity crowdfunding at all, but traditional networks of angels and VCs operating online to reduce transaction costs and add passive investors at a low cost. As such, they are virtually the same markets as have traditionally existed, and therefore history shows they are not lemons markets.

Title III, on the other hand, is a paradigm shift. This is not simply moving a current network online, but creating a new one altogether. This is because: (1) Title III is more than moving existing networks online; unaccredited investors are not part of existing angel/VC networks, and thus their inclusion would form new networks of players unknown to each other; (2) given the sheer number of unaccredited versus accredited investors, this would more closely resemble a non-expert based "wisdom of the crowds" situation than piggybacking on expert investors;¹³⁸ and (3) given the foregoing, the identity and quality of the entrepreneurs, investors, and matchmaking sites under Title III might be different.

A. TITLE III AS A VIABLE MARKET?

From the outset, it must be emphasized that what follows are my predictions for Title III, which are, at this point, an educated guess since it has not yet been implemented. Twelve states have evidently tired of waiting for the SEC to act on Title III and have implemented their own intrastate Title III-like exemptions.¹³⁹ However, my preliminary review of those ex-

138. Crowdfunding also by its nature implies a significant number of investors each contributing small sums of capital. See Joan MacLeod Heminway & Sheldon Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 881 (2011) ("[T]he idea of crowdfunding is to obtain [funds] from a large audience (the 'crowd'), where each individual will provide a very small amount.").

139. These states are: Alabama, Colorado, Georgia, Idaho, Indiana, Kansas, Maine, Maryland, Michigan, Tennessee, Washington, and Wisconsin. N. AM. SEC. ADMINISTRATORS ASS'N, (Aug. 1, 2015), http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2014/12/NASAA-Crowdfunding-Index_8-1-2015a1.pdf.

emptions finds that they have not been used much, and, therefore, are unlikely to inform us about how the federal exemption will play.¹⁴⁰

There are two important and interrelated questions that must be answered to determine Title III's viability. First, what subset of entrepreneurs will Title III attract? Is it only the lemons—the low-quality entrepreneurs who cannot receive funding through traditional sources or Title II? Or can Title III also attract high-quality startups? Second, and relatedly, will information asymmetry problems be so great under Title III that on the investor side, dumb money floods the market and skews valuations? Should this happen, high-quality startups will be indistinguishable from poor ones, resulting in high-quality startups exiting Title III, leaving only the lemons behind.

1. What Subset of Startups Would Choose Title III?

Will high-quality startups elect to use Title III to raise funds once it is implemented? Potential problems jump off the page. Selling to unaccredited investors involves considerably more risk than selling to accredited investors, even under relaxed rules. Unsophisticated investors are unlikely to appreciate the significant risk of losing their entire investment in a startup that fails (as most startups do). Compare this with angels and VCs, who understand that most startups fail and therefore diversify for protection.¹⁴¹ How is an unaccredited investor supposed to adequately diversify with a relatively small cap on annual Title III investing?

Piling on, unaccredited investors are more likely to sue if things go bad.¹⁴² Receiving small sums from a multitude of in-

140. For example, Georgia has the “Invest Georgia Exemption” program, which was adopted in November 2011. GA. COMP. R. & REGS. 590-4-2.08 (2014). This exemption allows businesses to raise up to \$1 million and non-accredited investors can invest up to \$10,000. *Id.* Nevertheless, only six companies had taken advantage of the exemption as of mid-2013. Patrick Clark, *Kansas and Georgia Beat the SEC on Crowdfunding Rules. Now Others Are Trying*, BLOOMBERG BUS. (June 20, 2013), <http://www.bloomberg.com/bw/articles/2013-06-20/kansas-and-georgia-beat-the-sec-on-crowdfunding-rules-dot-now-others-are-trying>.

141. See Ibrahim, *supra* note 66, at 1424 n.91 (citing a prior study supporting the proposition that angels diversify by investing in multiple startups); D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 142 (1998) (“[T]he venture capitalist has a diversified portfolio of opportunities . . .” (quoting Christopher B. Barry, *New Directions in Research on Venture Capital Finance*, 23 FIN. MGMT. 3, 7–8 (1994))).

142. Absent fraud, the potential for suits in the crowdfunding context is uncertain at best, however. Consider fiduciary duty suits, a classic means of

vestors complicates a young startup's capital structure, which can create administrative problems¹⁴³ and scare away follow-on financing from angels and VCs.¹⁴⁴ Given that Title II platforms are proving successful and attracting well-known angels and VCs, who can offer cash and value-added services, wouldn't a rational entrepreneur seek out those investors over the general public, who can provide only money?¹⁴⁵

These problems are real, but despite them, there are two types of high-quality startups that might elect to use Title III to raise funds. First, Title III should appeal to high-quality startups that are too young for "professional" financing under Title II or traditional methods. In short, these startups are too early stage for even a \$100,000 angel investment to be on the table. Instead, they might seek only \$20,000 to develop a prototype, hire a lawyer to incorporate, or obtain a patent.¹⁴⁶ Instead of bootstrapping with credit cards or hitting up the entrepreneur's parents, these startups might look to Title III.

Second, even for high-quality startups that have progressed a bit further, Title III would appeal to that subset of startups that need cash but do *not* need value-added services from investors. I have previously argued that some cash-efficient startups—which are good prospects for Title III sites

trying to reduce agency costs for shareholders. First, a shareholder or plaintiff's lawyer (depending on whether a suit is direct or derivative) would need to be sufficiently incentivized to bring suit. This is unlikely for crowdfunded startups where small individual and even aggregate investments are at stake. Second, even if suit was brought, most startups fail due to the technology not working as expected, another competitor being first to market, inability to obtain funding needed for development, or other reasons that would implicate a director's duty of care. As Steven Bradford correctly observes, "Even in the absence of fraud or self-dealing, many crowdfunded small businesses will fail." Bradford, *supra* note 10, at 108; *see also* STROSS, *supra* note 86, at 14 (quoting Paul Graham as stating, "If you start a startup, you'll probably fail. Most startups fail. It's the nature of the business"). Duty of care claims are well known to be losers in most instances.

