

PRICING DISCLOSURE: CROWDFUNDING'S CURIOUS CONUNDRUM

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Securities—financial investments—are weird. It is hard to know what they are worth. For example, Facebook went public for \$38 per share. Why not \$3.80 or \$380? Despite being clueless about their value, we buy securities all the time—directly and indirectly. Did we get a good deal, a solid investment, a fair price? Or was the price a departure from reality, a cognitive mistake, a fraud? What are investors told about this esoteric (and fundamental) question? As we move from highly regulated public offerings to lightly regulated “crowdfunding,” pricing disclosure in securities offerings—the subject of this article—becomes even more relevant.

In registered securities offerings to the public, investors receive prospectus disclosure about the pricing of the offered securities. It is the standard boilerplate that gives no clue of how the price for the offering has actually been set. Instead, as the standard disclosure intimates, pricing in such offerings happens behind the scenes in negotiations between the offering's managing underwriter and the issuer, using various valuation models, multiples and comparables and indications of market demand. That is, market intermediaries do the dirty work for public investors to ensure a modicum of price fairness.

In unregistered private offerings to sophisticated investors, price-related disclosure arises in the parties' negotiations and happens under the watchful eye of the antifraud standards of Rule 10b-5. Private investors (by virtue of their superior financial acumen) are assumed to be keenly aware of the pricing models and multiples that underlie their price negotiations. They typically receive detailed financial information, but only cursory explanations (if at all) of the valuation methods and assumptions used in pricing of the offered securities. This pricing disclosure reflects the general attitude in a private placement that investors are “on their own.”

In between these two methods of capital formation have been unregistered offerings to public investors—a wrinkle allowed under special

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SEC exemptions for small offerings of less than \$5 million (recently raised to \$50 million by the JOBS Act). Here the SEC requires additional pricing disclosure, reflecting the agency's view that there is no way unsophisticated investors can apply a DCF/CAPM analysis (whatever that means) to price a securities offering. But companies have hardly used these exemptions because they are chock-full of potholes, including liability concerns and a costly patchwork of state regulation.

But all of this changed earlier this year when Congress passed and President Obama signed the JOBS Act. JOBS is the Orwellian acronym for Jumpstart Our Business Startups, based on the legislation's questionable assumption that small businesses will hire new employees if the companies have greater access to securities investors. Among other things, the new law allows small companies to raise capital on the Internet—through something called crowdfunding—without the need for audited financials, compendious disclosure documents or typical underwriters.

To prevent the new law from becoming a license for securities scams, there are some interesting (and as yet untested) protections. For one, companies seeking crowdfunding can raise capital only through a securities firm or Internet portal; direct offerings by issuers are not allowed. For another, these intermediaries are to provide investors with “investor education” materials to prepare them for the risks of this new kind of investing. Finally, the new law creates a lower negligence threshold for antifraud liability, which applies both to the company raising the capital and the securities firm or portal serving as intermediary.

So here is the question for this article: what kind of price disclosure should companies (and their intermediaries) provide unsophisticated investors in a crowdfunding when the Internet starts to buzz with promises of “the next Google” or a local winery simply looks for funding beyond its local bank? My answer: in this context, the SEC in creating its crowdfunding disclosure rules and judges (or others who might resolve crowdfunding fraud claims) should see information on securities valuation/pricing as “material” (even “highly material”) and treat as fraudulent any failure by companies (and their intermediaries) to tell investors how they came up with a price of \$20/share or an interest rate of 12.3%. Not only will crowdfunding investors receive some assurance that the price they paid was connected to reality, but business entrepreneurs and crowdfunding intermediaries will be put through the steps of thinking about the offering and its price. That is, meaningful pricing disclosure in a crowdfunding—both as a matter of investor protection and to ensure efficient capital formation by small business—must get into the nitty-gritty of valuation methods and assumptions used in the offering. And, to be relevant to the reasonable crowdfunding investor, it's gotta be in plain English.

Simple enough. But there is a conundrum. Crowdfunding, as prescribed in the JOBS Act, can happen only in small packages—essentially capped at \$500,000 per offering given the requirement of an audit for offerings above this amount. Thus, even if the SEC and the courts accept my premise that pricing disclosure has to be ramped up for crowdfunding, it is unclear how enforcement of this heightened disclosure regime would happen. Public enforcement by the SEC would likely happen only in egregious cases, in view of the agency's limited resources and political preference to go after high-profile cases. Private enforcement by aggrieved investors would be a stretch, given the necessarily small amounts involved. The largest recovery in a crowdfunding fraud—at least under the federal securities laws—would likely be \$500,000, hardly justifying the attention of most class action lawyers.

So another necessary component of an effective regime of investor protection in crowdfunding, beyond meaningful standards of pricing disclosure, is a set of enforcement mechanisms less daunting and thus more effective than court litigation. Arbitration comes to mind. But this may be a panacea. Arbitration, predictably, would be designed by, for and of securities firms and the new crowdfunding portals—the repeat players in the game. Certainly, there is reason for caution given the way customer-broker arbitration has been captured by brokerage firms. More realistic may be some “guarantee” service offered by securities firms and the portals. In some respects, this was the solution (heightened liability for underwriters and auditors) devised in the Securities Act of 1933 to revive investor confidence in public offerings after the previous big financial crisis.

Here is how this article proceeds. First, I look at the dreary, parthenogenetic topic of the disclosure of pricing and valuation in securities offerings. I describe the SEC rules on the information investors receive about how securities have been priced—in registered public offerings, unregistered private placements and unregistered offerings to public investors. Second, I consider how the current liability schemes for securities offerings deal with false or misleading information about securities pricing, with particular attention to how liability hinges on investor sophistication. Third, I review the JOBS Act's disclosure and investor education provisions applicable in a crowdfunding offering, particularly regarding pricing issues. I then assert that the Act's new liability provisions should be understood to compel detailed (and investor-friendly) disclosure—as well as meaningful investor education—on the pricing of securities sold in a crowdfunding. Finally, I consider how such a liability scheme might work in practice, suggesting alternatives to court litigation to ensure full and fair pricing disclosure to crowdfunding investors.

I. PRICING DISCLOSURE IN SECURITIES OFFERINGS

SEC disclosure rules reflect the bifurcated regulatory world for securities offerings. Encompassing disclosure is generally required when securities are sold to public investors, while light (or even no) disclosure is the order of the day when securities are sold to private investors.

Issuers in registered offerings to public investors must disclose information about how the offered securities have been priced—particularly in offerings (such as initial public offerings) without a prior market. Although the SEC once urged issuers to describe the valuation methods behind their pricing decision, the SEC has come to accept a mostly desultory (boilerplate) listing of pricing factors. The assumption—though not articulated—seems to be that in registered offerings the presence of a managing underwriter and institutional investors makes meaningful pricing disclosure unnecessary. When such intermediation is not present, as in penny-stock offerings and offerings by blank-check companies, the SEC has required more fulsome pricing disclosure.

