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Underwriting Crowdfunding

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Abstract

Crowdfunding has more in common with an initial public offering (IPO) than may be readily apparent. Both are coordinated sales of securities to public investors (in crowdfunding's case, the "crowd"). Both rely on disclosure to mitigate information asymmetries between a company and its investors. Yet IPOs protect investors better for two reasons. First, companies undertaking an IPO have significant track records to disclose, unlike nascent startups. Second, IPOs are underwritten, meaning a reputational intermediary vouches for them.

This Essay considers applying underwriting to Regulation Crowdfunding (Regulation CF) to allow crowdfunding to mimic an IPO. It tackles questions such as: Who would be the underwriter? What potential legal liability would crowdfunding underwriters face? And what changes to Regulation CF are necessary to permit underwritten crowdfunding offerings?

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I. Introduction

Crowdfunding in many ways resembles an initial public offering (IPO). Both are coordinated sales of securities by a company, both for the first time,[1] and both to the public at large. But crowdfunding is much less regulated than an IPO.[2] So long as a startup lists its offering on a "funding portal"—which is a website not even required to register as a broker-dealer[3]—then anyone with an Internet connection and a few dollars can buy in.[4] Unlike companies undertaking an IPO, crowdfunding startups are largely unknown entities with minimal track records or operating history,[5] exacerbating the risk of loss for investors.

Crowdfunding was legalized by the Jumpstart Our Business Startups (JOBS) Act of 2012,[6] with the final rules set forth in 2015's Regulation Crowdfunding (Regulation CF).[7] Since 2015, startups in the food, beverage, lifestyle, and tech fields have been selling securities to unaccredited, unsophisticated investors under the protections of Regulation CF.[8] In its June 2019 report on crowdfunding's first three years, the SEC estimated there were 1,351 offerings under Regulation CF, 539 of which reached their

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1. Obviously, a company undertaking an IPO will have sold securities, likely in a coordinated fashion, in private placements prior to an IPO. But an IPO is the first coordinated sale to the public at large.
2. Equity crowdfunding, the focus of this Essay, involves selling securities to investors, and thus is regulated by the Securities and Exchange Commission (SEC). *See* Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. 561, 568 (2015) (distinguishing equity crowdfunding from rewards-based or donative crowdfunding, which do not involve selling securities and there is far less regulation).
3. *See* 17 C.F.R. § 227.300(a) (2016) (defining intermediaries that may sell under Regulation Crowdfunding as registered brokers, funding portals, or registered national securities association members).
4. *See* Ibrahim, *Equity Crowdfunding*, *supra* note 2, at 571 (detailing the difference between "true equity crowdfunding" which allows unaccredited investors to participate as compared to "most Rule 506 offerings, and virtually all startups' sales to angels and VCs, are limited to accredited investors"); *see also* 17 C.F.R. §227.100(a)(2) (detailing investment limits for accredited compared to unaccredited investors).
5. *See* U.S. SEC. & EXCHANGE COMM., REPORT TO THE COMMISSION: REGULATION CROWDFUNDING 5 (June 18, 2019), https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf (hereinafter SEC REPORT) (over the first three years of Regulation CF, "the median offering was by an issuer that was incorporated approximately two years prior to the offering and employed about three people."); *see also* Andrew A. Schwartz, *The Gatekeepers of Crowdfunding*, 75 WASH. & LEE L. REV. 885, 901 (2018) ("Public companies, such as those that trade on the New York Stock Exchange, as well as foreign companies, are . . . excluded" from using Regulation CF).
6. Jumpstart our Business Startups (JOBS) Act, Pub. L. 112–106, 126 Stat. 306 (2012).
7. 82 Fed. Reg. 17552 (Apr. 12, 2017).
8. Marc A. Leaf, Robert T. Esposito & Abigail Luhn, *Leading the Crowd: An Analysis of the First 50 Crowdfunding Offerings*, DRINKER BIDDLE & REATH LLP (July 14, 2016), https://www.drinkerbiddle.com/insights/publications/2016/07/leading-the-crowd-first-50-crowdfunding-offerings (stating that "[a]s of June 30, 2016, 50 companies have filed a Form C with the SEC to offer securities under the Regulation Crowdfunding exemption").

target goal in the offering.[9] The average crowdfunding offering sought the target amount of $52,428.[10]

The SEC's June 2019 report on crowdfunding's initial results is generally positive.[11] Despite the small individual offerings, in the aggregate, crowdfunding efforts raised almost $1 billion in 2017.[12] Still, the SEC warns that its report examines a relatively short time frame under "favorable economic conditions."[13] And most importantly, it is unclear what is happening now with those successful offerings. Did they go on to raise additional funding? Did anyone provide the entrepreneur with the value-added services that are as important than capital for growing a new business?[14]

Despite some academic skepticism,[15] I have argued that crowdfunding can work.[16] And the initial results are bearing that prediction out. But major structural problems still remain. Information asymmetry, agency costs, and adverse selection problems are rife in this environment, and all must be sufficiently mitigated for crowdfunding to succeed.[17] This Essay argues that, due to the similarities between crowdfunding and IPOs, the SEC should also consider allowing in crowdfunding what has worked well in firm-commitment IPOs: *underwriting*. Crowdfunding may not yet offer enough economic incentive for underwriters, but if that can be changed, the effective signaling

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9. SEC REPORT, *supra* note 5, at 4; *see also* JD Alois, *Three Years of Reg CF: 44 Funding Portals, 9 Departures, 1 Suspension & $200 Million Raised*, CROWDFUND INSIDER (May 21, 2019, 11:21 AM), https://www.crowdfundinsider.com/2019/05/147569-three-years-of-reg-cf-44-funding-portals-9-departures-1-suspension-200-million-raised/ (listing numerous funding portals).
10. SEC REPORT, *supra* note 5, at 4.
11. SEC REPORT, *supra* note 5, at 4–5 (discussing initial results); *but see* Joyce M. Rosenberg, *Begun with big hopes, crowdfund investing proves no bonanza*, ASSOCIATED PRESS (May 9, 2018), https://www.apnews.com/eda654006c834db58e2d483a70abb819 (discussing crowdfunding's slow start).
12. SCOTT KUPOR, SECRETS OF SAND HILL ROAD: VENTURE CAPITAL AND HOW TO GET IT 273 (2019) ("[I]n 2017, roughly $1 billion was raised through crowdfunding efforts in the US, an increase of about 25 percent from the previous year.").
13. SEC REPORT, *supra* note 5, at 3.
14. See *infra* notes 78–79 and accompanying text on the importance of value-added services to entrepreneurial businesses as they grow.
15. Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493, 496 (2014) (suggesting that opportunities will be "terrible"); 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, 1767 (2012) ("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."); *Cf.*, Joseph M. Green & John F. Coyle, *Crowdfunding and the Not-So-Safe SAFE*, 102 VA. L. REV. ONLINE 168 (2016) (arguing that so-called SAFE securities are inappropriate for investors in crowdfunding offerings).
16. Ibrahim, *Equity Crowdfunding*, *supra* note 2, at 589–91 (arguing that crowdfunding appeals to self-sufficient managers of a new business); Darian M. Ibrahim, *Crowdfunding Without the Crowd*, 95 N.C.L. REV. 1481, 1499 (2017) (applauding the expanding screening role for funding portals under regulation CF).
17. *See* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1077 (discussing the trio of problems that must be overcome in startup investing; uncertainty, information asymmetry and agency costs).

they provide is the best way to help crowdfunding take its place as a sound waystation in entrepreneurial finance.

In IPOs, underwriters such as Goldman Sachs perform valuable diligence on companies going public, counsel them on capital structure and legal matters, and "rent" their reputations to the companies—essentially vouching for them to public investors who are at an informational disadvantage about the quality of these companies.[18] Thus, underwriters are reputational intermediaries who have a financial and reputational interest in selecting high-quality offerings to underwrite.[19] Importantly, in a firm-commitment offering, underwriters actually buy all of the shares a company is offering to the public, then turn around and immediately resell them.[20] This minimizes risk for the issuer (all of its offered shares are sold to the underwriter) and incentivizes the underwriter to carefully select the securities it will underwrite.[21] In essence, firm-commitment IPOs provide a valuable selection and risk-minimizing function for public investors.