143. See John S. Wroldsen, *The Crowdfund Act's Strange Bedfellows: Democracy and Start-Up Company Investing*, 62 KAN. L. REV. 357, 368 (2013) ("[T]he rule of thumb [that startups have fewer investors] often makes good business sense for start-up companies because, among other reasons, managing relationships with fewer investors involves lower transaction costs.").

144. Ibrahim, *supra* note 66, at 1428–31 (arguing that angels do not over-complicate their investments so the startups are more attractive for VCs down the road).

145. See Palmiter, *supra* note 12, at 389 ("[C]rowdfunding under the JOBS Act could fizzle or bomb.").

146. It might seem that more funding is always better, but this is not the case. The earlier stage a startup is in, the lower its valuation and thus the more equity it must give away for a given amount of funding.

given its annual \$1 million cap on fundraising¹⁴⁷—should avoid VCs and stick to angel investors.¹⁴⁸ This is because the VC's value-added services are not necessary, and therefore VC cash is not worth the complications that come with it.¹⁴⁹

Title III startups would take the argument one step further and forego (or delay) angel value-added services as well. A strong entrepreneurial team might be able to guide a cash-efficient startup from launch to a quick sale without much professional help. For cash-efficient startups, equity crowdfunding under Title III offers a low-cost and readily available source of capital while keeping decision-making fully in the hands of the entrepreneur. Compare that with Title II, where the active investors are still presumably hands-on, as in traditional entrepreneurial finance.¹⁵⁰ In short, the inherent passivity of Title III investors—a seeming negative—would actually appeal to entrepreneurs who wish to *unbundle* the cash and value-added service components of traditional entrepreneurial finance.¹⁵¹ In obtaining only cash from investors, these startups could also obtain a better price for their shares, as there would be no inherent premium in the share price for value-added services.¹⁵²

If Title III sites attract high-quality startups under the circumstances envisioned above, it follows that high-quality investors will visit Title III sites to find them. If Title III investors are predominantly the general public, then sophisticated angels and VCs would enjoy an informational advantage over these investors. They could exploit that informational advantage in a kind of arbitrage, hopping into Title III and picking off good startups on the cheap.¹⁵³ In short, Title III's inefficiencies could

147. 15 U.S.C. § 77d(a)(6)(A) (2012).

148. See generally Ibrahim, *supra* note 99.

149. *Id.* at 259–65.

150. See *supra* notes 113–28 and accompanying text.

151. Although it is generally assumed that entrepreneurs benefit from VC and angel value-added services, this is not a uniformly held view. See Smith, *supra* note 141, at 134–35 (examining the risks entrepreneurs face when they seek value-added services from VCs); cf. Bradford, *supra* note 10, at 104 (noting that crowdfunded startups will not receive angels' and VCs' value-added services, but arguing that “crowdfunding is not a substitute for venture capital or angel investing; it is aimed at entrepreneurs who do not have access to such funding”).

152. Fisch, *supra* note 10, at 84 (“Although it is difficult to quantify the value of management, monitoring and consulting services, the small business' cost of capital should include a component of payment for these services in addition to the cost of capital funds.”).

153. Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 789 (1985) (“If

be exploited by those in the know, which would make it worthwhile for them to invest there.¹⁵⁴

2. Avoiding the Lemons Problem: Title III and Information Asymmetry

If a segment of high-quality entrepreneurs and investors would be inclined to use Title III, the related question is whether information asymmetry problems will be so great that dumb money floods the market and skews valuations in such a way that the good startups cannot distinguish themselves from bad ones.

This is a classic “market for lemons” problem. As Zohor Golshen and Gideon Parchomovsky succinctly describe it:

A “lemons market” is a market in which asymmetric information exists between sellers and buyers. Since the buyers are not fully informed as to the quality of the products, they discount the price of all products. High quality products will not sell for a price that reflects their quality and will, thus, exit the market. Only “lemons” are left in the market.¹⁵⁵

While it is all an educated guess at this point, Title III is unlikely to replace traditional entrepreneurial finance or Title II. Startups have historically preferred to use Rule 506 to raise funds from accredited investors only, and there is unlikely to be

she assumes that the market is inefficient, she would expect to earn extra profits (though she may fail to do so), and thus would acquire the information. If she believed that the market was efficient, however, she would recognize that she could not profit from acquiring the information, and therefore would lack any incentive to acquire costly information.”); see also Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 618 (1988) (explaining the weak connection between the stock market and the allocation of real resources).

154. It could be argued that this pattern would lead to an unsustainable result. As Ronald J. Gilson and Reinier H. Kraakman write:

Traders would initially acquire information because, in an inefficient market, they could earn returns on their investment in acquisition. As more traders became initially informed, however, the price system would convey more information to uninformed traders, thereby lowering the returns to informed traders. At the point at which the market became fully efficient, there would be no return to informed traders for having acquired the information, and, as a result, information acquisition would cease. The market would sink into informational inefficiency once more, only to repeat the cycle as soon as some traders again found information acquisition profitable.

Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 577–78 (1985). I am, however, skeptical that Title III markets would come to this.

155. Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 762 n.192 (2006).

a sea change toward seeking out unaccredited investors.¹⁵⁶ Further, most startups probably still need both an investor's cash and value-added services. Still, Title III will have an important role to play for very early-stage or niche startups.

a. The Importance of Unaccredited Investors Under Title III

Dumb money is a danger to Title III's viability. In traditional entrepreneurial finance and under Title II, smart money sets a startup valuation. Under Title III, however, if most money is dumb money that is randomly distributed (i.e., not funneled to the best startups), then valuations will be skewed. Exacerbating this concern is that high-quality investors cannot move pricing by investing significant sums, as in public markets, since all investors are capped in annual investment amounts.¹⁵⁷ Even without these investment caps, I have argued that part of the Internet's attraction for accredited investors is the ability to add tag-along passive investors at a low cost. In other words, accredited investors *want* unaccredited investors to follow them into startups.

Therefore, if unaccredited investors will mostly populate Title III, and if their money needs to be funneled to good startups, it follows that Title III's viability depends on solving the information asymmetry problem for unaccredited investors. Consequently, the remainder of my discussion focuses on ways of reducing information asymmetry for unaccredited investors under Title III.

b. Reducing Information Asymmetry for Unaccredited Investors

I have already discussed the massive information asymmetry that exists in startup investing generally and how angels and VCs manage the problem.¹⁵⁸ To recap, VCs reduce the entrepreneur's informational advantage through staged financing and other signals of startup quality,¹⁵⁹ while angels learn of

156. See *supra* notes 66–78 and accompanying text.

157. It is true that accredited investors can invest more than unaccredited investors under these caps, but it is doubtful it will be enough to overcome the likely greater supply of unaccredited investor money from more unaccredited participants.

158. See *supra* notes 55–78 and accompanying text.

159. These include following high-quality angels and other VCs into deals and using preferred stock versus the entrepreneur's common stock. Jeffrey Trester, *Venture Capital Contracting Under Asymmetric Information* 5–6 (Wharton Fin. Insts. Ctr. Working Paper No. 94-06, Oct. 1993), <http://fic>

promising entrepreneurs from networks of trust and bring their own expertise to bear on familiar technologies.¹⁶⁰ Title II imports the traditional angel screening mechanisms to the Internet.¹⁶¹ Therefore, in traditional entrepreneurial finance and under Title II, high-quality entrepreneurs can distinguish themselves from low-quality entrepreneurs, and thus we do not have a market for lemons.

The question is whether the same can be predicted for Title III. With the paradigm shift that is Title III, networks of trust do not exist. Instead, the majority of players will likely be unknown to each other. Therefore, we must look for other ways to reduce information asymmetry for investors and avoid the lemons problem.¹⁶² Three possible ways are (i) disclosure; (ii) the wisdom of crowds; and (iii) the use of reputational intermediaries. These three alternatives are now discussed in turn.

i. Disclosure

Securities regulation's mandatory-disclosure regime is a classic way of evening the informational playing field between issuers and investors. As the Supreme Court stated in the famous case of *Ralston Purina*, the Securities Act of 1933 was intended "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."¹⁶³

Title III weakens the disclosure required in sales to unaccredited investors. Under Title III, issuers must disclose items such as the nature of the startup, the names of the directors and a description of the issuer's ownership and capital structure, a description of the current business, the anticipated business plan, a description of the stated purpose and intended use of the proceeds of the offering sought by the issuer, the target amount of funding sought from the offering, and the issuer's financial condition, which may include income tax filings and

.wharton.upenn.edu/fic/papers/94/9406.pdf.

160. See *supra* notes 65–78 and accompanying text.

161. See *supra* notes 79–145 and accompanying text.

162. *Reducing Barriers to Capital Formation: Hearing Before the Subcomm. on Capital Mkts. and Gov. Sponsored Enterprises of the H. Comm. on Fin. Servs.*, 113th Cong. 11–12 (2013) (statement of Donald C. Langevoort, Thomas Aquinas Reynolds Professor of Law, Georgetown University Law Center) (urging the committee to consider ways to help investors tell the difference between good and bad actors based on the premise that any innovations made by the JOBS Act in capital-raising would not work without these safeguards).

163. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953).

audited financial statements.¹⁶⁴ These are more lenient requirements than what was previously required under Rule 506, for example, which required unaccredited investors to receive significant financial and non-financial information. Depending on certain factors, this disclosure could be the “same kind of information as [would be] required in Part I of a registration statement.”¹⁶⁵

At least one prominent scholar, Thomas Hazen, has called for greater disclosure under Title III.¹⁶⁶ Can mandatory disclosure—either of to the extent required by Title III or enhanced, as Hazen calls for—solve the lemons problem? It is unlikely for several reasons, including: (1) financial and other illiteracy among unaccredited investors; (2) the inapplicability of the efficient capital markets hypothesis (ECMH) to crowdfunding; and (3) previous relevant experience in a European market, Germany’s Neuer Markt.

First, mandatory disclosure is an imperfect fit for the type of investors that crowdfunding targets. Omri Ben-Shahar and Carl Schneider have taken a systematic look at why mandatory disclosure generally fails.¹⁶⁷ They argue, on a foundational level, that familiarizing ourselves with disclosure is unpleasant. They write that, at its core, mandatory disclosure is “an enormous educational enterprise of a kind academics may enjoy but that most people do not.”¹⁶⁸ Further, unsophisticated people “often can’t read” the disclosures, if reading means to “extract useful meaning from them.”¹⁶⁹ The authors illuminate three broad categories of reading comprehension problems: “illiteracy, innumeracy, and sector illiteracy.”¹⁷⁰ The latter two, and potentially all three, would seem to apply in the crowdfunding context with nascent startups of a technical nature.¹⁷¹ This is

164. 15 U.S.C. § 77d-1(b) (2012).

165. 17 C.F.R. 230.502(b)(2)(A) (2014).

166. See Hazen, *supra* note 13, at 1767 (arguing that disclosures “could be less burdensome than those currently required under Regulation A, but they should still be sufficiently detailed to provide investors with sufficient information to enable them to make an informed investment decision”).

167. OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE (2014).

168. *Id.* at 56.

169. *Id.* at 79.

170. *Id.* at 91.