In unregistered public offerings, the SEC seems to assume that sophisticated investors can figure out whether an offering's pricing is fair. The SEC has not considered—in any analysis or study of investor behavior—how investors actually receive and process pricing disclosure. In unregistered public offerings, SEC rules give cursory and inconsistent recognition to the special needs of public investors in such offerings for pricing disclosure. The SEC, however, has noted the relevance in these offerings that intermediation may not be available in setting the offering's price.

In practice, issuers offer minimal disclosure on the pricing decision. In registered public offerings, investors receive opaque, boilerplate disclosure that lists multiple pricing factors, including that pricing happens in negotiations between the issuer and the managing underwriter. Pricing disclosure in unregistered offerings to public investors, even when subject to more demanding SEC disclosure rules, is often unhelpful. Even more opaque, though, is pricing disclosure in private offerings to which SEC disclosure rules do not apply, with issuers sometimes stating that pricing is a matter of judgment within the issuer's discretion.

A. *Pricing Disclosure in Registered Offerings*

Item 505(a) of Regulation S-K (Item 505)—as promulgated by the SEC in 1982—requires issuers of common equity in a registered offering to “describe the various factors considered in determining . . . offering price” when either (1) there is not an established public trading market, or (2) there is a material disparity between the offering price of the common

equity and the market price of outstanding shares of the same class.¹ Thus, SEC disclosure rules require that investors in an initial public offering (IPO) receive a list of the factors the issuer considered (but not the valuation method used) in setting the offering price.²

The requirement that pricing *factors* be disclosed, however, represents a dilution of prior disclosure guidelines—on which Item 505 is generally based—that called for issuers in an IPO to describe the *manner* in which the securities had been priced.³ Disclosure guidelines in the 1970s and 1980s called on issuers to give an overall valuation of the company and describe how the company had been valued, with specific reference to the valuation metrics (such as assets or earnings) that had been used.⁴

¹ Determination of Offering Price, 17 C.F.R. § 229.505 (2012). The same pricing disclosure rules apply regardless of the size of the issuer. *See* Smaller Reporting Company Regulatory Relief and Simplification, Securities Act Release No. 8876, Exchange Act Release No. 56,994, 17 Fed. Reg. 934, 934 (Jan. 4, 2008) (rescinding Regulation S-B and moving disclosure requirements for small issuers into Regulation S-K); *see also* Small Business Initiatives, Securities Act Release No. 6924, Exchange Act Release No. 30,468, 50 SEC Docket 1536, 1568 (Mar. 11, 1992). Previously, Item 505 of Regulation S-B, applicable to public offerings by small issuers, contained the same language as Item 505 of Regulation S-K (Item 505). *Id.*

² 17 C.F.R. § 229.505.

³ Item 505 was adopted in 1982 and consolidates disclosure guidelines that had been proposed by the SEC in 1980. *See* Proposed Revision of Regulation S-K and Proposed Rescission of Guide for Preparation and Filing of Registration Statements and Reports, Securities Act Release No. 6332, 23 SEC Docket 311, 320 (Aug. 18, 1981) [hereinafter Proposed Revision of Regulation S-K] (explaining that Item 505 is the consolidation of paragraphs (a)(8) and (c)(6) of proposed Item 45 of Securities Release No. 6276). And the proposed guidelines, specifically Proposed Item 45 dealing with disclosure of securities pricing, came from the now-rescinded SEC industry guides. *See* Industry Guide 5-Preparation of Prospectuses, Securities Act Release No. 6276, Exchange Act Release No. 17,399, 21 SEC Docket 1052, 1079 (Dec. 23, 1980) [hereinafter Guides Release] (“[I]n view of the significance of the disclosure required by Guide 5 with respect to first-time issues, the Commission is recommending the notes to Guide 5 which call for disclosure of an established trading market and the method of determining the offering price of first-time issues be added to proposed Item 45 . . .”). The only difference between Item 505 and the prior pricing-disclosure guideline is that Item 505 refers to common equity where there is no established market while the prior industry guideline applied to securities registered for the first time. *See* Proposed Revision of Regulation S-K, *supra*, at 320.

⁴ The proposed 1980 guidelines were SEC’s first major step toward implementing recommendations by an SEC advisory committee to re-evaluate the agency’s rules and regulations “to ‘keep the disclosure requirements current and effective and prevent the development of an encrusting layer of unnecessary and irrelevant information.’” Proposed Revision of Regulation S-K, *supra* note 3, at 312 (quoting

1. *Prior Guidelines on Pricing Disclosure*

According to pricing disclosure guidelines used by the SEC before its adoption of Regulation S-K (Reg S-K), disclosure in an IPO was to include "the manner in which the value of the securities has been estimated . . . with an appropriate caveat, e.g., that such assigned value may bear no relationship to the assets, earnings or other criteria of value applicable to the registrant."⁵ Disclosure of the manner by which an offering was priced, however, was dropped from Item 505 without explanation.⁶

The earlier SEC disclosure guidelines called on issuers in an IPO to identify risks of mispricing on the prospectus cover page, with a cross-reference to detailed disclosure on how the offering price had been determined.⁷ These guidelines were intended to discourage the use of stock

STAFF OF H. COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., REP. OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION 338 (Comm. Print 1977)); *see* Guides Release, *supra* note 3, at 1104.

⁵ Guides Release, *supra* note 3, at 1105. The language for Proposed Item 45(e)(2) seems to be based on similar language in Securities Act Release No. 5396, which amended Industry Guide 5. *Compare* Notice of Adoption of Guide 59 and Amendments to Guides 5 and 16 of the Guides for Preparation and Filing of Registration Statements Under the Securities Act of 1933, Securities Act Release No. 5396, 1 SEC Docket 16, 18 (June 1, 1973) [hereinafter Amendments to Guides 5 and 16] ("Guide 5 is amended by adding thereto, the following paragraphs There also should be included, with appropriate cross reference to disclosure elsewhere in the prospectus, a statement of the value placed on the outstanding securities as a result of the estimated price with appropriate caveats as to the reliability of such estimates. Such disclosure also should include . . . reference to the fact that such value may bear no relationship to the assets, earnings or other criteria of value applicable to the registrant."), *with* Guides Release, *supra* note 3, at 1105 (Language of Proposed Item 45(e)(2)(iii)) ("If no market exists for the subject securities, the manner in which the value of outstanding securities has been estimated should be set forth, together with appropriate caveat, e.g., that such assigned value may bear no relationship to the assets, earnings or other criteria of value applicable to the registrant.").