With some changes to Regulation CF, crowdfunding offerings could employ the "firm commitment" underwriting mechanism that makes traditional IPOs successful. Crowdfunding offerings, like IPOs, could use underwriters to serve as reputational intermediaries between startups and investors. Many thorny issues would have to be resolved for underwriting crowdfunding to become a reality, most notably: 1) who would have sufficient incentive to serve as underwriter; and 2) what would an underwriter's legal liability be for serving as underwriter?[22]

Previewing the first question, there are several candidates for underwriter, but a funding portal or angel investor is the most likely candidate.[23] A funding portal or angel investor may underwrite a crowdfunding offering for several reasons: first, to be sure the target fundraising goal is met; second, to signal support for the startup to

18. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984) (discussing the value added by having an investment banker involved in the process); *see* Bengi Ertuna, et al., *The Effect of the Issuer-Underwriter Relationship on IPOs: The Case of an Emerging Market*, 8 J. ENTREPRENEURIAL FIN. 43, 45 (2003); Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 U.C.L.A. L. REV. 781, 788 (2001) ("reputational intermediaries . . . vouch for disclosure quality and thereby reduce information asymmetry in securities markets.").

19. 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, 14 (1998) ("Financial intermediaries . . . have reputations to protect as repeat players in the capital marketplace.").

20. STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 491 (5th ed. 2019) (underwriters ". . . purchase the entire offering from the issuer before turning around and reselling the securities to investors.").

21. *Id.*

22. The second question is related to the first: a party is less likely to have economic incentive to serve as underwriter if a high probability of potential legal liability factors into the calculation.

23. See *infra* Part IV.B. A funding portal is the website that hosts crowdfunding offerings. Stuart R. Kohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1439 (2012). An angel investor is a wealthy individual, usually an ex-entrepreneur, who invests personal funds in startups. Ibrahim, *Crowdfunding Without the Crowd*, *supra* note 16, at 1494.

follow-on investors; and third, to force the startup into professionalizing disclosures by complying with Regulation CF's requirements. In answer to the second question, a funding portal or angel may face liability for a startup's fraud should they serve as underwriter, substantially changing the risk/reward calculus in underwriting a crowdfunding offering.

Despite these issues, the underwriting thought experiment is worth considering. Without underwriters, crowdfunding offerings are akin to direct public offerings (DPOs), or sales securities into the public markets directly to the ultimate investors. DPOs are more suited for well-known companies like Snap than for brand-new startups that need reputational capital to signal quality to potential investors.[24]

This Essay explores what changes would be necessary to current law to allow underwritten crowdfunding offerings. In particular, Regulation CF would need the following amendments: 1) the crowdfunding exemption itself should be open to underwriters also instead of just issuers (i.e., underwriters should be permitted to avail themselves of the Regulation CF offering exemption and immediately resell securities to the crowd *as if* they were the issuer);[25] 2) in larger crowdfunding offerings, the $107,000 investment limit for any one investor should be removed for underwriters (as the underwriter would need to purchase an entire crowdfunding offering to mimic a firm-commitment IPO);[26] and 3) the current one-year required holding period should be eliminated for underwriters, permitting them to immediately resell crowdfunding securities.[27]

II. How Initial Public Offerings (IPOs) Work

An initial public offering, or IPO, is when a privately-held company makes a coordinated sale of its securities to the public for the first time.[28] The process is expensive and time-intensive.[29] And it is highly regulated by the SEC, both in terms of the timing and content of disclosures. There are different types of IPOs, the major ones being the firm-commitment IPO and the DPO previewed in the Introduction, as well as the best-

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24. *See, e.g.*, Kyla Houge, *Reverse Mergers: A Legitimate Method for Companies to Go Public or an Easy Way to Commit Fraud?*, 36 J. NAT'L ASS'N JUD. 325, 338 (2016) ("[A] direct public offering can also benefit larger corporations who wish to 'leverage their name recognition on a global basis.'"); *see also* Anita Anand, *The Efficiency of Direct Public Offerings*, 7 J. SMALL & EMERGING BUS. L. 433, 449 (2003) (suggesting "investors [are] more inclined to invest in DPOs" of "seasoned issuers").

25. See *infra* Part V.A.

26. See *infra* Part V.B.

27. See *infra* Part V.C.

28. Gladriel Shobe, *Private Benefits in Public Offerings: Tax Receivable Agreements in IPOs*, 71 VAND. L. REV. 889, 890 (2018) ("[P]re-IPO owners sold shares of a company to the public, turning a privately held company into a publicly held company . . . [and] the interests that the pre-IPO owners sold to the public represented shares in the whole publicly traded company.").

29. *See* Barry McCarthy, *IPOs Are Too Expensive and Cumbersome*, FIN. TIMES (Aug. 7, 2018), https://www.ft.com/content/60cd1bb8-9970-11e8-88de-49c908b1f264.

efforts and Dutch auction IPOs.[30] Each IPO method differs in its specifics, and consequently, in the signal it sends public investors about the quality of the offering.

A. The Firm-Commitment IPO

The firm-commitment IPO is the most common and most favored type of IPO by issuers, underwriters, and the public.[31] In a firm commitment, the company going public (the "issuer") hires an investment bank as underwriter. Multiple investment banks serve as underwriters, but the process is managed by a lead underwriter.[32] The lead underwriter (hereinafter referred to as just "the underwriter" for simplicity) counsels the company on its capital structure, number of shares to sell to the public, the offering price, and various other matters.[33] The underwriter also uses its connections to find investors for the offering.[34]

The unique and defining feature of a firm-commitment IPO is that the underwriter actually purchases all the shares the company is offering.[35] The underwriter then turns around and resells the shares to other investors.[36] Using a real estate analogy, a firm-commitment offering would involve the realtor buying the seller's house outright, then reselling it to the eventual buyer.[37] The realtor must price the initial sale correctly in order to make a profit on the resale. And the realtor must be confident that she can resell the house before purchasing it.

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30. *See also* Christine Hurt, *What Google Can't Tell Us About Internet Auctions (And What It Can)*, 37 U. TOL. L. REV. 403, 413 (2006) (discussing "an online IPO auction process called OpenIPO").

31. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 22 (7th ed. 2017) (The "most common" type of underwriting "in the country is firm-commitment underwriting.").

32. *See* Jeremy McClane, *The Agency Costs of Teamwork*, 101 CORNELL L. REV. 1229, 1240–42 (2016) (describing the role of underwriters, including the lead underwriter); William K. Sjostrom, Jr., *Rebalancing Private Placement Regulation*, 36 SEATTLE U. L. REV. 1143, 1146 (2013) ("Public offerings are typically marketed and sold to the public by a syndicate of underwriters.").

33. *See* McClane, *supra* note 32, at 1241–44.

34. Mark Koba, *Initial Public Offering: CNBC Explains*, CNBC (Apr. 20, 2012, 10:54 AM), https://www.cnbc.com/id/47099278. *See* Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 725 (2005) ("Critical to the underwriter's incentive to underprice is the fact that the underwriter has the power to determine which institutions and individuals will be able to share in this wealth extraction.").

35. *See* Cody L. Lipke, *Direct Listing: How Spotify is Streaming on the NYSE and Why the SEC Should Press Play*, 12 J. BUS. ENTREPRENEURSHIP & L. 149, 153 (2019) ("[T]he underwriter takes on the risk by purchasing the security at a fixed price and then sells the security to the public at a higher offering price.").

36. Royce de R. Barondes, *NASD Regulation of IPO Conflicts of Interest—Does Gatekeeping Work?*, 79 TUL. L. REV. 859, 868 (2005) ("In a typical IPO, a syndicate (group) of investment banks formally purchases securities from an issuer and immediately resells them to the public."); Christine Hurt, *Moral Hazard*, *supra* note 34, at 723–25 ("In an IPO, the issuing company sells its shares at the offering price. If the offering price increases in the first day, even dramatically, the issuer does not profit from any share price increase. The resellers . . . capture this price increase.").