171. Bradford, *supra* note 10, at 109–10 (giving statistics and noting that “[m]any American are not financially literate”); *id.* at 112 (“Since crowdfunding sites are usually open to the general public, at least some of the people investing in crowdfunding offerings will not have the basic financial knowledge

assuming potential investors even attempt to read the disclosures, which is questionable at best.¹⁷²

Second, while these problems also exist in public markets, public markets rely at least in part on the ECMH to remedy them. Under the ECMH, succinctly put, sophisticated investors move market prices by absorbing disclosures and trading in significant volumes on that information.¹⁷³ Unsophisticated investors then rely on the adjusted stock price as a good proxy for new information about the company.¹⁷⁴ While there are certainly well-known criticisms and shortcomings of the ECMH, it is still at least a crude mechanism that makes disclosure work for unsophisticated investors in the public markets context. Title III crowdfunding sites would not be efficient markets, so the ECMH cannot benefit its unsophisticated participants. As mentioned, accredited investor annual caps under Title III exacerbate the problem by not allowing smart money to adequately “price up” good startups (or “price down” bad ones).

Third, previous experience with a significant disclosure regime for growth companies is instructive. Because the rest of the world does not have the sophisticated network of private angels and VCs found in the U.S., efforts have been made to es-

required to understand the risks.”); Fisch, *supra* note 10, at 78 (“Small businesses generally have difficulty raising capital because of informational asymmetries and the inability of investors to judge the quality of the offering. These deficiencies are not remedied by the type of information that can be posted on a Web site.”).

172. Susanna Kim Ripken, *Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward-Looking Statements*, 2005 U. ILL. L. REV. 929, 932 (noting that the SEC originally “objected to the dissemination of forward-looking statements, fearing that unsophisticated investors would rely too heavily on this type of speculative information”).

173. See generally Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970) (introducing the theory of efficient capital markets).

174. A court describes this process:

In face-to-face transactions, the inquiry into an investor’s reliance upon information is into the subjective pricing of that information by that investor. With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.

Basic Inc. v. Levinson, 485 U.S. 224, 244 (1988) (quoting *In re LTV Securities Litigation*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)).

establish public markets for growth companies. One such effort at a junior stock exchange, the Neuer Markt in Germany, imposed significant regulatory restraints on companies that listed there, including strict disclosure rules.¹⁷⁵ As John Coffee observes, the Neuer Markt's "requirements were more rigorous than those specified either by its parent, the Deutsche Boerse, or, more surprisingly, by the SEC."¹⁷⁶ Despite these strictures, "the Neuer Markt became plagued by scandals and saw its market capitalization slide by 73% since the end of 1999,"¹⁷⁷ and was shut down in 2003.¹⁷⁸ By contrast, another junior stock exchange for growth companies—London's Alternative Investment Market (AIM)—employs a "light-touch" regulatory scheme (similar to Title III) and has been far more successful.¹⁷⁹

To be clear, I am not arguing that Title III startups should not be subject to mandatory disclosure. Indeed, disclosure is a must for entrepreneurs to inform potential investors about their startups and the investment under consideration. What I am arguing, however, is that there are good reasons to believe that mandatory disclosure alone will not solve the lemons problem because unaccredited investors will not adequately benefit from mandatory disclosure under Title III.¹⁸⁰ Therefore, we turn to a second option: the wisdom of crowds.

ii. The Wisdom of the Crowd

The second way that unaccredited investors may not suffer from information asymmetry is if assembling them over the Internet produces a collective wisdom that would not otherwise exist. The concept of the "crowd" under Title III is messy and

175. John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1804 (2002) ("Intended as a market for high growth firms, the Neuer Markt adopted a unique style by advertising itself as the 'most regulated market' in Europe.").

176. *Id.*

177. *Id.* at 1805.

178. Coffee claims that "the fate of Neuer Markt shows less the failure of heightened disclosure standards than the strength of the network externalities that link firms traded on the same high profile market. Once some firms on the Neuer Markt became mired in scandals, the Neuer Markt's reputation became tarnished." *Id.* However, my point is that heightened disclosure, without more, was not sufficient to avoid a market failure in the Neuer Markt.

179. See *infra* notes 215–24 and accompanying text.

180. I have not even discussed the behavioral biases that may plague unsophisticated investors, which would also cut against a predominantly disclosure-based solution to the potential lemons problem in crowdfunding.

ambiguous. For example, Joan Heminway actually defines this hypothetical “crowd” as an “ill-defined group of potential and actual investors in securities offered and sold through crowd-funding.”¹⁸¹

As Heminway notes: “Crowds can be ‘mad’—irrational, foolish, and even stupid. On the other hand, crowds can be ‘wise’—rational, sensible, and intelligent.”¹⁸² She goes on to suggest that “preliminarily indicat[ions are] that the crowd [under Title III] has the potential for wisdom.”¹⁸³ Using James Surowiecki’s framework, Heminway notes that Title III crowds are likely to be heterogeneous, independent, and operate in a decentralized manner.¹⁸⁴

In more general terms, the idea is that crowds may be better at spotting a diamond in the rough than experts. This is especially true where the crowds know something in particular about the product or technology. Consider a new video game that a certain group on the Internet is addicted to. This virtual crowd would better be able to predict this game’s broader success than an angel or VC who has never played the game (or its rivals). In these cases, the Title III crowds would fund the good game and not its rivals, thus resulting in correct pricing and no lemons market.

Much like AngelList’s concept of social proof, a knowledgeable segment of the crowd would benefit the unknowledgeable rest of the lot—these investors could tag along to the knowledgeable crowd’s decisions. In one study, early investors in crowdfunded projects were found to have a significant influence on later investors.¹⁸⁵ In particular, later investors (the “crowd”) were heavily influenced to invest when early investors were either app developers or experienced investors.¹⁸⁶ While the early

181. Joan MacLeod Heminway, *Investor and Market Protection in the Crowdfunding Era: Disclosing to and for the “Crowd,”* 38 VT. L. REV. 827, 829 (2014).

