Crowdfunding Unequity in the United States

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This paper contends that crowdfunding "unequity"[2]—short-term financial interests in businesses or projects—holds promise in filling a gap in the U.S. small business finance market and argues for regulatory action in the United States to facilitate financing transactions of that kind. The idea of crowdfunding unequity emanates from experience in the U.S. crowdfunding market in the time preceding the legislative activity that led to the enactment of the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012, known as the CROWDFUND Act.[3] While crowdfunding unequity is not the financing answer for all business ventures, it may provide a needed missing link in the financing lifecycle of certain early-stage ventures.

Over the past six or so years, crowdfunding has rapidly become an alternative means of funding small businesses and entrepreneurial projects. A marriage of social networking and traditional funding methods, crowdfunding allows venture participants to use the Internet to find new funders and secure funds from them relatively quickly and efficiently. As a general matter, the business or project creates a webpage, most often on a crowdfunding website hosted by a third-party, and solicits funds in small units (e.g., $10 increments) from the veritable crowd—a disaggregated, diverse mass of Internet users. Thus, as originally conceived, the concept involved getting a little bit of financial capital from many different funders. This can be an attractive option for entrepreneurs who have exhausted their friends-and-family funding if traditional seed or angel funding is not then available or advisable.

In some countries, however, including the United States, securities laws have constrained the interests that can be offered to funders in crowdfunded offerings. Under U.S. federal law, offers and sales of securities must be registered unless an exemption is available.[4] Registration is a somewhat baroque, relatively lengthy, and expensive process, and until the adoption of the CROWDFUND Act, U.S. federal law did not include an exemption that applied to crowdfunded offerings of securities.[5] As a result, most U.S. crowdfunding has focused on financings that do not involve the offer and sale of securities.

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[2] Joan MacLeod Heminway, *What is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREPREN. BUS. L.J. 335, 360 (2012), *available at* http://ssrn.com/abstract=2210162.

[3] The CROWDFUND Act is Title III of the Jumpstart Our Business Startups Act (JOBS Act), landmark legislation deregulating various aspects of the public and private markets for securities offerings in the United States. *See* Jumpstart Our Business Startups Act §§ 301–05, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.).

[4] 15 U.S.C. § 77e (2012).

[5] *See* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 907-21 (2011), *available at* http://ssrn.com/abstract=1875584.

Business venturers desiring to secure funding from the crowd may engage funders in a variety of different ways, many of which do not implicate an offer or sale of securities. Venture participants may accept donations from benefactors—offering them only an altruistic benefit in return for their funding. This type of crowdfunding often is used in social enterprise (although social enterprise also uses other forms of crowdfunding[6]) and is referred to as "donation crowdfunding." They also may promise funders goods or services provided by the business. For example, an indie band or movie production firm might promise free or reduced-price tickets or preferred seating to funders as a token of gratitude. This type of crowdfunding often is labeled "reward crowdfunding." In addition, business venturers may solicit funds in the form of a pre-payment for the firm's product or service—to be delivered once the product or service has been fully developed (pre-purchase crowdfunding)—or may solicit non-interest bearing loans through a Web-based portal (microcredit crowdfunding). None of these funding transactions are offers or sales of securities under U.S. federal law.

Crowdfunded interests in a business or project are securities under U.S. federal law, however, if they involve a transaction in which the funder invests money in a common enterprise with the expectation of making a profit generated primarily from the efforts of others.[7] This set of criteria define an "investment contract," one of the instruments defined as a security in both the U.S. Securities Act of 1933, as amended (1933 Act), and the U.S. Securities Exchange Act of 1934, as amended. The investment contract definition comes from seminal decisional (judge-made) law in the United States, but the concept is rooted in the statutory law definition of a security (which also encompasses, e.g., traditional equity and debt instruments). Effectively, then, any crowdfunding interest in a business owned by someone else that involves a pooling of investor funds and the expectation of even a scintilla of pecuniary gain is a security under U.S. federal law. The broad definition of an investment contract has constrained crowdfunding's potential benefits to small businesses.