37. *See* Gilson & Kraakman, *supra* note 18, at 643 n.247.

The firm-commitment method is not without critics for its clubbiness. Issuers leave money on the table by underpricing the sales to underwriters.[38] The underwriter then turns around and sells the shares to its favored institutional investors, who are usually its client base for other investment banking services the underwriter provides.[39] Those favored investors then sell to the public, who end up paying a premium for the shares.[40] Still, the firm-commitment IPO is the gold standard because the underwriter, not the issuer, carries the risk "if the offering is undersubscribed."[41] Investment banks play the role of reputational intermediary between issuers and investors in all IPOs, and in particular in firm-commitment IPOs.[42] In this role, investment banks act "as reputational agents for the issuer, attesting to the investment worthiness of an

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38. Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 660 (1988) ("Underwriters thus can be expected to err on the side of underpricing, which helps ensure that all the shares sell quickly and they receive the spread on the entire issue."); *id.* at 664 ("Underwriter mispricing of new issues means that corporations going public may face wildly differing costs of equity capital; some firms sell stock at steep discounts while others raise funds at bargain basement rates."); Sean J. Griffith, *Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 BROOKLYN L. REV. 583, 590–99 (2004) (discussing various theories as to why underwriters underprice, such as "spinning", in which the underwriter offers underpriced IPO shares to important customers to raise future goodwill); Michelle Lowry & Susan Shu, *Litigation Risk and IPO Underpricing*, 65 J. FIN. ECON. 309, 310 (2002) (theorizing that underpricing insures issuers and underwriters against future legal liability); Tom C. W. Lin, *Infinite Financial Intermediation*, 50 WAKE FOREST L. REV. 643, 649 (2015); Barondes, *supra* note 36, at 868 ("The investment banks' profits come from the 'spread,' the difference between their purchase prices and the prices at which they offer the securities to the market.").

39. *See* McClane, *supra* note 32, at 1242 ("The investors to whom the IPO is marketed are typically large institutional investors."); Hurt, *supra* note 30, at 404, 405 ("The recipients of those [IPO] shares are usually institutional investors known to the underwriters and regular customers of the underwriters."); Barondes, *supra* note 36, at 870 ("If the investment bank facilitates profitable transactions for investor-customers, the investment bank may get other future business at market prices.").

40. Barondes, *supra* note 36, at 867 ("Historically, stock sold in an IPO on average has traded immediately following the IPO, e.g., by the close of business on the first trading day, at a significant premium."); Andres Rueda, *The Hot IPO Phenomenon and the Great Internet Bust*, 7 FORDHAM J. CORP. & FIN. L. 21, 51 (2001) ("Any investor lucky enough to be allocated shares of a hot IPO is virtually guaranteed a risk-free profit by 'flipping' it in the aftermarket.").

41. Jay B. Kesten & Murat C. Mungan, *Political Uncertainty and the Market for IPOs*, 41 J. CORP. L. 431, 439 (2015) (articulating that the underwriter bears the risk in a firm-backed IPO and therefore if the underwriter thinks the price is too high the underwriter will acknowledge that risk). As a practical matter, the underwriter's risk is minimal, as the underwriter does not sign the underwriting agreement until it has secured commitments from subsequent purchasers. *See, e.g.*, 74 Fed. Reg. 68101, 68117 (Dec. 22, 2009) (Goldman Sachs asserting in a filing with Dept. of Labor that they do not execute an underwriting agreement until they have received sufficient indication of interest).

42. Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279, 283 (2000) ("[A]n investor who lacks information on individual issuers might have good information on intermediaries, such as broker-dealers, mutual funds, or exchanges. Such investors will select intermediaries that offer desired investors protections.").

offering to the public."[43] Thus, firm commitments benefit the public as well as the issuer, underwriter, and favored institutional investors.[44] Due to these advantages, 90% of all public offerings are firm commitments.[45]

B. The Best-Efforts IPO

The less common form of IPO is the best efforts. In the best-efforts IPO, the underwriter does not actually purchase all the shares in the offering. Instead, the issuer retains ownership of these shares and sells directly to institutional and retail investors.[46] An underwriter is still involved in structuring the offering, selling efforts, etc.: for lending its reputational capital and expertise to the issuer, the underwriter receives a commission on sales.[47] Returning to our real estate analogy, this is the equivalent of a brokered-home sale, with the realtor taking a cut of the purchase price from the seller. Because the underwriter does not purchase the shares outright, however, the reputational signal it sends the issuer is less than in a firm commitment.[48] The underwriter is not fully standing behind the company's prospects, since the gold standard is a firm-commitment offering, thus the credibility signal it sends the public about the company's prospects is weaker.[49]

Direct public offerings and Dutch auction IPOs also exist, but are better seen as offshoots of the firm-commitment or best-efforts IPOs than separate offering types. DPOs and Dutch auctions have even less need for underwriters. A DPO is just as it sounds: the issuer sells directly to the public. Employing our real estate analogy once more, the DPO is the "for sale by owner" option of home selling. A Dutch auction is

43. Lin, *supra* note 38, at 649. *See also* Gilson & Kraakman, *supra* note 18, at 620 ("In essence, the investment banker rents the issuer its reputation."); Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 14 (2002) ("The reliability of ratings can be explained by reputation costs: the profitability of rating agencies is directly dependent on their reputations. Inaccurate ratings will impair, if not destroy, a rating agency's reputation.").

44. *See* Gilson & Kraakman, *supra* note 18, at 620 (articulating how the underwriter bears the loss or risk associated with the IPO).

45. Kesten & Mungan, *supra* note 41, at 439.

46. HAZEN, *supra* note 31, at 73 (a best-efforts underwriting "does not put the underwriter at risk in the event that investors do not purchase the entire allotment being offered to the public.") *See also* Rueda, *supra* note 40, at 32.

47. HAZEN, *supra* note 31, at 73 ("Best efforts underwriting is generally used by less established issuers that cannot find an investment banker who is willing to make a firm commitment because of the speculative nature of the distribution."). *See also* Jennifer O'Hare, *Institutional Investors, Registration Rights, and the Specter of Liability Under Section 11 of the Securities Act of 1933*, 1996 WIS. L. REV. 217, 218 n.5 (1996) ("[I]n a best efforts underwriting, the traditional underwriter does not assume the risk of placing the securities. Rather than purchasing the securities from the issuer, the traditional underwriter merely promises to use its "best efforts" in finding purchasers.").

48. Arthur McMahon, *It Takes a Village to Fund a Start-Up: How an Electronic Community for Early-Stage Investments Can Bring Democracy Back to Equity Crowdfunding*, 84 U. CIN. L. REV. 1269, 1308 (2016) (best-efforts "typically signals a lower quality offering").

49. O'Hare, *supra* note 47, at 247 ("Traditional underwriters conducting best efforts offerings do not undertake firm commitment risk.").

similar, but the offering price is set by the public, not by the issuer.[50] A Dutch auction is a "strategic game" where bidders have to take into account probable bids that others might make.[51] The price rises at the auction until one bidder remains, each bidding the highest they are willing to pay.[52] Therefore, the market clearing price is determined by the investors.[53] In sharp contrast to the firm-commitment underwriting, the DPO and Dutch auction minimize the role of underwriters.[54] As such, the role of underwriters as reputational intermediaries between issuers and the public is dramatically reduced. Due to the firm commitment's advantages, this Essay only considers importing the firm commitment mechanism to the crowdfunding context.