⁶ The SEC does not mention Proposed Item 45(e)(2) in later releases revising proposed items or adopting Item 505. *See* Proposed Revision of Regulation S-K, *supra* note 3 (next SEC release proposing further revisions); Adoption of Integrated Disclosure System, Securities Act Release No. 6383, Exchange Act Release No. 18,524, 24 SEC Docket 1262 (Mar. 3, 1982).

⁷ Contents of Prospectuses and to Guides for Preparation and Filing of Registration Statements, Securities Act Release No. 5278, 37 Fed. Reg. 15,985, 15,986 (Aug. 9, 1972). The Note following subsection (g) to Industry Guide 5 required an issuer of securities for which there has been no previous market to state this fact on the cover page in connection with identification of risks and they must include a cross-reference to further discussion in the prospectus regarding determination of offering price. *See id.*

phrases and boilerplate that offered little meaningful information.⁸ As the SEC explained, the guidelines required “bare bones statements be amplified by disclosure of factors that were considered in establishing the offering price” to indicate the how the price was set by the company or between negotiations of the company and underwriters.⁹

In a 1972 examination of “hot issues,” the SEC had commented on the “important responsibility [of underwriters] in the pricing of securities in an initial public offering.”¹⁰ According to the SEC, the managing underwriter must assure after due diligence that the price reflects the value of the securities “giving weight to, among other factors, such fundamentals as the business, operations, and prospects of the issuer and the nature and financial condition of the issuer.”¹¹ Significantly, the SEC recommended disclosure of the aggregate value of the securities and the relationship of this estimate to earnings, assets and other criteria of value with respect to the registrant.¹²

As the SEC explained, new companies must disclose “the method by which the price of the offering is to be determined” because “pricing of securities to be offered by new high risk ventures often results in an aggregate value placed on the outstanding shares . . . which bear little or no relationship to the issuer’s assets, earnings, or other criteria of value.”¹³ For example, the agency suggested issuers should give “some explanation . . . as to . . . whether a higher price to the public [compared to that paid by insiders] is based on subsequent financial progress or business developments.”¹⁴

⁸ U.S. SEC. & EXCH. COMM’N, 39TH ANNUAL REPORT, at 13 (1973) (Guide 5 . . . as amended, notes that stock phrases or ‘boiler plate’ relating to subjects such as the company’s chances of success or competition often do not often provide meaningful disclosure . . .”).

⁹ Amendments to Guides 5 and 16, *supra* note 5, at 16.

¹⁰ Hot Issues, Securities Act Release No. 5274, Exchange Act Release No. 9670, 37 Fed. Reg. 16,005, 16,006 (July 26, 1972).

¹¹ *Id.*

¹² *See id.* at 16,008. This language seems to be the foundation of the language used in Proposed Item 45(e)(2)(iii), which as noted, does not seem to have been incorporated in Regulation S-K. *See* Amendments to Guides 5 and 16, *supra* note 5, at 18 (amending Guide 5 to include relevant language); Guides Release, *supra* note 3, at 1105 (“If no market exists for the subject securities, the manner in which the value of outstanding securities has been estimated should be set forth, together with appropriate caveat, e.g., that such assigned value may bear no relationship to the assets, earnings or other criteria of value applicable to the registrant.”).

¹³ Registration Statements, Securities Act Release No. 5279, 37 Fed. Reg. 16,010, 16,010 (July 26, 1972).

¹⁴ *Id.*

Then in 1981, without explanation, the SEC moved away from this earlier approach focused on *pricing/valuation methods* to one focused on *pricing factors*. The apparent assumption of this move was that investors were adequately protected from mispricing by the operation of presumptively efficient securities markets, which in the 1980s were becoming increasingly institutionalized, and the negotiations between issuers and managing underwriters in public offerings, which served to ensure a fair market valuation of the offered securities.¹⁵

2. *Pricing Disclosure in Registered IPOs*

Despite the admonitions in the earlier SEC guidelines that issuers avoid boilerplate disclosure to IPO investors, this has become the dominant practice. Consider typical disclosure from the prospectus for the IPO of Netflix in 2002:

Before this offering, there has been no public market for our common stock. The initial public offering price was determined through negotiations among us and the representatives. In addition to prevailing market conditions, the factors considered in determining the initial public offering price are:

- the valuation multiples of publicly traded companies that the representatives believe to be comparable to us;
- our financial information;
- the history of, and the prospects for, its past and present operations, and the prospects for, and timing of, our future revenues;
- an assessment of our management, its past and present operations, and the prospects for, and timing of, our future revenues;
- the present state of our development; and
- the above factors in relation to market values and various valuation measures of other companies engaged in activities similar to ours.¹⁶

¹⁵ For example, the SEC assumed that unsophisticated investors were protected by efficient markets, making additional pricing disclosure superfluous. *See* Securities Act Concepts and Their Effects on Capital Formation, Securities Act Release No. 7314, Exchange Act Release No. 37,480, 62 SEC Docket 1046, 1049–52 (July 25, 1996) [hereinafter *Securities Act Concepts*]. And, in considering the need for pricing disclosure in penny-stock offerings, the SEC took the view that Item 505 provided adequate disclosure in a typical public offering. *See* Proposed Revision of Regulation S-K, *supra* note 3, at 320.

¹⁶ Netflix, Inc., Prospectus (Rule 424(b)(4)), at 78 (May 22, 2002).

This state of the art has passed muster with the SEC and its staff. In fact, the SEC has not given further guidance or interpretation of Item 505.¹⁷

3. *Pricing Disclosure in Low-Intermediation Registered IPOs*

The SEC, however, has not been oblivious to the importance of meaningful pricing disclosure when there is a lack of intermediation in registered public offerings. In its 1980 guidelines on disclosure in registered offerings, the SEC considered whether issuers of penny stocks (equity securities at under \$5.00/share) should be required to provide a signed letter “explaining the reasons for such a low stock price.”¹⁸ In adopting Reg S-K, the SEC concluded extra disclosure was not necessary for penny-stock offerings because “Item 505 will provide investors with adequate disclosure and . . . such additional requirements would be duplicative”¹⁹ But in 1989, the SEC returned to the question and concluded that the market for penny stock is frequently dominated by broker-dealers—“thereby permitting arbitrary pricing.”²⁰ Ultimately, the agency adopted rules requiring broker-dealers to provide investors in penny stock detailed information on the risks of investing in such stock, current market quotations and monthly statements showing the changes in market price of such stock held in a customer’s account.²¹

Further, in discussing new rules on blank-check companies (issuers of securities without a specific business plan for the proceeds), the SEC stated:

Ordinarily, the price at which securities are to be offered takes into account a number of factors, including book value, asset value, projected earnings, the price-earnings ratio of other companies in the same industry, and current market price. In an initial public offering, certain of these typical factors . . . are not available. Where an offering is made by a blank check company, objective pricing factors are scarce and pricing is largely arbitrarily determined.²²

¹⁷ See *Regulation S-K*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm> (last updated July 8, 2011).