182. *Id.* at 830 (citations omitted).

183. *Id.* at 845. However, Heminway also correctly notes that “[s]ignificant empirical research is needed” to determine whether Title III crowds will be wise or not. *Id.*

184. *Id.* at 845–46; see also Edward L. Glaeser & Cass R. Sunstein, *Extremism and Social Learning*, 1 J. LEGAL ANALYSIS 263, 267–70 (2009) (explaining that a homogenous group will lead to extremism, not wisdom).

185. Keongtae Kim & Siva Viswanathan, *The Experts in the Crowd: The Role of Reputable Investors in a Crowdfunding Market* 3 (Nov. 2013) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2258243).

186. *Id.*

investors in this study sound like experts, it stands to reason that a knowledgeable segment of the crowd could serve the same signaling function for later investors.¹⁸⁷

iii. Reputational Intermediaries

Another potential solution to the lemons problem is the use of reputational intermediaries as a means of signaling startup quality. Signals are important in solving the lemons problem. In the classic used car example, dealers signal that their cars are not lemons by issuing a warranty.¹⁸⁸ In securities markets, reputational intermediaries such as accountants and investment banks offer signals of quality for the companies they represent, thereby reducing information asymmetries for potential investors.¹⁸⁹ As Bernard Black writes: “The principal role of reputational intermediaries is to vouch for disclosure quality and thereby reduce information asymmetry in securities markets.”¹⁹⁰ These repeat players’ reputations are tied to the companies they represent, and thus they have incentives to guard against the companies failing or committing fraud.¹⁹¹

Signaling is not that important for the accredited investors

187. *Id.* at 7 (citing studies finding that social networks of early investors can influence later investors in non-equity based crowdfunding projects).

188. Akerlof, *supra* note 17, at 499–500; Brian JM Quinn, *Putting Your Money Where Your Mouth Is: The Performance of Earnouts in Corporate Acquisitions*, 81 U. CIN. L. REV. 127, 138 (2012) (“In the context of Akerlof’s used cars, a seller might offer a warranty on the quality of the car as an example of a costly signal to demonstrate the seller’s confidence in its unobservable quality.”).

189. Langevoort, *supra* note 41, at 14 (“[I]nvestors are more likely to rely on the disclosures when a reputable intermediary is involved, and hence demand less of a risk premium.”); Jonathan R. Macey & Maureen O’Hara, *The Economics of Stock Exchange Listing Fees and Listing Requirements*, 11 J. FIN. INTERMEDIATION 297, 301 (2002).

190. Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 788 (2001); *see also* Goshen & Parchomovsky, *supra* note 155, at 763 n.196 (explaining that public company “issuers attempt to avoid the ‘lemons market’ by using underwriters, and underpricing the IPOs (sometimes heavily)”); Langevoort, *supra* note 41, at 14 (writing that much attention has been paid to the “function that financial intermediaries play in signaling and bonding the informational credibility of issuer disclosure”).

191. *See* Fisch, *supra* note 10, at 79 (“Investors may also view the absence of outside expert involvement in Internet offerings as a negative signal.”) This theory of reputational constraints on bad behavior is not without its real-world exceptions, including Arthur Anderson’s role in the fall of Enron. *See* JOHN C. COFFEE, GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 325–30 (2006) (discussing why reputational constraints failed to cause Arthur Andersen to more closely monitor Enron).

who know what they are looking for, or for knowledgeable segments of the crowd (think of the game-players described in the previous Section), but will be important for everyone else on Title III. Even Title II relies on reputational intermediary-signaling for its tag-along passive investors. Recall that heavy hitter angels and the “social proof” function signal startup quality under Title II, and FundersClub’s intensive screening process signals startup quality for those who make it onto the FundersClub site. Who can serve as reputational intermediary under Title III?

Again, a look overseas at a junior stock exchange for growth companies is instructive, but this time we examine the AIM. The AIM has been the most successful of all of the junior stock exchanges established worldwide.¹⁹² Unlike other “feeder” exchanges to larger stock exchanges, it is not uncommon for companies to even migrate “downward” from the London Stock Exchange (LSE) to the AIM.¹⁹³ While some of AIM’s success is attributable to its heavy institutional-investor makeup,¹⁹⁴ AIM has also been touted for its institutional structure for compa-

192. See Jose Miguel Mendoza, *Securities Regulation in Low-Tier Listing Venues: The Rise of the Alternative Investment Market*, 13 *FORDHAM J. CORP. & FIN. L.* 257, 284 (2008) (explaining that the LSE “draws praise from investors, firms, and policy-makers alike, due to AIM’s impressive results since 2000.” (footnote omitted)). The AIM has been subject to ebbs and flows, and not all are convinced of its success. Robert Prentice notes “AIM has been criticized for being less than diligent in policing fraud among its listing companies.” Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 *CARDOZO L. REV.* 703, 755 (2007) (footnote omitted). He also observes that there have been “an accelerating number of delistings on AIM and most of its stock are not liquid.” *Id.* at 755–56; see also Steven M. Davidoff, *Regulating Listings in a Global Market*, 86 *N.C. L. REV.* 89, 137 (2007) (AIM shares are not actively traded). Still, compared to other junior exchanges worldwide, most point to AIM as having the most success. See generally Mendoza, *supra*.

193. Michael Potter, Explaining the Continued Rise of London’s Alternative Investment Market (May 20, 2010) (unpublished manuscript) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1648835 (“[O]nly 111 companies have moved from the AIM to the LSE compared with 231 moving in the opposite direction.”); see also Mendoza, *supra* note 192, at 287 (“AIM is not merely a free-rider on London’s and the LSE’s reputation. Rather, AIM succeeds because it supplies a scarce product to the marketplace: rapid, low-cost access to public equity for small firms with high growth potential.” (footnote omitted)).