III. Why Crowdfunding Resembles an IPO

Like in an IPO, crowdfunding companies are usually selling securities to "public" investors (the "crowd") for the first time.[55] While on first blush crowdfunding seems to more closely resemble a private placement than an IPO,[56] the opposite is true. In a private placement, startups sell securities to well-heeled, experienced angels and VCs who do not need or get the protections of the disclosure provisions of the securities laws.[57] Most notably, disclosure is not required in the common Rule 506 private placement involving only accredited investors.[58] Networks, prior interactions between

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50. Peter B. Oh, *The Dutch Auction Myth*, 42 WAKE FOREST L. REV. 853, 855 (2007) (describing a Dutch auction as an IPO that "conducts price discovery via an auction," as opposed to meetings and roadshows by underwriters); *see also* Langevoort, *supra* note 19, at 13 (in Dutch auctions, "investors submit bids for the securities, with the price set at the sum necessary to sell the desired number of shares").

51. Anita I. Anand, *Is the Dutch IPO a Good Idea?*, 11 STAN. J.L. BUS. & FIN. 232, 234 (2006); *see also* HAZEN, *supra* note 31, at 74 (calling the Dutch auction "relatively infrequently used").

52. Anand, *supra* note 51, at 233; *see also* Eugene Choo, *Going Dutch: The Google IPO*, 20 BERKELEY TECH. L.J. 405, 414–15 (2005).

53. Choo, *supra* note 52, at 414–15.

54. *Id.* at 416 ("Although the investment banks fill orders and sell shares, they have much less control over the price.").

55. Crowdfunding companies are unlikely to have coordinated securities sales prior to the crowdfunding offering, while companies undertaking IPOs will have sold numerous securities to investors in private placements prior to the IPO. Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOs*, 2015 U. ILL. L. REV. 217, 239 ("Crowdfunding via an Internet website walks a strange path between regulated public offerings and exempt private placements; crowdfunding generally seeks to attract small amounts of capital, as in a private placement, but in a very public offering from large numbers of investors.").

56. Hurt, *supra* note 29, at 415–417 (discussing criticism of Google's Dutch auction as resulting in far lower prices than a traditional IPO could have received).

57. *See generally* Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PENN. J. BUS. L. 107 (2011).

58. Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573, 1611 (2013) ("Capital-raising transactions under Rule 506, if directed solely at accredited investors, did not mandate disclosure."). *Cf.* Alan Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 21 (1999) ("Though not required by the Securities Act or any explicit

entrepreneur and investor, and narrow subject matter focus all reduce information asymmetries and minimize the need for formal protections like mandatory disclosure for angels and VCs.[59] None of these things are true for the crowd in a Regulation CF offering, or for the public in an IPO.

In IPOs, companies sell their shares in a coordinated matter to the public for the first time. Because public investors have little to go on (more or less depending on the company), the IPO process requires substantial disclosure, often for the first time, on a Form S-1 registration statement.[60] This is securities law's primary means of reducing information asymmetries between the company and investors.[61] In other words, because close networks and prior interactions between entrepreneur and investor vanish when a company expands its sights to public investors, securities law steps in with its most important investor-protection tool: disclosure. The massive disclosures required in an IPO are well-known.[62]

Crowdfunding was explicitly designed to open formerly private investment opportunities to the public at large.[63] To invest in a privately held startup before

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exemptive condition, offering circulars for unregistered private placements generally mimic and sometimes go beyond the disclosures mandated in a registered offering."). For a historical look at Rule 506 and the other Regulation D private placement exemptions, see Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 374–79 (1984).

59. Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1431 (2008) (angel–entrepreneur connection "reduces uncertainty and information asymmetry in the way deals are sourced and selected").

60. Jennifer O'Hare, *Institutional Investors, Registration Rights, and the Specter of Liability Under Section 11 of the Securities Act of 1933*, 1996 Wis. L. Rev. 217, 217 n. 4 ("The disclosure required in a registration statement is extensive."); William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 Brandeis L.J. 549, 561 (2006) ("Form S-1 is a full-blown registration statement, i.e., with limited exceptions for seasoned issuers, each required disclosure item must be set forth in the prospectus."); *US IPO Guide*, LATHAM & WATKINS LLP, at 3 (2019), https://www.lw.com/thoughtLeadership/lw-us-ipo-guide (describing the financial disclosure process accompanying the IPO).

61. Steven L. Schwartz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044, 1068 (2005) ("The most obvious way to solve this information asymmetry problem is for the firm issuing securities (issuer) to provide investors—both current and future—with all possible information, thereby reducing the information asymmetry."); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 740 (2006) ("more public disclosure leads to fewer instances of asymmetric information"); Schwarcz, *supra* note 43, at 10 (the function of securities law is to "reduc[e] the information asymmetry between issuers of securities and investors").

62. On-ramps and emerging growth company classifications are designed to lessen that burden and entice more companies to go public. *See, e.g.*, U.S. SEC. & EXCHANGE COMM., *Going Public* (Feb. 11, 2019), https://www.sec.gov/smallbusiness/goingpublic.

63. Thereby opening up new paths to capital for entrepreneurs. *See* Abraham J.B. Cable, *Mad Money: Rethinking Private Placements*, 71 WASH. & LEE L. REV. 2253, 2255 (2014) (observing that President Obama commended the JOBS act "for nurturing the next Facebook or Apple by easing restrictions on . . . private placements"); Schwartz, *supra* note 5, at 905 ("crowdfunding was also designed to promote an inclusion vision of entrepreneurship . . . [serving] entrepreneurs of modest means, without a rich uncle, and who lack wealthy friends.").

Regulation CF, an investor had to be accredited (i.e., wealthy) and, as a practical matter, connected. The fear was that game-changing companies on their way up were only available to these investors, while the general public had to wait until an IPO (when the buy-in price is much higher and the astronomical gains are in the past).[64] If these investment opportunities are no longer network- or relationship-driven, however, disclosure is again needed to mitigate information asymmetries. Because crowdfunding startups are in their earliest stages, the information asymmetries are even greater, and disclosure is even more important. Regulation CF requires significant disclosures for small, nascent startups.[65] In fact, disclosure costs seem to have minimized the amount Regulation CF was used in its first few years.[66]

Disclosure is not enough, however.[67] In IPOs, as explained, the type of offering and identity of the underwriter are important signals of issuer quality to public investors. Should a top investment bank like Goldman Sachs underwrite an IPO, it sends a strong signal to potential investors who may otherwise be at an informational disadvantage even after reading S-1 disclosures.[68] The risk-reducing mechanisms for the crowd beyond disclosure are even more important, as startups can only disclose so much given they are so young.[69] Crowdfunding startups are literally just starting up,

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64. Arthur McMahon, III, *It Takes a Village to Fund a Start-up: How an Electronic Community for Early-Stage Investments Can Bring Democracy Back to Equity Crowdfunding*, 84 U. CIN. L. REV. 1269, 1274 (2016) ("[O]thers have praised [crowdfunding's] ability to give ordinary, middle class investors access to potentially lucrative start-up investments that have been historically reserved to the wealthy or well connected.").

65. These disclosures include varying degrees of financial statements based on the amount being offered and sold in the prior twelve-month period. 17 C.F.R. § 227.201(s). *See also* Schwartz, *supra* note 5, at 901 (companies using Regulation CF "must provide numerous disclosures to investors, intermediaries, and the SEC"); SEC REPORT, *supra* note 5, at 18 ("Due to the young age of the issuers, approximately half of the crowdfunding issuers disclosed a prior year of financial statements."); *id.* at 24 (during the first three years of crowdfunding campaigns under Regulation CF, "disclosure preparation [was] most expensive in dollar terms, averaging $6,218 per campaign, followed by marketing and legal expenses").

66. SEC REPORT, *supra* note 5, at 30 ("[M]arket participants have expressed concern about the cost and complexity of relying on Regulation [CF, noting] the time and cost required to comply with the [disclosure] regulations . . . .").

67. Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PENN. L. REV. 647, 651 (2014) (making the case that mandatory disclosure usually fails).

68. For a counterargument on reputational intermediary value, *see* Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 273 (2003) ("Intermediaries do not always function effectively . . . . Indeed, the presence of high-reputation intermediaries may lull investors into a false sense of security, causing them to rely on the intermediaries and seek out less information on their own."); *See* Choi, *supra* note 42, at 295 ("Although intermediaries can be an efficient source of investor protections, they may also be a source of additional risks for investors. Intermediaries may act unfaithfully in their screening for issuer quality.").