¹⁸ See Guides Release, *supra* note 3, at 1064–65.

¹⁹ Proposed Revision of Regulation S-K, *supra* note 3, at 320.

²⁰ Sales Practice Requirements for Certain Low-Priced Securities, Exchange Act Release No. 27,160, 44 SEC Docket 600, 603 n.14 (Aug. 22, 1989).

²¹ 17 C.F.R. §§ 240.15g-1 to -100 (2011); Amendments to the Penny Stock Rules, Exchange Act Release No. 51,983, 70 Fed. Reg. 40,614, 40,614–33 (July 13, 2005).

²² Penny Stock Definition for Purposes of Blank Check Rule, Securities Act Release No. 7006, Exchange Act Release No. 32,575, 54 SEC Docket 1020, 1022 (July 2, 1993).

Based on this assessment, the SEC cautioned blank-check companies to “provide complete issuer disclosure to investors.”²³

B. Pricing Disclosure in Unregistered Offerings

Unregistered offerings are permitted if exempt from registration. Some exemptions—such as section 4(2) of the Securities Act (section 4(2)) for private placements—come free of specific disclosure requirements. Other exemptions—such as under Regulation A (Reg A) and Regulation D (Reg D)—impose a variety of conditions, including specific disclosure requirements.

Most unregistered offerings that occur under Reg D happen as Rule 506 offerings, given that the exemption imposes no dollar limits and preempts state blue sky registration requirements.²⁴ In addition, issuers generally open their Reg D offerings only to accredited investors, thus avoiding compliance with Reg D’s specific disclosure requirements.²⁵ Thus, most Reg D offerings do not—and need not—comply with the pricing disclosure rules that otherwise would apply to a registered offering or to one made under Rule 505 or 506 that included non-accredited investors.

Issuers using Rule 505 or 506 in offerings that include non-accredited investors—representing only about 9.7% of the total of such offerings—must provide the non-accredited investors with a disclosure document whose contents are specified in Reg D.²⁶ The requirements for pricing disclosure under Reg D vary. For offerings over \$7.5 million, the disclosure requirements are the same as those that apply to registered offerings—thus leaving investors, as we have seen, with only a list of pricing factors, without meaningful disclosure of the pricing/valuation methods used. For smaller offerings, the disclosure requirements track the regime laid out in Reg A for exempt *public* offerings.

²³ *Id.*

²⁴ See Rutheford B Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC’s Crown Jewel Exemptions*, 66 BUS. LAW. 919, 922 (2011). This was based on review of approximately 27,000 Form Ds filed between September 15, 2008 and October 18, 2010, finding that 94.0% of offerings were made under Rule 506, with only 1.6% under Rule 505. *See id.* at 926. Even though more than half of the Reg D offerings in the sample were for less than \$5 million—thus qualifying for Rule 505—issuers overwhelmingly chose Rule 506. *See id.*

²⁵ *See id.* at 929–30 (based on review of sample of 1000 Form D filings from September 15, 2010 to October 12, 2010, finding that 394 of 438 (90.0%) of offerings under \$5 million were made exclusively to accredited investors).

²⁶ 17 C.F.R. § 230.502(b)(2)(i)(D) (2012); *see also* Campbell, *supra* note 23, at 929 tbl.VI (based on review of 1000 Form D filings in 2010, finding that 91 of 941 (9.7%) of Rule 505 and 506 offerings included non-accredited investors).

Reg A, though itself rarely used,²⁷ provides some helpful guidance from the SEC on the level of pricing disclosure appropriate for public investors in the absence of intermediation. The SEC disclosure rules for these mini-registrations require that issuers provide information about how the offering's price compares to company earnings, revenues and assets.²⁸ It is the only time when the information that investors (of all stripes) hunger to know is actually required by SEC disclosure rule.

1. Pricing Disclosure in Private Placements

Offerings under section 4(2)—as well as its safe harbor Rule 506—do not require that investors receive specific disclosure, including of pricing. Thus, the only guidance to issuers on pricing disclosure comes by virtue of Rule 10b-5 and its liability scheme that creates a duty for the issuer to undertake complete and honest disclosure. The assumption is that sophisticated investors will fend for themselves, including by analyzing a company's prospects and financials to determine price fairness.

Not surprisingly, issuers undertaking private placements treat pricing disclosure as an afterthought. In a sampling of some recent private placements of different types of securities, the offering memos provide pricing disclosure that is desultory at best:

Example #1: The Company is offering ___ Units of Common Stock and Warrants, each Unit consisting of ___ share of Common Stock and ___ Warrants . . . The purchase price for each Unit is \$49,000.

Example #2: The exercise price for each Share is \$1.25. This price was determined by Management of the Company, in its sole judgment.

Example #3: Series A Preferred Stock – 5,000,000 shares. Price per share – \$0.50 . . . Risk Factor: The price of the Shares was determined arbitrarily and is not based on any empirical valuation. As a result, the price of the Shares may not represent the fair market value of such Shares.²⁹

²⁷ In a comprehensive study of the use of Regulation A, Professor Campbell found that the SEC received on average only eight filings under Regulation A annually from 1995–2004. See Rutheford B Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital,"* 31 DEL. J. CORP. L. 77, 83 (2006).

²⁸ U.S. SEC. & EXCH. COMM'N, FORM 1-A: OFFERING STATEMENT UNDER REGULATION A 10 (2012) [hereinafter FORM 1-A].

²⁹ Confidential private placement memos on file with author.

Nowhere do the memos identify the pricing model used in the offering (such as earnings multiples, adjusted book value, discounted cash flow) or the assumptions underlying the model used. Instead, private investors are forced to come to their own conclusions. *Caveat emptor* is the stated basis on which the privately placed securities are offered.

2. Pricing Disclosure in Exempt Public Offerings

Some registration exemptions permit offerings to public investors, provided they receive a specified disclosure document and other protections. For example, Rule 505 (unlike Rule 506, which requires investor sophistication) permits offerings to non-accredited investors who lack sophistication—provided they receive a disclosure document.³⁰ Likewise, Reg A exempts offerings to public investors (now up to \$50 million following the Jumpstart Our Business Startups Act (JOBS Act)) from full-blown registration if the issuer complies with disclosure and other requirements—a *de facto* mini-registration. In both situations, the offering can be made to unsophisticated investors, without the protective presence of intermediaries or other sophisticated investors.