The CROWDFUND Act was proposed and enacted in the United States with the intent to allow small businesses to engage in securities crowdfunding without having to, among other things, go through the complex, expensive, time-consuming registration process under the 1933 Act. Specifically, the CROWDFUND Act includes an exemption from registration for crowdfunded securities offerings that are conducted under specific conditions. These conditions include mandatory disclosures, compliance with antifraud rules, and the involvement of an intermediary (a registered broker or funding portal, a new type of securities intermediary created under the CROWDFUND Act).[8] The U.S. Securities and Exchange Commission (SEC) is required to draft rules to implement the CROWDFUND

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[6] *See*, *e.g.*, Joan MacLeod Heminway, *To Be or Not to Be (a Security): Funding For-Profit Social Enterprises*, 25 REGENT L. REV. 299, 317, 324-35 (2013), *available at* http://ssrn.com/abstract=2256767.
[7] *Id.* at 885-906.
[8] *See* Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals under the CROWDFUND Act*, 13 U.C. DAVIS BUS. L.J. 177 (2013), *available at* http://ssrn.com/abstract=2293248.

Act and may add requirements to those provided in the CROWDFUND Act. Those SEC rules, although due at the beginning of 2013, are still being drafted. Only after adoption of the CROWDFUND Act rules by the SEC will securities crowdfunding be able to proceed in the United States without registration.

There are serious questions about whether the CROWDFUND Act, as approved by the U.S. Congress and signed into law by the President, can ever (regardless of the nature of the pending SEC rulemaking) be of any real help to the small businesses that may need it most. The cost of mandatory disclosure and potential fraud liability under new provisions in the Act, when added to the cost of retaining the required registered broker or funding portal, may be so significant that crowdfunding will be too expensive for many businesses and projects seeking funding (funding that is limited to $1,000,000 in a 12-month period). Even leaving aside these questions, however, one might logically ask why an entrepreneur would want to have the burden (at least potentially) of a significant number of registered equity or debt holders at an early stage in the business's development. Potential future financing sources—angel or venture capital investors, underwriters, bank landers—may view preexisting commitments to a significant number of funders negatively, putting entrepreneurs at a disadvantage in obtaining ongoing funding.

In the years preceding the enactment of the CROWDFUND Act in the United States, a number of crowdfunding websites began to host offerings of interests in businesses and projects that afforded funders a small share of the venture's revenues or profits for a short period of time (a year or two, generally, at most).[9] Funders were offered no "say" in the operation of the business whatsoever (although in some cases, they could volunteer to help promote the business, for instance).[10] These interests also might include some non-monetary reward (e.g., a promise of goods or services provided by the business). The financial attributes of these interests mimic short-term equity investments, but the instruments do not incorporate the management and control interests that equity instruments include. They are simple financial instruments with little overhang on the finances or operations of the venture being funded.

Although at first blush one might wonder why anyone would buy such an instrument (given that the small potential revenue or profit share would never be sufficient to allow an investor to recoup his or her initial investment), individuals bought these interests. It seems that, in large part, the same thing that attract s funders in non-securities crowdfunding appeals to funders in securities crowdfunding: the desire to support a small business that is doing something they appreciate. The small piece of "skin in the game" that investors get in crowdfunded unequity may enhance their desire to provide funding—supplying a premium on their altruism—making the cost-benefit calculation favoring funding a bit clearer. There is a potential market, then, for unequity.

Unequity, then, could be an instrument of choice for some early-stage businesses that plan to use crowdfunding to raise a small amount of money capital. In particular, businesses

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[9] Heminway, *supra* note 2, at 360.
[10] *See id.*

focusing on performance art, social enterprise, or small consumer products that either need very little development capital or need limited funding to reach a threshold of production that affords the venture access to more traditional capital funding sources may find crowdfunded unequity attractive. Investors also may find these unequity more attractive than participation in donation or reward-based crowdfunding.

The utility and attractiveness of crowdfunded unequity deserves further consideration. Accordingly, the U.S Congress or SEC should assist in enabling unequity crowdfunding, at least on a limited, pilot basis, by clearing regulatory barriers. If crowdfunding under the CROWDFUND Act is too expensive to attract the small businesses that could and would use unequity crowdfunding, then new legislative or regulatory efforts should be devoted to creating a more targeted, less expensive registration exemption for the crowdfunding of unequity. There are a number ways in which this facilitation could be structured.

This paper offers additional information on unequity's advantages in the market for small business capital funding and outlines steps that could be taken to permit cost-effective unequity crowdfunding for these ventures. Specifically, the paper traces the development of the market for unequity in the early years of crowdfunding and maps the attributes of unequity to various considerations in early-stage business finance to illustrate the potential viability of the market for crowdfunded unequity and its utility in the lifecycle of small-business capital finance. The paper then concludes by offering suggestions for facilitating unequity crowdfunding in the United States.