69. *See* Cable, *supra* note 63, at 2276 ("[M]andatory disclosure systems tend to emphasize historical facts over projections and future plans, and so provide little benefit to a company with limited or no operating history."); Gregory D. Deschler, *Wisdom of the Intermediary Crowd: What the Proposed Rules Mean for Ambitious Crowdfunding Intermediaries*, 58 ST. LOUIS. L.J. 1145, 1175 (2014) (noting the challenges of early-stage issuers disclosing three years of information if they have not reached three years); Erica Wu, *Biotech Crowdfunding:*

and thus their future is more important than their past or present.[70]

The original regulatory design of Regulation CF sought to employ the wisdom of the crowd[71] to solve the adverse selection problem in choosing among startups. However, as I have previously argued, crowd-based wisdom is a poor fit for investing, and a particularly poor fit for startup investing.[72] Consequently, *intermediation* is necessary to give crowdfunding a chance at success.[73] Regulation CF, unlike the original JOBS Act, did move toward expert intermediation by allowing funding portals to pre-screen or "curate" the startups that list on the portal, and by allowing investment groups to operate within the portals.[74] Therefore, funding portals themselves, and the expert investors who might be enticed to dabble in crowdfunding opportunities, can guide choices for the unsophisticated.[75] Still, due to investment limit restrictions and fears of being tagged as broker-dealers, the expert intermediation allowed by Regulation CF may not go far enough.[76] Signaling is key in crowdfunding, and we must continue to look for even better signaling mechanisms than are currently being employed.

How the JOBS act Alone Cannot Save Investors, 18 COLUM. BUS. L. REV. 1061, 1092 (2018) ("Missing from the [Regulation CF] disclosure requirements . . . are any details of the actual achievements and potential success of the venture."); David Mashburn, *The Anti-Crowd Pleaser: Fixing the Crowdfund Act's Hidden Risks and Inadequate Remedies*, 63 EMORY L.J. 127, 157 (2013) ("Startups face multiple disadvantages compared to more mature companies due to startups' limited human, informational, and financial resources; personal financial pressures; and greater risk and complexity in decision-making.").

70. C. Steven Bradford, *Online Arbitration as a Remedy for Crowdfunding Fraud*, 45 FLA. ST. U.L. REV. 1165, 1168 (2018) ("[T]he companies using the [crowdfunding] exemption will be small companies whose securities are not publicly traded, so little additional public information will be available.").

71. Thompson & Langevoort, *supra* note 58, at 1606 ("[E]xposing an entrepreneur's idea to an open forum allows for communication among interested parties, allowing the crowd's collective reaction to elicit new information . . . .").

72. Ibrahim, *Crowdfunding Without the Crowd*, *supra* note 16, at 1492–93 (arguing that in startup investing, the diversity of opinion and independence criteria for using crowd-based solutions are not present).

73. *See* Ibrahim, *Equity Crowdfunding*, *supra* note 2, at 606 (articulating the need for intermediaries and the risk, they curtail); *see also* Lin, *supra* note 38, at 645 ("[D]isintermediation, [or the] complete elimination of mediums from financial transactions, is so difficult."); *id.* at 643 ("Intermediation is a fundamental fact of finance."); Ibrahim, *Crowdfunding Without the Crowd*, *supra* note 16, at 1484; Langevoort, *supra* note 19, at 13 ("For quite a while now, both law and economics have understood that intermediation plays an important role in the sale of securities.").

74. On funding portals, *see* Schwartz, *supra* note 5, at 910 ("The SEC concurred that [Regulation CF] would only work, or would at least work much better, if funding portals had the power to select which companies to include, and which to exclude, from its site."); on investment groups operating on funding portal sites, *see* Ibrahim, *Crowdfunding Without the Crowd*, *supra* note 16, at 1502 (giving the example of Y Combinator's investment group).

75. Kathryn Judge, *Intermediary Influence*, 82 U. CHI. L. REV. 573, 574 (2015) ("Intermediaries can bridge information asymmetries, enable parties to find one another, and otherwise make it easier for parties to overcome the many barriers to transacting.").

76. SEC Report, supra note 5, at 10 (detailing how Regulation CF "provide[s] a safe harbor from broker-dealer registration restrictions").

IV. Underwriting Crowdfunding: The Idea

A. Why Underwrite Crowdfunding

This Section considers why crowdfunding would be a more promising option for all parties involved if the process could mimic a firm-commitment IPO. An underwritten crowdfunding offering would offer several advantages. First, for the crowd, an underwriter would further strengthen the role of intermediation plays in helping unsophisticated investors avoid the extreme adverse selection problems present in selecting among nascent startups.

Second, for entrepreneurs, an underwritten crowdfunding offering guarantees the offering is successful, as the underwriter buys all the securities and also increases the chance the startup will receive follow-on capital after the crowdfunding campaign concludes.[77] Crowdfunding startups of the rapid-growth variety need to attract follow-on capital and value-added services such as advice and connections.[78] Angels and VCs have long offered value-added services that are critical to a growing business.[79] Capital is becoming cheaper for startups, but seasoned advice on how to deploy it remains as important as ever.[80]

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77. Ibrahim, *Crowdfunding Without the Crowd*, *supra* note 16, at 1492–93 (discussing the signaling function of angel capital); KUPOR, *supra* note 12, at 52 ("[S]ignaling matters. Venture firms develop a positive reputation for backing successful startup companies, and that positive brand signaling enables those firms to continue to attract the best new entrepreneurs.").

78. *Cf.* Ibrahim, *Equity Crowdfunding*, supra note 2, at 566 (startups with strong entrepreneurs may be able to crowdfund in their earliest stages to get a discount for the lack of the crowd's value-added services at their earliest stages).

79. D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 170 n.162 (1998) (giving an example of the value-added services VCs can provide to entrepreneurs); D. Gordon Smith, *Team Production in Venture Capital Investing*, 24 IOWA J. CORP. L. 949, 953–54 (1999) ("[T]he Venture Capitalist also contributes so-called 'value-added services.' In a recent survey, entrepreneurs were asked to rate the importance of twelve value-added services to their choice of a venture capitalist. The five services achieving the highest ratings were the following: (1) serving as a sounding board to entrepreneur team; (2) obtaining alternate sources of financing; (3) recruiting management personnel; (4) interfacing with investor group; and (5) formulating business strategy. These results closely track the results obtained in many other surveys of entrepreneurs and venture capitalists, thus suggesting a large degree of consensus regarding the relative importance of value-added services provided by venture capitalists." (citations omitted)); *see* Sam Hogg, *3 Ways VCs Can Add Value to Your Startup Beyond the Cash*, ENTREPRENEUR (Oct. 9, 2014), https://www.entrepreneur.com/article/237354.

80. Anthony Mirhaydari, *Private Markets Drowning in Cheap Cash*, PITCHBOOK (Oct. 6, 2017), https://pitchbook.com/news/articles/private-markets-drowning-in-cheap-cash ("VCs are pushing earlier into the startup lifecycle, with buzz surrounding the raising of new pre-seed funds that aim to step in where family, friends and individual angels traditionally bootstrap embryonic enterprises."); *see also* KUPOR, *supra* note 12, at 20 (noting that cloud computing and other changes "mean that the amount of money you need to raise . . . to get started is much less than in the past"); *id.* at 274 ("If money remains abundant, and value creation in startups . . . remains a function of being able to build large, self-sustaining businesses, then the firms that provide meaningful value to entrepreneurs beyond just being a source of capital likely have an ongoing role to play.").

Third, for underwriters, underwriting a crowdfunding offering is likely to result in entrepreneur–underwriter collaboration on offering price, and thus a more realistic ask from the entrepreneur.[81] Obviously underwriters face their own challenges, including incentive issues. These will be discussed below.

