NOT ALL THAT GLITTERS IS GOLD – LIMITATIONS OF EQUITY CROWDFUNDING REGULATIONS

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INTRODUCTION

Many startup companies have aspirations of being a Fortune 500 company, but without adequate access to funding many companies will neither maximize their potential nor meet their business objectives.[1] The World Bank publishes an annual report on conducting business throughout the world, stating

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1. *See Generally* Jeanee Bell & Marla Corneilus, *Underdeveloped: A National Study of Challenges Facing Nonprofit Fundraising*, https://www.compasspoint.org/

which countries are best for starting a new business.[2] One of the major factors in the World Bank's ranking of ease of doing business is the ease and reliability of getting credit and access to funding.[3] While some companies have extremely successful capital raising events, such as Twitter, which sold 70 million shares for $26 each in its Initial Public Offering ("IPO") in November 2013.[4] At the end of the first day of trading, Twitter shares closed at $44.90 per share.[5] Through its IPO, Twitter managed to raise more than $1.82 billion, the largest IPO by a technology company since Facebook's IPO in 2012.[6] However, most companies do not follow in the footsteps of Twitter. In fact, startup businesses have a high failure rate with half closing up shop within the first five years of opening.[7] Of the startup businesses that survive, the chances of going public are bleak.[8] However, innovation has not been limited to the technology world; new strategies, business models, and techniques are being

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sites/default/files/images/UnderDeveloped_CompassPoint_HaasJrFund_January%202013.pdf (Jan. 2013) (discussing the challenges non-profits face when raising money and the impact it has on their ability to meet their objectives).

2. The World Bank & Intl. Fin. Corp., *Doing Business in a More Transparent World*, http://www.doingbusiness.org/~/media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB12-FullReport.pdf (2012).

3. The World Bank & Intl. Fin. Corp., *Doing Business, Measuring Business Regulations, Economy Rankings*, http://www.doingbusiness.org/rankings (March 13, 2014) (ranking the U.S. as number 3 for getting credit).

4. Steve Schaefer, *Twitter Stock Pops in NYSE Debut, Finishes First Day With 73% Gain*, shttp://www.forbes.com/sites/steveschaefer/2013/11/07/twitter-opens-at-45-10-stock-pops-73-in-nyse-debut/, Forbes (Nov. 7, 2013) (chronicling the trading activity post the initial public offering of Twitter).

5. *Id.*

6. Lee Spears and Sarah Frier, *Twitter Raises $1.82 Billion Pricing IPON Above Offer Range*, Bloomberg.com, November 6, 2013, http://www.Bloomberg.com/news/2013-11-06/twitter-raises-1-82-billion-pricing-ipo-above-offering-range.html (discussing Twitter's successful IPO).

7. *See* United States Department of Labor, *Business Employment Dynamics: Entrepreneurship and the U.S. Economy*, http://www.bls.gov/bdm/entrepreneurship/bdm_chart3.htm, Bureau of Labor Statistics (last accessed Dec. 11, 2013) (indicating that the survival rate of establishments after 5 years of opening was 49.3% in 2006). *See also Startup Business Failure Rate by Industry*, http://www.statisticbrain.com/startup-failure-by-industry/, Statistic Brain (Jul. 27, 2013) (stating that the percentage of failed startups after 5 years of opening is fifty-five percent).

8. *See* Deborah Gage, *The Venture Capital Secret: 3 Out of 4 Start-Ups Fail*,, http://online.wsj.com/news/articles/SB10000872396390443720204578004980476429190, The Wall Street Journal (Sept. 20, 2012), , (stating that, of the companies that were initially funded by venture capital between 2006 and 2011, eleven percent either were acquired or went public).

developed to increase access to funding for startup companies, expanding access to financial capital from merely traditional avenues such as IPOs and traditional bank loans.[9]

While IPOs can be enticing, the reality is that most companies do not have that option, as selling an ownership interest in one's company brings with it serious legal restrictions and monetary costs.[10] For example, the Sarbanes-Oxley Act of 2002 increased company costs to report under the new regulations.[11] Despite the prospects of going public, a new capital raising opportunity, referred to as "crowdfunding," is providing small businesses and startups with an alternate means of raising capital.[12] Kickstarter, a popular crowdfunding website, has seen over one billion dollars in total pledged dollars used to start over 58,000 different projects.[13] However, crowdfunding represents a departure from traditional forms of raising capital and brings with it new concerns and possibilities. In support of this new system, recent equity crowdfunding regulations could provide startup companies with the opportunity to issue equity to investors in exchange for capital contributions without having to go public or having to rely on other existing funding sources.[14]

This article examines the risks and benefits of equity crowdfunding and the proposed U.S. Securities and Exchange Commission ("SEC") crowdfunding rules mandated by Congress. Section I of this article sets forth the basic concept of equity crowdfunding and why it may be useful for small businesses. Section II examines alternative sources of funding and the history of crowdfunding including its use thus far and the more recent development of equity

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9. *See* John A. Pearce II & Jamie Hopkins, *Regulation of L3Cs for Social Entrepreneurship: A Prerequisite to Increase Utilization*, 92 Neb. L. Rev. 259, 260 (2013) (noting the benefits of a new business model designed to help socially beneficial companies raise capital through tranche investing).

10. *See* Jennifer Mercier Moseley, *Recent Developments in Securities Law, 2013 Leading Lawyers on Understanding Important Legislation and Complying with SEC Rules and Regulations: Challenges for Start-Up and Development Stage Companies and the Impact of the Jobs Act*, 2013 WL 5290490,1 (Oct. 2013) (discussing the legal restrictions on selling securities and the associated financial costs).

11. Pub.L. 107–204, 116 Stat. 745, enacted July 30, 2002.

12. See Paul Belleflamme, Thomas Lambert, and Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd*, 2 (Jul. 9, 2013) (Journal of Business Venturing, Forthcoming; International Conference of the French Finance Association (AFFI), May 11-13, 2011, available at http://ssrn.com/abstract=1836873) (stating that "crowdfunding has become a valuable alternative source of funding for entrepreneurs seeking external financing").

13. Kickstarter, *Kickstarter Stats,* https://www.kickstarter.com/help/stats (accessed Feb 13, 2014).

14. Crowdfunding, 78 Fed. Reg. 66427 (proposed Nov. 5, 2013), (*available at* https://www.federalregister.gov/articles/2013/11/05/2013-25355/crowdfunding) (proposing equity crowdfunding regulations required under Title III of the Jumpstart Our Business Startups Act).

crowdfunding regulations. Section III argues that the appropriate level of regulation is one that allows small businesses to participate in equity crowdfunding without extreme hardships. Section IV of this article discusses limitations of equity crowdfunding generally as well as limitations to the proposed rules surrounding equity crowdfunding. Lastly, Section V concludes this article by setting forth recommendations on how equity crowdfunding can be structured as to maximize the benefits without having an unregulated industry. Despite the potential benefits associated with equity crowdfunding and the need for some government oversight and investor protections, the proposed SEC crowdfunding rules will inhibit the usefulness of crowdfunding by increasing the costs associated with raising this form of capital investment and decreasing some of the initial value of crowdfunding for startup companies.