Reg D-exempt public offerings. Non-accredited investors in a Rule 505 offering must receive a disclosure document, ostensibly with pricing disclosure. If the issuer qualifies for Reg A, disclosure must comply with Form 1-A.³¹ If not eligible for Reg A, issuers must provide investors a disclosure document that conforms to Form S-1, the registration statement filed in a registered offering.³²

Curiously, for Rule 505 issuers that do not qualify for Reg A disclosure, the pricing disclosure required in their offering largely tracks that required in a registered public offering—that is, there is virtually no recognition of the need for pricing guidance to unsophisticated, non-accredited investors when the offering lacks meaningful intermediation. For Rule 505 offerings, financial disclosure varies depending on the offering amount. For offerings up to \$2 million, the issuer must provide the information required in Article 8 of Regulation S-X.³³ Pricing disclosure in

³⁰ Regulation D, Item 502(b)(2)(i) requires issuers of offerings under Rule 505 or Rule 506 not subject to the reporting requirements of section 13 or 15(d) to disclose specific information about their business and the securities offered to all non-accredited purchasers. 17 C.F.R. § 230.502(a), (b)(2)(i).

³¹ *Id.* § 230.502(b)(2)(i)(A).

³² *Id.*

³³ *Id.* § 230.502(b)(2)(i)(B)(1); *see also* Smaller Reporting Company Regulatory Relief and Simplification, Securities Act Release No. 8876, Exchange Act Release No. 56,994, 92 SEC Docket 436, 440 (Dec. 19, 2007) (explaining that Article 8 of Regulation S-X contains scaled disclosure requirements and generally limits the number of years of information provided based on the size of the company).

offerings between \$2 million and \$7.5 million is that required under Form S-1—namely, the listing of pricing factors required by Item 505 of Reg S-K, without any need to describe the pricing methodology.³⁴ The same reference to Form S-1 is also true for offerings above \$7.5 million (necessarily under Rule 506, given that Rule 505 has a \$5 million cap).³⁵

Although the SEC has interpreted the Reg D disclosure regime to require that investors be furnished information “to the extent material to the understanding of the issuer, its business, and the securities being offered,” the SEC’s interpretive guidance is noticeably silent on the question of pricing disclosure.³⁶ In a concept release, the SEC has raised the question whether sophisticated investors need as much disclosure as unsophisticated investors where there is no efficient capital market for the pricing of the offered securities.³⁷ But the agency has never answered the question with respect to pricing disclosure in exempt public offerings under Reg D.

In practice, pricing disclosure under the Reg D disclosure rules is the exception. Most Reg D offerings are made exclusively to accredited investors, exempting the offering from the Reg D disclosure requirements.³⁸ In addition, most smaller Reg D offerings under \$5 million are made without intermediation by a securities firm acting as broker or underwriter.³⁹ Thus, investors in a Reg D offering, though mostly accredited, must fend for themselves in deciding whether the price of the offered securities is a fair one.

³⁴ 17 C.F.R. § 230.502(2)(i)(B)(2) (requiring financial disclosure based on Form S-1 for smaller reporting companies); see HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *SECURITIES AND FEDERAL CORPORATE LAW* § 29:2.1 (2d ed. 2008) (identifying that pricing disclosure in a Regulation D offering is under Item 505 of Regulation S-K).

³⁵ 17 C.F.R. § 230.502(b)(2)(i)(B)(3).

³⁶ See Interpretive Release on Regulation D, Securities Act Release No. 6455, 27 SEC Docket 347, 355 (Mar. 3, 1983) (interpreting disclosure requirements of Rule 502(b) of Regulation D). In addition, Rule 502(b)(2) requires all Regulation D issuers to provide “additional information to non-accredited investors [and] the opportunity for further investor inquiries . . .” *Id.* at 357.

³⁷ Securities Act Concepts, *supra* note 15, at 1050–51 (soliciting comments on whether “the broad dissemination of publicly available information regarding a company, which the ‘efficient market theory assume[s],’ is in fact a reality for most investors”). Further, the SEC questioned whether it mattered under the efficient market theory “if just sophisticated investors have this information?” *Id.* at 1051.

³⁸ See Campbell, *supra* note 24, at 929 tbl.VI (based on sample of 1000 Reg D filings from September to October 2010, finding that 885 (88.5%) were made exclusively to accredited investors).

³⁹ See *id.* at 931 tbl.IX (based on sample of 1000 Reg D filings during September and October 2010, finding that 49 of 552 (8.9%) of offerings below \$5 million involved a securities firm).

Reg A-exempt mini-registration. Reg A is designed to allow smaller issuers to raise capital without going through a full-blown registration, but instead in a less-exacting and less-costly mini-registration. The SEC regime for Reg A offerings assumes they will typically be made to unsophisticated public investors without protections that come from a market or the presence of sophisticated investors in the offerings. The pricing disclosure required under Reg A is generally the most complete and useful under the federal securities laws—though it still does not call for pricing analysis based on discounted cash flow, the most widely used method for securities valuation.

Reg A issuers must provide investors an Offering Circular, contained in Part II of Form 1-A.⁴⁰ Recognizing the special needs of Reg A investors, the SEC specifies that information in the Offering Circular must be “presented in a clear, concise and understandable manner.”⁴¹ Specifically, the SEC requires all corporate issuers to provide narrative disclosure based on Model A of the Offering Circular.⁴²

The Offering Price Factors section of Model A (Items 5–8) gives Reg A issuers guidance on making disclosures “relevant to the price at which the securities are being offered”—including after-tax earnings, price-earnings multiples and net tangible asset value.⁴³ The SEC states that the information is intended to allow potential investors to “consider whether or not the offering price . . . for the securit[y] is appropriate at the present stage of the Company’s development.”⁴⁴

Specifically, Item 5 asks for disclosure of the net, after-tax earnings for the last fiscal year, with losses shown in parenthesis.⁴⁵ Item 6 asks for the

⁴⁰ 17 C.F.R. § 239.90; *see also* FORM 1-A, *supra* note 28. All information in the offering circular is subject to the general requirements of Rule 252 on form and Rules 253 and 255 on content. *See* 17 C.F.R. § 230.252 (explaining that an offering statement consists of a facing sheet and contents must not be misleading); *id.* § 230.253 (explaining that an Offering Circular shall include narrative and financial information required by Form 1-A); *id.* § 230.255.

⁴¹ 17 C.F.R. § 230.253.

⁴² Small Business Initiatives, Securities Act Release No. 6949, Exchange Act Release No. 30,968, 51 SEC Docket 2154, 2201 (July 30, 1992).

⁴³ *Id.* at 2223. The financial information used in these price-relevant items must be consistent with the financial statements provided in Part F/S. *Id.* at 2224 (Instruction Note, Items 5–8). Part F/S of Form 1-A requires the issuer to provide financial statements prepared in accordance with the GAAP. *Id.* at 2221–22. These statements include the company’s balance sheet prepared within ninety days prior to filing the offering statement, statements of income, cash flows and stockholder equity for the two preceding fiscal years, specific financial statements of businesses to be acquired and pro forma financial information. *Id.* at 2223–24.