B. Who Will Be the Underwriter?

Finding a willing underwriter may be the most challenging obstacle to implementing this Essay's idea. It is fairly easy to rule out investment banks as likely candidates for crowdfunding underwriter for several reasons. First, an underwritten crowdfunding offering of $50,000 would only yield a few thousand dollars on resale: far too little for an investment bank to get involved.[82] In fact, investment banks mostly underwrite IPOs for later business from the offering company and to reward institutional clients.[83] Neither incentive is present in crowdfunding.[84]

Two more likely candidates for underwriter emerge: the funding portal and the angel investor.[85] Funding portals are where crowdfunding issuers list their offerings. Funding portals are paid a "success fee" for startups that reach their crowdfunding goals.[86] Should a funding portal also underwrite an offering, it would presumably forego the success fee (since it would be paying itself) in lieu of a higher repurchase price on resale, emulating the gross spread in a typical IPO.[87] Perhaps lesser-known funding portals would offer underwriting services to attract issuers, even if it meant registering as broker-dealers. Some funding portals such as SeedInvest are already curating among the startups wishing to crowdfund on their websites, so presumably they have done the diligence necessary to decide which of their listings are the most promising.

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81. Langevoort, *supra* note 19, at 13 ("Start-up issuers lack knowledge about such matters as pricing and structuring deals, and about what type of information is useful to potential investors.").

82. *See* Felix Salmon, *Where Banks Really Make Money on IPOs*, REUTERS (Mar. 11, 2013), http://blogs.reuters.com/felix-salmon/2013/03/11/where-banks-really-make-money-on-ipos.

83. *See supra* note 39 and accompanying text.

84. Most startups fail, so the risk/reward on any particular startup becoming a lifelong client is heavily skewed toward the risk. *339 Startup Failure Post-Mortems*, CBINSIGHTS, https://www.cbinsights.com/research/startup-failure-post-mortem/ (last updated Jan. 21, 2020).

85. On funding portals generally, *see* Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals Under the Crowdfund Act*, 13 U.C. DAVIS BUS. L.J. 177, 194 (2013).

86. SEC REPORT, *supra* note 5, at 47 ("[M]ost intermediaries received a percentage fee paid in cash and/or securities contingent on the completion of the offering."); *see also* Schwarcz, *supra* note 43, at 7 ("Rating agencies are virtually always paid their fee by the issuer of the securities applying for the rating . . . [there would be a] collective action problem in coordinating potential investors to pay this fee.").

87. Sung C. Bae & Ham Levy, *The Valuation of Firm Commitment Underwriting Contracts for Seasoned New Equity Issues: Theory and Evidence*, 19 J. FIN. MGMT. 48, 48 (1990) ("[A] gross underwriting spread [is the difference] between the price that the issuing firm is paid for the stock and the price at which the stock is sold to the public.").

Other funding portals may wish to consider a change to their business model to follow suit. During Regulation CF's first three years, the "majority of initiated and completed offerings were conducted through the three largest funding portals,"[88] perhaps leaving lesser-used funding portals looking for a competitive angle to attract more offerings and stay afloat.[89]

An angel investor is another possible underwriting candidate.[90] As Donald Langevoort noted some time ago about VCs, "a venture capital firm is a repeat player with a high degree of investment expertise that must both repeatedly attract its own capital and prepare its portfolio companies for ultimate public distribution. Thus, *it has a reputational interest not unlike an underwriter.*"[91] VCs, however, are more likely to be the follow-on investors *after* a successful crowdfunding campaign. Angels, due to their smaller investments at earlier stages, are potential crowdfunding underwriters. Angels invest their personal funds in early-stage startups, at lesser amounts than VCs, and for pecuniary and non-pecuniary reasons.[92]

Why would an angel underwrite a crowdfunding offering? The dollar amounts are right for angel investment size,[93] and angels who cannot underwrite a larger offering are reliant on the crowd realizing its merits and joining in the original campaign. An underwritten crowdfunding campaign also has the advantage of giving the angel immediate diversification of risk and cash back in hand, whereas a traditional Regulation D campaign would see the angel holding all the shares indefinitely. And Regulation CF can force a company to professionalize itself in ways that a private placement might not, making the startup a more attractive candidate for follow-on financing from VCs.[94] Finally, a strategic angel could realize that a successful crowdfunding campaign can demonstrate to follow-on investors that the startup has a motivated consumer base

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88. SEC REPORT, *supra* note 5, at 27.
89. *See id.* ("It is possible that smaller intermediaries may exit the crowdfunding market if they fail to attract sufficient deal flow to sustain their business model.").
90. CAPSTONE AND CAPSTONE PRESS STAFF, THE CAPSTONE ENCYCLOPEDIA OF BUSINESS 13 (2003) ("Angel investors are wealthy private individuals who invest in start-up companies, usually during the early stages of financing.").
91. Langevoort, *supra* note 19, at 19 (emphasis added).
92. Ibrahim, *The (Not So) Puzzling Behavior*, *supra* note 59, at 1439–1440 (angels invest both to earn a profit and to give back to the entrepreneurial community that made them successful).
93. *See* Jeffery Sohl, *The Angel Investor Market in 2017: Angels Remain Bullish for Seed and Start-Up Investing*, 16 CTR. FOR VENTURE RESEARCH 2 (noting that average angel investments are around $388,860); *see also* Ibrahim, *The (Not So) Puzzling Behavior*, *supra* note 59, at 1418 ("A typical angel round ranges from $100,000 to $1 million or even $2 million . . . ."). As noted earlier, the average crowdfunding target amount is currently around $50,000. *See supra* note 10 and accompanying text.
94. *See* Darian M. Ibrahim, *Crowdfunding Signals*, 53 GEORGIA L. REV. 197, 222 (2018) (Under Regulation CF, "[t]he entrepreneur must put together disclosure, deal terms, and other information in a professional format, viewable on the Internet. This may not lead to a stronger product or service, but having to work with attorneys and accountants and describe what the company is doing can help the entrepreneur sharpen her strategy and explain it to others. A company willing to bear these costs at an early stage signals to investors that it is willing to 'do it right.'").

for its product or service,[95] as existing customers are likely to be the crowd that invests in the offering.[96]

C. Economic Risk and Legal Liability for Crowdfunding Underwriters

Despite the potential positives for funding portals or angels to serve as underwriter, two major concerns must be explored. First, the economics are probably not there to incentivize a funding portal or angel to underwrite crowdfunding. A firm-commitment underwriting of a $50,000 crowdfunding offering would only yield a potential upside of a few thousand dollars, but would carry theoretically a $50,000 risk if the underwriter could not subsequently resell. However, just like the modern firm-commitment IPO, this risk could be ameliorated if the underwriting agreement was not signed until subsequent purchase commitments were obtained.[97]

Potential legal liability that comes with serving as underwriter must also factor into the equation, however. Under Regulation CF's Section 4(A)(c), liability for crowdfunding misstatements and omissions lie with the "issuer," which is broadly defined to include "any person who offers or sells the security in such offering."[98] In an underwritten crowdfunding offering, "issuer" would most likely capture the underwriter as the actual seller of the security (the one who passes title).[99] Section 4(A)(c) liability lies for an issuer's innocent misrepresentations or omissions without plaintiffs needing to prove scienter, reliance, or loss causation.[100] In fact, Section 4(A)(c) liability explicitly resembles Section 12(a)(2) liability for public offerings.[101]

However, when it comes to the underwriter, a potentially thorny issue is whether the Supreme Court's 10b-5 restriction limiting liability to the actual "makers" of misstatements or omissions also applies under Section 4(A)(c).[102] Under one

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95. *Id.* at 220. ("[C]rowdfunding shows follow-on investors that the company has a real customer base and that there is demand for its product or service.").

96. *Id.* at 219 ("Who invests in crowdfunding campaigns? For companies selling consumer products or services, it is likely the company's customers. These customers use the company's product or service, like it, and think others will too.") (citation omitted).

97. *See supra* note 41 and accompanying text.

98. 15 U.S.C.S. § 77d-1. A statutory offeror is a solicitor for value, and most likely includes the funding portal hosting the offering. Pinter v. Dahl, 486 U.S. 622, 643–44 (1988) (articulating the statutory interpretation for section 12(1)).