194. Mendoza, *supra* note 192, at 297 (“[W]ealthy individuals with experience in securities trading, institutional investors, and entities specializing in AIM investments comprise most of AIM’s investor base” (footnote omitted)). But see *id.* (“The LSE does attract more retail investors to AIM by offering certain advantages, including tax breaks for individuals that invest in its low-tier market segment.” (footnote omitted)).

nies, which consists of “light-touch” regulation coupled with heavy reliance on Nominated Advisors, or *Nomads*, for each listed company.¹⁹⁵

Each company who wants to list on AIM must convince one of the forty-three authorized Nomads to vouch for it.¹⁹⁶ “Most nomads are investment banks or corporate finance firms.”¹⁹⁷ The Nomad helps its companies establish and abide by good corporate governance procedures.¹⁹⁸ Nomads must sign off on all non-routine announcements its company makes to the market.¹⁹⁹ Nomads act as private regulators for their companies, even signing off on security sales without direct approval from the AIM or LSE.²⁰⁰ The LSE considers the Nomad-company relationship so important that if a company terminates its Nomad, trading in the company’s securities is suspended until it hires a new Nomad.²⁰¹ The LSE website contains a more complete description of the Nomad-company relationship, which reveals its depth and breadth.²⁰²

195. The AIM has a “comply or explain” policy. *Id.* at 295 (“The genius of AIM’s regulatory model lies with the comply-or-explain option provided to each listed company to adapt to the exchange’s flexible and reduced set of rules.” (footnote omitted)).

196. For a search tool companies can use to find Nomads, see *Nomad Search Engine*, LONDON STOCK EXCHANGE, <http://www.londonstockexchange.com/exchange/companies-and-advisors/aim/for-companies/nomad-search.html> (last visited Nov. 2, 2015).

197. Stéphane Rousseau, *London Calling?: The Experience of the Alternative Investment Market and the Competitiveness of Canadian Stock Exchanges*, 23 BANKING & FIN. L. REV. 51, 63 (2007); see also Mendoza, *supra* note 192, at 316 n.323 (noting that, among qualifications, “Nomad applicants must (i) have practiced corporate finance for a period of at least two years”).

198. See LONDON STOCK EXCH., A GUIDE TO AIM 10 (Nigel Page ed., 2010), http://www.lseg.com/sites/default/files/content/documents/LSEG_AIM_Guide.pdf (explaining that a Nomad will, “[a]mong other things . . . ensure the directors are appropriate and capable of acting as a board for a company . . . [and the Nomad will] act as the primary regulator”).

199. See LONDON STOCK EXCH., CORPORATE GOVERNANCE FOR MAIN MARKET AND AIM COMPANIES 94 (Nigel Page ed. 2012), <http://www.londonstockexchange.com/companies-and-advisors/aim/publications/documents/corpgov.pdf>.

200. See LONDON STOCK EXCH., *supra* note 198.

201. See *id.* at 3.

202. Nomad offers a description of its advising:

A Nomad is responsible for advising and guiding a company on its responsibilities in relation to its admission to AIM as well as its continuing obligations once on market. To help fulfil [sic] this role, the Nomad will:

*undertake extensive due diligence to ensure a company is suitable for AIM

If we envision startup problems that investors might be worried about as trifold—fraud, measurable qualities (e.g., good corporate governance practices), and viable business models—the Nomad appears to tackle the first two. However, given the identity of the Nomads as corporate finance experts, it is doubtful they do much to tackle the third problem of predicting a viable business model. Nomads are not the equivalents of angels or VCs in technical know-how or experience; instead, they are advisors appropriate to help young companies with no prior experience being listed on a securities exchange. As such, Nomads can be held liable to the LSE for “improper reporting by their supervised companies” and [are] subject to “investor lawsuits if investors are misled,”²⁰³ but it does not appear that Nomads are liable for a sponsored company’s business failure absent fraud.

Given the close relationship between a Nomad and its listed companies, the Nomad serves as a classic reputational intermediary. As described by one commentator, “[t]he Nomad’s role is central to AIM’s regulatory model, as these entities act as gatekeepers, advisers, and regulators of AIM-listed companies.”²⁰⁴ He goes on to observe that “*AIM can be considered a ‘reputational market,’ in which investors rely on the standing of Nomads as a proxy for the quality of listed companies.*”²⁰⁵ Another commentator contends that the “signal that investors derive from a company’s being qualified as suitable for AIM rests

*provide guidance throughout the flotation process

*prepare the company for being on a public market

*help prepare the AIM admission document

*confirm appropriateness of the company to the Exchange

*act as the primary regulator throughout a company’s time on AIM.

Choosing Your Advisor, LONDON STOCK EXCHANGE, <http://www.londonstockexchange.com/companies-and-advisors/aim/for-companies/choosing/advisor.htm> (last visited Nov. 2, 2015).

203. Mendoza, *supra* note 192, at 318; *see also* LONDON STOCK EXCH., *supra* note 199, at 96 (explaining that the LSE can impose penalties on Nomads ranging from a monetary fine to a formal censure to a suspension); Rousseau, *supra* note 197, at 98–99 (explaining the potential civil liability for Nomads); Siobhan Kennedy, *LSE Hits Nabarro Wells with £250,000 Fine over AIM Checks*, TIMES ONLINE (Oct. 19, 2007), <http://www.thetimes.co.uk/tto/business/industries/banking/article2155593.ece> (reporting that the London Stock Exchange fined Nomad Nabarro Wells £250,000 for failings of “due skill and care” expected of a Nomad).

204. Mendoza, *supra* note 192, at 295; *see also* Rousseau, *supra* note 197, at 62 (“The nomad is the hallmark of the AIM.”).