⁴⁴ *Id.* at 2224.

⁴⁵ *Id.* at 2223.

disclosure of the offering price as a multiple of earnings, if the issuer had profits, adjusted to reflect for any stock splits or recapitalizations.⁴⁶ Item 7(a) asks for disclosure of the net tangible book value of the issuer, defined as the “total assets (exclusive of copyrights, patents, goodwill, research and development costs and similar intangible items) minus total liabilities.”⁴⁷ Item 7(a) also requires disclosure of reasons for any pricing variation if the net tangible book value per share is substantially less than the offering price per share.⁴⁸ Item 7(b) requires disclosure about securities the issuer sold during the last twelve months, including the amount, number of purchasers, the relationship of those purchasers to the issuer, the price at which the securities were sold and the type of consideration received, if not cash.⁴⁹

Item 8(a) requires disclosure of the “percentage of . . . the Company . . . the investors in this offering have” assuming exercise of outstanding options, warrants or rights and conversion of convertible securities.⁵⁰ Item 8(b) requires disclosure of the “post-offering value” that management attributes to the issuer based on “the price per security set forth on the cover page”⁵¹

The Reg A pricing disclosures—not part of the disclosure requirements for registered offerings—were added by the SEC in 1980, clarifying the requirements of the Act’s Schedule I so that investors could “consider whether or not the offering price . . . for the securities is appropriate at the present stage”⁵² The ostensible purpose was to provide investors “a more complete document at the time of filing with the Commission,” to ease the burden on issuers to identify material information needed by unsophisticated public investors in the absence of protective intermediation.⁵³ While SEC staff has offered interpretive guidance on

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ Small Business Initiatives, *supra* note 42, at 2223.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* at 2224.

⁵² *Id.*; *see also* The Small Offering Exemption from Registration Requirements, Securities Act Release No. 6275, 21 SEC Docket 1024, 1028 (Dec. 23, 1980); Notice of Proposed Revision and Consolidation of Regulation A and Regulation D, Securities Act Release No. 3613, 21 Fed. Reg. 1147 (Feb. 18, 1956) (showing Schedule I simply listed information needed in the Offering Circular, but did not give explanations to issuers or require disclosure of information to allow an investors to determine specifically whether the security is correctly priced).

⁵³ The Small Offering Exemption from Regulation Requirements, *supra* note 52, at 1028.

aspects of Form 1-A, it has not interpreted the offering price factors that are to be disclosed in the Offering Circular.⁵⁴

In practice, however, Reg A has not become the mini-registration workhorse for exempt public offerings that some expected.⁵⁵ Despite some fanfare in the early 1990s that Reg A might be used to facilitate Internet offerings to public investors, it never panned out. In its 1998 review of the regulation applicable to securities offerings, the SEC commented that though the disclosure requirements in a Reg A offering were less extensive than those applicable to small issuers under Regulation S-B, only a small number of reporting small issuers actually use Form 1-A.⁵⁶ Professor Campbell arrived at the same conclusion in his extensive study of the use of the SEC's offering exemptions.⁵⁷ Small issuers that might qualify to use Reg A frequently choose Rule 506 under Reg D, given the latter's preemption of state blue sky registration requirements.⁵⁸ The lesson: for small public offerings to be feasible, they must receive significant regulatory dispensations, particularly from mandatory *ex ante* disclosure and auditing requirements.

II. PRICING DISCLOSURE IN CROWDFUNDING

The JOBS Act of 2012 opens a new chapter in the regulation of securities offerings. It introduces the possibility for small issuers to use the Internet to access capital ("funding") from public investors (the "crowd")—at far lower cost than in a registered offering and with fewer regulatory burdens than in an exempt unregistered offering. As a practical matter, "crowdfunding"—in its current form—will be effectively capped at

⁵⁴ *Questions and Answers of General Applicability*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/divisions/corpfin/guidance/safinterp.htm> (last updated Sept. 17, 2010) (Question 228.01). The lack of interpretation may be because the SEC has stated "the textual disclosure requirements of Part II—Offering Circular are essentially self-explanatory." The Small Offering Exemption from Registration Requirements, *supra* note 52, at 1028.

⁵⁵ In a comprehensive study of the use of Regulation A, Professor Campbell found that the SEC received on average only eight filings under Regulation A annually from 1995–2004. See Campbell, *supra* note 27, at 83.

⁵⁶ The Regulation of Securities Offerings, Securities Act Release No. 7606, Exchange Act Release No. 40,632, Investment Company Act Release No. 23,519, 68 SEC Docket 835, 865 (Nov. 3, 1998) (explaining that small business issuers who provide non-financial statement disclosure based on Form 1-A, instead of Regulation S-B are called "transitional small business issuers").

⁵⁷ Campbell, *supra* note 27, at 83 (finding only eight filings per year under Regulation A during the period from 1995–2004).

⁵⁸ See Campbell, *supra* note 24, at 934–38.

\$500,000, with individual investors limited in the amount they can invest based on their annual income.⁵⁹

Despite its promise, crowdfunding under the JOBS Act could fizzle or bomb. There is a chance that crowdfunding intermediaries—a mandated element under the new law—will not want to undertake the liability risks imposed on them.⁶⁰ There is also a chance that crowdfunding will become a tool for Internet frauds and scams, at first harming investors and eventually scaring them away.⁶¹

⁵⁹ Investors whose annual income or net worth is below \$100,000 may invest the greater of \$2000 or 5% of their annual income or net worth in a twelve-month period. Jumpstart Our Business Startups Act § 302(a), Pub. L. No. 112-106, 126 Stat 315 (2012) (to be codified at 15 U.S.C. § 77d(a)(6)(B)). Investors with an annual income or net worth exceeding \$100,000 may invest 10% of their annual income or net worth up to a \$10,000 maximum per twelve months. *Id.* The Act's language is ambiguous as to how the maximum amount allowed for investment will be calculated. See Steven C. Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. (forthcoming Fall 2012), available at <http://ssrn.com/abstract=2066088>. The statute is unclear whether the limits are calculated based on the greater or lesser of annual income or net worth. For example, if annual income is \$150,000 but net worth is \$75,000, will the maximum be 5% of net worth or 10% of annual income?

⁶⁰ A person acting as an intermediary in a crowdfunding will likely fall within the definition of an "underwriter," even if the person is not a traditional securities professional. 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, 1760 & n.148 (2012) ("The term 'underwriter' means 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 . . ." (citing 15 U.S.C. § 77b(a)(11))); see also Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1439 (2012) (explaining that no one may choose to become an intermediary because of the mandated requirements and liability attached to the undertaking).