99. Pinter v. Dahl, 486 U.S. 622, 643 (1988).

100. *See* Bradford, *supra* note 70, at 1183 (2018) (under 4(A)(c), the "investor does not have to prove that the fraud caused a loss."); *id.* at 1184 ("Section 4(A)(c) has no scienter requirement."); Mashburn, *supra* note 69, at 152 (Section 4(A)(c) plaintiff "does not have to prove reliance as required under Rule 10b-5").

101. Mashburn, *supra* note 69, at 151–57 (discussing that the liability created under 4(A)(c) is replicated as if under Section 12(a)(2) and further noting that Section 4(A)(c) provides liability for more than public offerings by replacing use of the sale of securities by prospectus with "by any means of any written or oral communication"); *see* Thompson & Langevoort, *supra* note 58, at 1607 (noting that imposing Section 12(a)(2)-like liability in crowdfunding offerings is an "interesting reversal of *Gustafson*," a Supreme Court case removing 12(a)(2) liability in private placements).

102. C. Steven Bradford, *Shooting the Messenger: The Liability of Crowdfunding Intermediaries for*

interpretation, the answer is no: an underwriter who did not help craft the issuer's crowdfunding disclosures would not be the "maker" of the issuer's misstatements or omissions for 4(A)(c) liability purposes.[103] But Steven Bradford sees reasons to read the liability more broadly under Section 4(A)(c).[104] Under his reading, underwriters could be liable for a startup's misstatements or omissions unless they took reasonable care to investigate them.[105] In other words, "underwriters" would be makers of an issuer's misstatements under this reading, but would have a Section 12(a)(2)-like due diligence defense.[106]

This potential specter of legal liability could chill a funding portal or angel's incentive to act as a crowdfunding underwriter.[107] This is particularly true considering that, as a practical matter, the underwriter would presumably have deeper pockets than a startup—especially one that goes belly up due to fraud.[108] On the other hand, underwriters would likely have conducted significant due diligence when deciding to invest. Because startups also have less to disclose, perhaps the due diligence an underwriter would do as a matter of course would suffice (as long as they reasonably investigate and confirm the crowdfunding disclosures).

In addition to the explicit Section 4(A)(c) private right of action for fraudulent crowdfunding disclosures, Rule 10b-5 liability is also available, but a more remote concern for underwriters given its scienter and other requirements.[109] The SEC could also bring action against crowdfunding issuers and underwriters for fraud.[110] But due to its limited resources and other priorities, crowdfunding may not be the SEC's top

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the Fraud of Others, 83 U. CIN. L. REV. 371, 395–97 (2014).

103. *Id.* at 396 (issuer is used twice in 4(A)(c), and if the statute is referring to the "same 'issuer' both times, then a crowdfunding intermediary would be liable only for false statements it made").

104. *Id.* (articulating that the two reasons being that 4(A)(c) expressly creates a private right of action, where 10b-5 does not, and 4(A)(6) uses the word issuer twice, and possibly differently).

105. Joan M. Heminway, *Crowdfunding and the Public/Private Divide in U.S. Securities Regulation*, 83 U. CIN. L. REV. 477, 495 (2014) ("Misstatements and omissions liability under the CROWDFUND Act does not include Section 11's strict liability protections, but it does incorporate a due diligence-like scheme based on Section 12(a)(2).").

106. *Id.*

107. *See generally* Dana B. Klinges, *Expanding the Liability of Managing Underwriters Under the Securities Act of 1933*, 53 FORDHAM L. REV. 1063 (1985).

108. Professor Bradford thinks that the $1.07 million maximum offering amount under Regulation CF will dissuade class action lawyers from pursuing 4(A)(c) liability. *See* Bradford, *supra* note 70, at 1168–69. However, should an angel or VC with deep pockets stand as the defendant, plaintiff's lawyers may take more interest.

109. 10b-5 liability potentially lies for any securities transaction, although *Janus Capital Group v. First Derivative Traders*, 564 U.S. 135 (2011), would potentially limit its applicability to underwriters who did not prepare the startup's disclosure materials. William K. Sjostrom, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C.L. REV. 639, 648–49 (2009) (Rule 10b-5 applies to "all sales of securities, whether by a public or private company").

110. Bradford, *supra* note 70, at 1181 ("One option is public enforcement [of Regulation CF]. The SEC can bring an action under a number of federal antifraud protections.").

priority.[111] So far, there have been few enforcement actions against startups under Regulation CF.[112] According to the SEC's 2019 report, "a search of publicly available information in the Commission's litigation releases has not identified civil complaints or administrative proceedings filed against Regulation Crowdfunding issuers or intermediaries."[113] Thus, Section 4(A)(c) is the most likely area of legal concern for crowdfunding underwriters.

V. The Legal Changes Needed to Permit Underwritten Crowdfunding Offerings

The incentive and liability issues discussed above would need to be resolved or else there would be no underwriters. Still, for completeness, this Essay looks ahead to Regulation CF changes that would be needed to permit underwritings.[114] This Part will detail three main areas where removing certain restrictions would allow for firm-commitment type underwritten crowdfunding offerings.

The first change is broadening who can sell in a crowdfunding offering under Regulation CF.[115] Currently, Regulation CF restricts use of the exemption to "issuers."[116] This Essay's proposal could only be effectuated if underwriters were also allowed to sell through a funding portal under the Regulation CF exemption. Second, the $107,000-per-year investment limit for angels or other parties acting as underwriters would need to be removed for larger offerings.[117] Third, Regulation CF generally puts a twelve-month resale restriction on securities purchased in a crowdfunding offering.[118] To mimic a firm-commitment IPO, underwriters would need to be allowed to resell securities to the crowd immediately. Each of these proposed changes will be discussed below.

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111. *Id.* at 1181–82 ("The SEC has limited resources for enforcement and, because of the small amounts involved, crowdfunding is unlikely to be one of its enforcement priorities."); *id.* at 1182 ("The SEC could get a bigger bang for its enforcement buck elsewhere.").

112. SEC REPORT, *supra* note 5, at 5 (noting, however, that "this inference is inherently limited by the potential latency of misconduct as well as a relatively short period of observation").

113. SEC REPORT, *supra* note 5, at 42 ("One state reported two instances where the state regulator alerted an issuer about potentially misleading statements or content in their offering materials.").

114. I am not the first to suggest some revamping of Regulation CF, although the prior proposals did not contemplate importing the underwriting process to this context. *See* Jo Won, *Jumpstart Regulation Crowdfunding: What is Wrong and How to Fix It*, 22 LEWIS & CLARK L. REV. 1393, 1405–21 (2018); *see also* Thomas Coke, *Why the New Crowdfunding Rules are Important but Ultimately a Letdown*, 17 J. BUS. & SEC. L. 217, 218 (2017) (discussing the "Fix Crowdfunding Act" that was pending at the time of that Article's publication).

115. 17 C.F.R. § 227.100.

116. 17 C.F.R. § 227.100(a) ("Exception. An *issuer* may offer or sell securities in reliance on Section 4(a)(b).") (emphasis added).

117. 17 C.F.R. § 227.100(a)(2).

118. 17 C.F.R. § 227.501 (securities sold under Regulation CF "may not be transferred by any purchaser of such securities during the one-year period beginning when the securities were issued").

A. Regulation CF Only Open to a Startup as an "Issuer"

Regulation CF only allows "issuers" to sell securities in a crowdfunding offering.[119] An issuer is defined as "every person who issues or proposes to issue any security," or anyone under the issuer's common control.[120] The technical definition of an underwriter, however, comes from Section 2(a)(11) of the 1933 Securities Act, and states that an underwriter is "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates, or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking."[121] To put in simpler terms, an underwriter is someone who buys securities with the purpose of reselling them. Thus, while the common perception of underwriters is a large investment bank such as Goldman Sachs, the definition is actually much broader.[122] Regulation CF should be specifically amended to clarify that underwriters may use the exemption.