205. Mendoza, *supra* note 192 at 295–96 (emphasis added); *see also id.* at 316 (“Without doubt, the comprehensive role of the Nominated Adviser is the strongest pillar of AIM’s regulatory model.”).

indirectly on their assessment of the nomad's reputation,"²⁰⁶ and that "the reputation of a [N]omad is its most valuable asset."²⁰⁷

The most obvious equivalent to the Nomad under Title III is the title's creation of "funding portals."²⁰⁸ A funding portal is an "Internet site that lists crowdfunding opportunities and provides a matching service for interested investors."²⁰⁹ In short, it would be the Title III equivalent to FundersClub or CircleUp.

As a mandated FundersClub or CircleUp, the funding portal is the right idea for avoiding the lemons problem, but it is poorly executed under Title III. Funding portals are currently envisioned as passive entities, for the most part, and "limited to putting buyers and sellers together."²¹⁰ The funding portal's role is directed at investors, including to "ensure that investors review [startup] disclosures, answer various questions, and affirm they understand the risk of loss."²¹¹ Further, it is tasked with ensuring investors do not exceed their investment caps.²¹² My suspicion is that this is fitting with the traditional practice of the government delegating gatekeeping tasks to private parties.²¹³

Consequently, it is clear that the funding portal's primary relationship is not with the startup at all. *Contrast that with the very different situation on the AIM, where the Nomads primary relationship is with the company, not investors.* What is needed is a funding portal that is more like a Nomad, or a FundersClub—a third party that can engage with startups, screen out the bad apples, and therefore signal something about the

206. Rousseau, *supra* note 197, at 94.

207. *Id.* at 97.

208. 15 U.S.C. § 77e (2014). See generally Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals Under the CROWDFUND Act*, 13 U.C. DAVIS BUS. L. J. 177, 178 (2013) ("This paper focuses on a new, statutorily ordained and mandated intermediary in certain securities offerings made through the Internet.").

209. Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1439 (2012). The funding portal was a late entry into the JOBS Act, spurred on by fears of fraud. *Id.*

210. Schwartz, *supra* note 15, at 1462 n.25 (listing five restrictions on funding portal activity that reveal the ACE-Net like passive role of the new funding portals).

211. Hazen, *supra* note 13, at 1756 (footnote omitted).

212. *Id.*

213. See, e.g., Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1636 (2010) ("Under Section 11 of the Securities Act, gatekeepers face potential civil liability for material misstatements or omissions in the registration statements of their clients.").

quality of startups that make it on to the site.

What we currently have, however, is a funding portal that acts almost exactly as ACE-Net did over a decade ago. ACE-Net, too, was a passive entity limited to putting buyers and sellers together.²¹⁴ It could not handle financing transactions, screen startups, or anything else that required an active role.²¹⁵ This was in part to avoid being classified as an exchange or broker-dealer under the securities laws as they existed at the time.²¹⁶ Yet ACE-Net was a disaster. And the inability of ACE-Net to signal anything about the companies it listed is a large reason why it failed, if the AIM is any indication.

B. SUGGESTED CHANGES TO TITLE III: MAKE FUNDING PORTALS THE EQUIVALENT OF AIM'S NOMADS

While the wisdom of the crowds may help to solve the lemons problem under Title III, there are no legal changes that are needed to facilitate it. However, if we want intermediation as well, we must re-craft the concept of a “funding portal” under Title III.

London's success with the AIM, whose regulatory structure is driven by the company-Nomad relationship, is highly instructive for making Title III work on the reputational intermediary front. I contend that Title III should be amended to change funding portals to make them work like Nomads. The overarching change needed in Title III is to make the funding portal's primary relationship be with *startups*, not *investors*. The following discussion addresses certain legislative changes that are needed to accomplish that objective.

First, Title III should be amended to remove all provisions attempting to detach funding portals and the companies they list. For example, under Title III as currently written, a funding portal must basically act as a “neutral third party”²¹⁷—an ACE-Net-like restriction. Consequently, it is not even clear if a funding portal could host an online discussion *among investors*

214. See Langevoort, *supra* note 41, at 8 (observing that with ACE-Net there is “the disappearance of the securities professional (*i.e.*, broker-dealer or investment advisor) as an intermediary . . . [which cannot] offer any investment advice or guidance”).

215. See Angel Capital Electronic Network, SEC No-Action Letter, *supra* note 108 ¶ 77,516.

216. See *id.* Conversely, the JOBS Act specifically excludes funding portals as broker-dealer. See 15 U.S.C. § 78c(h)(1) (2012).

217. See Jacques F. Baritot, *Increasing Protection for Crowdfunding Investors Under the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 259, 277 (2013).

about the quality of its listed startups that could help investors choose their investments.²¹⁸ While companies pay Nomads to assess their suitability for the AIM and to serve as a Nomad after listing,²¹⁹ it is unclear what compensation funding portals could receive from startups.²²⁰ To follow AIM's example, startups should be allowed to pay funding portals for their services pre-and post-listing to help attract high quality portals.

Second—the flip side of the coin—Title III's attempts to make the primary relationship between funding portal and *investor* should be rethought. The AIM experience had nothing of the sort, so we have no indication that an intermediary-investor relationship would be beneficial. Further, Title III's current requirements impose significant costs on funding portals.²²¹ Funding portals' time would be better spent checking and vouching for startups, after which funding portal-approval could serve as a signal of startup quality. To entice high-quality entities to act as funding portals, we should keep costs low and directed to where they really matter. Importantly, I am not claiming that Title III's investor education and funding-limit checks are unimportant—I put that question aside without further research.²²² I am only arguing that the model we have to learn from—the AIM—suggests funding portals should be tied to startups, not investors.