⁶¹ For example, the SEC has already received an advertisement soliciting crowdfunding investors for a company whose promoter estimates a market value "in excess of \$1 trillion" (twice the size of Apple, Inc.) that will bring a return on investment of "100 times [investment] in 1-to-3 years and 1,000 times by holding for 3-to-10 years." See Jonathon Weil, *Crowdfunding and the Greatest Investment Opportunity EVER!!!*, BLOOMBERG VIEW (Apr. 23, 2012, 5:18 PM), <http://www.bloomberg.com/news/2012-04-23/crowdfunding-and-the-greatest-investment-opportunity-ever-.html>. Criticism of the House Bill's crowdfunding provisions, which provided for neither disclosure nor accountability, was withering. See Emily Chasan, *SEC Advisory Group Stews over Crowdfunding*, CFO J. (Feb. 2, 2012, 4:57 PM), <http://blogs.wsj.com/cfo/2012/02/02/sec-advisory-group-stews-over-crowdfunding-dangers/> (explaining that the SEC's Advisory Committee on Small

Thus, critical to crowdfunding's future is whether the liability scheme introduced in the JOBS Act will be able to navigate between over- and under-vigilance. The liability scheme, loosely drawn from the one applicable to participants in a registered public offering, would seem to impose due diligence and materiality standards that could well be the drivers for disclosure in a crowdfunded offering.

If so, how pricing information is disclosed to crowdfunding investors—by definition, public investors lacking in sophistication⁶² and without the intermediation created by the presence of underwriters or institutional investors—will be a critical aspect of crowdfunding's success or failure.⁶³ SEC disclosure rules for non-intermediated public offerings, particularly under Reg A, offer some ideas on what pricing disclosure might look like in this new financing space. In addition, securities fraud litigation that has grappled with the contextual nature of “materiality” and the relevance of investor non-sophistication in exempt offerings offers guidance in formulating a workable crowdfunding liability regime.

In the end, it seems inescapable that pricing disclosure—of the valuation model used by the issuer and the assumptions built into the

and Emerging Companies worried it would be “too easy for businesses to commit fraud in crowdfunding scenarios”); Steven M. Davidoff, *From Congress, a Law Befitting a Sausage Factory*, N.Y. TIMES DEALBOOK (Apr. 3, 2012, 4:18 PM), <http://dealbook.nytimes.com/2012/04/03/from-congress-a-law-befitting-a-sausage-factory/?ref=todayspaper> (“There is real risk that Congress’s actions could harm the market. People pay more for American stocks than they would for those in other countries because we have enhanced antifraud rules. If investors lose faith in the United States market, stocks may decline in value.”).

⁶² A recent study by the SEC, mandated by section 917 of the Dodd-Frank Act, confirms this assumption. The study found that retail investors in the United States do not understand basic and critical financial concepts, such as compound interest, inflation, diversification or even the difference between stocks and bonds. See U.S. SEC. & EXCH. COMM’N, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS iii–iv (Aug. 2012) [hereinafter FINANCIAL LITERACY STUDY]. The study further found that the lack of this critical knowledge reduced the ability of investors to protect themselves from investment fraud and recommends methods to increase financial literacy among retail investors. See *id.* at iii–vii.

⁶³ See Hazen, *supra* note 60, at 1754 (explaining that meaningful disclosure must be part of any proposal attempting to strike a balance between investor protection and the desire to encourage small business financing). *But see* Bradford, *supra* note 59, at 25 (explaining that major flaws of the crowdfunding exemption include complicated and excessive disclosure requirements as well as the expectation that entrepreneurs have advanced understanding of corporate finance to properly disclose relevant information). For example, as Professor Bradford points out, new section 4A(b)(1)(H)(iv) requires companies using crowdfunding to explain to investors about “how the securities being offered are being valued,” requiring entrepreneurs to have sufficient knowledge of corporate finance to describe valuations. *Id.*

model—is material to investors in an offering, where the investors lack sophistication and valuation/pricing intermediaries are absent. Thus, failure to provide such disclosure would constitute a material omission on which a cause of action could be based to seek recovery of losses after a failed (essentially, mispriced) offering.

A. Crowdfunding Mechanism

The JOBS Act was signed into law in April 2012 with a lofty goal: to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.⁶⁴ In general, the JOBS Act seeks to increase access to public markets for a new category of issuer (the “emerging growth company”), reduce restrictions for all issuers using Reg D and Rule 144A, expand the use of Reg A and create new financing opportunities for small businesses through the crowdfunding mechanism.⁶⁵ The most controversial of these initiatives in the strongly bipartisan legislation, and the only one that underwent significant amendment after it passed the House, was Title III, “Crowdfunding.”⁶⁶

The hope of the JOBS Act’s crowdfunding mechanism is to give small businesses (and potentially some larger businesses) greater access to capital by making online securities offerings to a large number of investors—at greatly reduced costs by avoiding many of SEC registration requirements.⁶⁷ Crowdfunding originated in the United States not as an “investment” model, but rather through a “donational” one in which individuals gave money to fund various projects without expecting to receive profit or an

⁶⁴ Jumpstart Our Business Startups Act pmb., Pub. L. No. 112-106, 126 Stat. 306 (2012) (to be codified in scattered sections of 15 U.S.C.).

⁶⁵ Bruce Bennett et al., *The JOBS Act: New Rules for Emerging Growth Companies, Private Placements and “Crowdfunding,”* (Covington & Burling, LLP), Apr. 2, 2012, at 1. In addition, the JOBS Act requires intermediaries in a crowdfunding to provide investors with investor-education materials and disclosures regarding risks of investing in the offering. *Id.* at 8.

⁶⁶ DAVID A. CIFRINO ET AL., *THE IPO AND PUBLIC COMPANY PRIMER: A PRACTICAL GUIDE TO GOING PUBLIC, RAISING CAPITAL AND LIFE AS A PUBLIC COMPANY* 28 (2012).

⁶⁷ Joan Macleod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 880–81 (2010) (“As we use the term in this article, crowdfunding involves using a web-based business enterprise to seek and obtain incremental venture funds from the public using a website . . . to connect business or projects in need of funding . . . with potential funders.”); see also Paul Belleflamme et al., *Crowdfunding: Tapping the Right Crowd 2* (Apr. 25, 2012) (unpublished manuscript), available at <http://ssrn.com/abstract=1578175> (explaining that crowdfunding found its root in crowdsourcing, “which uses the crowd to obtain ideas, feedback and solutions in order to develop corporate activities. In the case of crowdfunding, the objective is to collect money for investment . . .” (citation omitted)).

ownership interest in the business in return.⁶⁸ Instead, “funders” often received returns on their donations in the form of samples of the completed product, tickets to the planned performances, credit in the film and so forth. Under this model, crowdfunded “issuers” were not offering securities and thus were not required to comply with SEC regulations.⁶⁹

As the popularity of crowdfunding grew, the pressure grew on regulators to allow for-profit crowdfunding and to create an exemption from SEC registration to encourage capital investment by “funders” seeking to earn a financial profit on their investment.⁷⁰ While commentators differed on the specific proposal that should be adopted, most agreed that a crowdfunding exemption would promote economic growth.⁷¹ Because crowdfunding offerings adopting an investment model most certainly constituted the sale of securities under federal securities laws,⁷² the SEC was forced to take action as companies tested the boundaries of the new model.⁷³ The push for an exemption from SEC registration requirements for crowdfunding reached a crescendo in late 2011 as commentators,

⁶⁸ CIFRINO ET AL., *supra* note 66, at 28.