B. Individual Investment Limits

Regulation CF limits how much an investor can invest in crowdfunding offerings in any given year.[123] The precise limits depend on different calculations and are not important for our purposes.[124] The important takeaway is that accredited investors

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119. 17 C.F.R. § 227.100. Regulation Crowdfunding added a new part to Section 4(a)(6) of the Securities Act, which "provides an exemption from the registration requirements of Securities Act Section 5 for certain crowdfunding transactions." To qualify for the exemption under Section 4(a)(6), crowdfunding transactions by an issuer (including all entities controlled by or under common control with the issuer) must meet specified requirements." Crowdfunding, 78 Fed. Reg. 66428, 66430 (Nov. 5, 2013). *See* Laila Sabagh, *The SEC's Regulation Crowdfunding: The Issuer's Dilemma*, 2. ADMIN. L. REV. ACCORD. 111, 120–21 (2017).

120. 15 U.S.C. § 77b(a)(4) ("[E]xcept that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors . . . or of the fixed, restricted management, or unity type, the term 'issuer' means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued . . . .").

121. 14 C.F.R. § 230.144.

122. CHOI & PRITCHARD, *supra* note 20, at 776 ("Section 2(a)(11) . . . captures far more than Wall Street investment banks as 'underwriters'.").

123. 17 C.F.R. § 227.100(a)(2). *See also* Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. 281, 305 (2014) (distinguishing accredited and unaccredited investors for crowdfunding purposes).

124. 17 C.F.R. § 227.100(a)(2)(i-ii) ("The aggregate amount of securities sold to any investor across all issuers in reliance on section 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)(6)) during the 12–month period preceding the date of such transaction, including the securities sold to such investor in such transaction, shall not exceed: The greater of $ 2,200 or 5 percent of the lesser of the investor's annual income or net worth if either the investor's annual income or net worth is less than $ 107,000; or 10 percent of the lesser of the investor's annual income or net worth, not to exceed an amount sold of $ 100,000, if both the

cannot invest more than $107,000 in crowdfunding in a given year (unaccredited investors less).[125] Accredited investors are any "natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000,"[126] or "[a]ny natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years."[127] The angels or other parties who would serve as underwriters would almost certainly meet this definition.

Regulatory investment accounts for individual investors are different than regulatory companies. They tackle risk in a different way.[128] Abraham Cable has argued that limiting risk for investors by investment size is not only good for crowdfunding, but could also provide a model for other financial regulation.[129] In crowdfunding, there is an "increased speculative risk in connection with whether the venture succeeds at all, as well as the increased illiquidity associated with investing in a company not listed on a stock exchange."[130] Especially for unsophisticated members of the crowd, an investment limit can mitigate the adverse selection effects of risky investment opportunities.

For accredited investors, however, the investment limits are more problematic. Accredited investors get special rules in other contexts because they are either better at selecting investments or can absorb losses better.[131] The SEC's report on crowdfunding's first three years notes that "[s]everal market participants and the 2017 and 2018 Small Business Forums recommended that the investment limits [in Regulation CF]

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investor's annual income and net worth are equal to or more than $ 107,000.").

125. *See* U.S. SECURITIES AND EXCHANGE COMM., *Updated Investor Bulletin: Crowdfunding for Investors* (May 10, 2017), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html (hereinafter SEC INVESTOR BULLETIN).

126. 17 C.F.R. § 230.501(a)(5). *See also* Howard Marks, *What Is Equity Crowdfunding?*, FORBES (Dec. 19, 2018, 8:00 AM), https://www.forbes.com/sites/howardmarks/2018/12/19/what-is-equity-crowdfunding (defining accredited investors as "those who have a net worth of more than $1 [million], excluding their home, or those who make over $200 [thousand] annually over the past two years"). There are other types of accredited investors beyond individuals as well. *See* 17 C.F.R. § 230.501(1–4), (7–8) (including banks, brokers or dealers, "private business development company[ies]," "[a]ny organization[s] described in section 501(c)(3)," directors, executive officers, or general partners of the issuer of the securities, trusts with total assets in excess of $5,000,000, or "any entity in which all of the equity owners are accredited investors").

127. 17 C.F.R. § 230.501(a)(6).

128. *See id.*

129. *See generally* Cable, *supra* note 63 (finding redeeming qualities in the investment caps and suggesting they might be useful in other areas of securities regulation). Importantly, this Essay only argues for removing investment caps under Regulation CF for accredited investors or funding portals serving as crowdfunding underwriters. The caps would still be in place for follow-on investors or non-underwritten crowdfunding offerings.

130. *See id.*

131. *See, e.g.*, U.S. SECURITIES & EXCHANGE COMM., *Report on the Review of the Definition of "Accredited Investor"* (Dec. 18, 2015), https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf; Coke, *supra* note 114, at 221 (discussing the investor limits as one of three major flaws in Regulation CF).

not apply to accredited investors, who face no such limits under other exemptions."[132] Ultimately, the limits mean "that a large swath of capital that is theoretically accessible is actually lopped off and will remain in other types of investments for the accredited investor only class."[133] The report also concluded that "conducting a separate Regulation D offering to allow accredited investors to invest greater amounts was unnecessarily confusing to investors and more costly to issuers."[134]

This Essay only goes so far as to recommend that accredited investors who serve as a crowdfunding underwriter face no investment limits. While the investment limits would not practically matter if the average crowdfunding offering size remains around $50,000, if crowdfunding becomes more popular or the subject of larger offerings, the investment limit would need to be relaxed for underwritten offerings.

C. Resale Restriction Removal

The final change to Regulation CF involves its current resale restriction. Regulation CF expressly prohibits the resale of securities purchased in a crowdfunding offering for a year.[135] There are six exceptions to the resale restriction.[136] A person can resell the shares within a year if that person is selling the shares (1) to the company that issued the securities; (2) to an accredited investor; (3) to a family member; (4) in connection with the purchaser's death or divorce or other similar circumstance; (5) to a trust controlled by the purchaser or a trust created for the benefit of a family member;[137] or (6) as a part of an offering registered with the SEC.[138]

The second exception—resale to other accredited investors—is likely insufficient to permit resales in this context, as underwriters would likely be reselling to the crowd of unaccredited investors. Adding a seventh exception to the one-year resale restriction—"(7) to anyone so long as the shares are being resold by an underwriter who purchased all of the available securities from the issuer"—would allow underwritten crowdfunding offerings to mimic firm-commitment IPOs.[139]

132. SEC REPORT, *supra* note 5, at 41.

133. Coke, *supra* note 114, at 221–22.

134. SEC REPORT, *supra* note 5, at 41–42.

135. 17 C.F.R. § 227.501.

136. *Id.*

137. *See* SEC INVESTOR BULLETIN, *supra* note 124 ("[F]amily member is defined as a child, stepchild, grandchild, parent, stepparent, grandparent, spouse or spousal equivalent, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, including adoptive relationships.").

138. 17 C.F.R. § 227.501; SEC INVESTOR BULLETIN, *supra* note 124.

139. To avoid gaming the securities laws, which are designed to prohibit an underwriter aiding an issuer by purchasing and immediately reselling without being subject to the issuer's restrictions, the underwriter could not be an affiliate of the issuer. JAMES D. COX, ET AL., SECURITIES REGULATION: CASES AND MATERIALS 245 (8th ed. 2017) ("Those who actively promote the sale of unregistered securities certainly are not a favored species under the Securities Act. The sweeping definition of underwriter in Section 2(a)(11) assures this result.").

VI. Conclusion

Underwriting is a process that has worked well in IPOs. Underwriters serve as valuable reputational intermediaries between companies and public investors. Crowdfunding is an area in dire need of reputational intermediaries to signal quality among the nascent startups seeking funding from the crowd. This Essay therefore considers importing firm-commitment underwriting into the crowdfunding process. If the economics could work to incentivize an underwriter to serve, including answering thorny liability questions, the advantages could make crowdfunding a more viable path to startup financing than it is today.