Third, furthering the idea of making funding portals re-

218. *See id.* (noting that the neutrality rule could prevent message boards, forums, and the like where investors could rate and share their experiences with particular startups).

219. *See* Rousseau, *supra* note 197, at 96 (“Under the current model, issuers pay nomads to assess whether they are suitable for AIM. They are paid by companies subsequently to admission to act as their sherpa.”).

220. *See* Heminway, *supra* note 181, at 196–97 (critiquing the strict restrictions on funding portals meant to avoid potential conflicts of interest and observing that brokers are not subject to the same restrictions); *see also* Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 274 (2003) (“Someone has to pay for intermediary services, and eliminating conflicts may block an important source of financing.”).

221. *See* Heminway, *supra* note 208, at 197 (explaining Congress “may have crippled the small business financing tool it sought to create in the CROWDFUND Act by pricing funding portals out of the market”); *see also id.* at 191 (“The CROWDFUND Act adds significant, mandatory burdens (and, as a result, costs) to this organically grown model—so many burdens, that it may be difficult for would-be funding portals to develop a profitable business model.” (footnote omitted)).

222. *See, e.g.,* Palmiter, *supra* note 12, at 399–401 (discussing favorably Title III's investor education requirements and citing other scholars who agree).

sponsible for their startups, Title III currently only requires funding portals to do one type of due diligence on the companies that wish to list with them: background checks.²²³ Recall that AIM does not allow companies to even list without a Nomad vouching for them, and FundersClub and CircleUp screen all their potential listings. These screening procedures involve far more diligence than a background check. Currently, Title III investors would receive no signal about a startup's quality from the fact that it passed a mere background check before being listed on a funding portal site.

Further, post-listing, Nomads are subject to potential liability from the LSE and investors for their sponsored companies' fraud. The JOBS Act clarifies that state securities commissions have enforcement authority over funding portals,²²⁴ but under the AIM experience, that authority should lie with the SEC as a centralized body. Further, the extent of a funding portal's private liability under Title III should be clarified.²²⁵

Thinking back to the trifold of potential problems Nomads could be designed to tackle—fraud, poor governance procedures, and viable business plans—Nomads tackle the first two but not the third.²²⁶ Funding portals, on the other hand, should focus on a different two—fraud and viable business plans—which are more important than corporate governance practices when it comes to nascent startups. The funding portal's primary signaling value would be to reveal that listed startups passed an initial screening for viability as a business and are not sham companies.

223. 15 U.S.C. § 77d-1(a)(5) (2012) (requiring funding portals to “take . . . measures to reduce the risk of fraud . . . including obtaining a background or securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent [of an issuer's equity]”).

224. *Id.* § 77r(c)(1)(B).

225. *See, e.g.,* Heminway, *supra* note 208, at 198 (“The CROWDFUND Act does not expressly impose fiduciary duties on funding portals. However, the SEC has broad authority under the CROWDFUND Act and the securities laws in general to promulgate rules and regulations.” (footnote omitted)); *see also id.* at 204 (“The CROWDFUND Act amends the 1933 Act to create a new Section 12(a)(2)-like cause of action against issuers who sell securities under the crowdfunding exemption There is a possibility that funding portals may be considered issuers for these purposes.” (footnote omitted)); Gregory D. Deschler, Comment, *Wisdom of the Intermediary Crowd: What the Proposed Rules Mean for Ambitious Crowdfunding Intermediaries*, 58 ST. LOUIS U. L.J. 1145, 1155–62 (2014) (discussing potential funding portal liability).

226. *See* Mendoza, *supra* note 192, at 317 (“AIM created the Nomad figure to advise small firms that lacked the experience to properly function as listed companies.” (footnote omitted)).

However, there are important limits on what a funding portal can and should be expected to do. First, there are the economics of funding portal viability. In short, each funding portal will likely need to list multitudes of small startups to make money, and therefore screening cannot be as intensive or selective as a FundersClub or CircleUp. This is both because of the funding portal's manpower time and cost and because funding portals will need to list many startups to earn fees, etc. Second, *too* intensive a screening process would put startups' fate in funding-portal hands and negate the ability of well-informed segments of the population (e.g., gamers, app developers) to select the winners. Therefore, it is important to allow Title III to use funding portals as reputational intermediaries for unsophisticated investors yet also give crowd-based wisdom a chance to work.

While the specifics can be debated, it is clear that Title III does not make funding portals the equivalent of AIM's Nomads in the most important way—by being tied in fate and fortune to the companies they list. Title III should be amended to make funding portals true reputational intermediaries for the startups they list. Both theory and practice show us that reputational intermediaries can signal a company's quality and thus reduce information asymmetries to a necessary level to avoid a market for lemons.

CONCLUSION

The SEC has dual objectives of making it easier for companies to raise capital and protect investors. Often those two goals are at odds and must be balanced.²²⁷ Crowdfunding under the JOBS Act is such a situation,²²⁸ and President Obama and Congress clearly put their thumb on the scale of capital formation over investor protection. That is fine under Title II, where tried-and-true angel investor methods of reducing risk are being successfully imported to the Internet. But Title III,

227. See Hazen, *supra* note 13, at 1738 (“Policymakers continually face the challenge of effectively balancing the benefits of encouraging small business formation against the investor protection goals of the securities laws.”).

228. See Bradford, *supra* note 10, at 8 (“Crafting a crowdfunding exemption requires a careful balancing of investor protection and capital formation.”); see also Langevoort, *supra* note 41, at 2 (“In the prevailing regulatory mindset, encouraging entrepreneurial capital formation competes with traditional investor protection. The strong bipartisan political influence of the small business community assures that this uneasy competition will continue, with minor ebbs and flows in one direction or another.” (footnote omitted)).

which enables full-blown crowdfunding, requires changes to the concept of a funding portal, coupled with crowd-based wisdom, to avoid becoming a market for lemons.