⁶⁹ Bradford, *supra* note 59, at 3 (explaining that fundraising and charitable donations are not regulated under securities laws).

⁷⁰ See *Crowdfunding: Connecting Investors and Job Creation: Hearing Before the Subcomm. on TARP, Fin. Servs. & Bailouts of Pub. & Private Programs of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 5–6 (2011) (statement of Meredith Cross, Director, Division of Corporate Finance, U.S. Securities and Exchange Commission) (“Interest in crowdfunding as a capital raising strategy . . . is growing The staff has been discussing crowdfunding . . . with business owners, representatives of small business industry organizations and State regulators.”); Cohn, *supra* note 60, at 1436 (indicating that online crowdfunding was occurring in large amounts, prompting the legislature to address the “continued benign sweeping under the enforcement radar screen”).

⁷¹ *Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Sec., Ins., & Inv. of the S. Comm. on Banking, Hous. & Urban Affairs*, 112th Cong. 1 (2011) (statement of John C. Coates IV, Professor, Harvard Law School) [hereinafter *Hearing*] (“[T]he proposals under review all raise the same general trade-off, which is best understood not as economic growth vs. investor protection, but as increasing economic growth by reducing the costs of capital-raising vs. reducing economic-growth by raising the costs of capital raising . . . the proposals are thus all best viewed as proposals for risky but potentially valuable experiments, and should be treated as such—with an open mind, but also with caution and care.”).

⁷² *Sec. & Exch. Comm'n v. W. J. Howey Co.*, 328 U.S. 293, 298–99 (1946) (defining an investment contract as an investment in a common enterprise with an expectation of profits to be derived from the efforts of the promoter).

⁷³ See, e.g., Migliozi, Securities Act Release No. 9216, 2011 WL 2246317 (June 8, 2011) (cease and desist order issued to block fundraiser for Pabst Blue Ribbon Beer, in which each donor given certificate of ownership in company and beer equal to the amount of contribution).

regulators, legislators and even the White House urged for an exemption, which culminated in legislative action.⁷⁴

1. *Crowdfunding's Legislative History*

The House crowdfunding provisions sought to give small issuers access to “Main Street” money through the Internet with little regulatory interference, thus to stimulate job creation.⁷⁵ The Senate, however, concluded the House Bill lacked vital investor protections.⁷⁶ The Senate

⁷⁴ See Hazen, *supra* note 60, at 1750–51 (explaining several different proposals recommended by legal commentators, congressional leaders and the White House to create a crowdfunding registration exemption). The crowdfunding language of the original JOBS Act, H.R. 3606, drew heavily on the bare-bones crowdfunding provisions in H.R. 2930, the Entrepreneur Access to Capital Act, which passed the House in November 2011, but lay dormant in the Senate as Senators considered two of their own crowdfunding bills. *Id.* at 1750 & n.83 (explaining that the House passed a bare-bones crowdfunding bill on November 9, 2011, while the original Capital Raising Online While Deterring Fraud and Unethical Nondisclosure Act of 2011, S. 1790, introduced by Senator Jeff Merkley on December 8, 2011, and the Democratizing Access to Capital Act of 2011, S. 1791, introduced by Senator Scott Brown on November 2, 2011, were being debated); H.R. REP. NO. 112-355, at 104 (2012). The principal difference between the passed House bill and the proposed Senate bills was that the House bill was not conditioned on meaningful disclosure, while the Senate bills required broader disclosure and accountability. See Hazen, *supra* note 60, at 1753–54 (explaining the proposed disclosure requirements in Senate bills 1790 and 1791). *But see* Cohn, *supra* note 60, at 1437–38 (criticizing Senate amendments for adding significant requirements, thus preventing small issuers from using the exemption).

⁷⁵ Since it was based on language of the already passed H.R. 2930, the original crowdfunding provision in the JOBS Act received glancing attention in the House, where the initial form of the bill was passed after only one day of consideration. 158 CONG. REC. H1288–89 (daily ed. Mar. 8, 2012) (indicating H.R. 3606 was passed 390–23 on March 8, with consideration beginning on March 7); *see also id.* at H1277–78 (2012) (statement of Rep. Frank) (explaining that, while supporting the bipartisan measure, allotting twenty to thirty minutes for the entire JOBS Act is not sufficient to properly weigh the controversial issues and potential amendments to the bill).

⁷⁶ See 158 CONG. REC. S1674, S1675 (daily ed. Mar. 14, 2012) (statement of Sen. Merkley) (explaining that pushing for ratification of the House Bill would lead to “predatory investing schemes” similar to those seen in the movie “The Boiler Room”); 158 CONG. REC. S1714, 1724–25 (daily ed. Mar. 15, 2012) (letter of Nick Bhargava, Partner, Motaavi, LLC) (Durham-based crowdfunding intermediary expressing concern of the language of Title III of the JOBS Act because it does not provide adequate investor protection and puts the entire crowdfunding industry at risk of significant fraud); *id.* at 1722–23 (letter of Mary Shapiro, Chairman, U.S. Securities and Exchange Commission) (explaining that while crowdfunding may be used to help raise capital at early stages of development in a business, failure to provide adequate investor safeguards would cause “investor confidence in

amended the Bill to require greater disclosure and to impose liability on issuers (as well as funding intermediaries) for misinformation in a crowdfunding offering.⁷⁷ Despite some resistance to the Senate amendments, the House concurred, paving the way for the Bill to be signed into law.⁷⁸

In both the House and Senate, crowdfunding was seen as a way to increase capital access for small businesses, leading to job growth based on data that job growth occurs after a company goes public.⁷⁹ In the Senate, crowdfunding was argued to be a tool to “unleash billions of dollars . . . of local investment [and] allow people with great innovative ideas to for the first time raise capital from our middle class.”⁸⁰

In the Senate, concerns about the House crowdfunding provisions in the JOBS Act centered on the lack of investor protection.⁸¹ As Senator Levin stated, “The House bill would expose retail-investors—those with no expertise and no resources—to assess the risks of participating in the

crowdfunding [to] be significantly undermined and would not achieve its goal of helping small businesses”).

⁷⁷ CIFRINO ET AL., *supra* note 66, at 28.

⁷⁸ See 158 CONG. REC. H1586 (daily ed. Mar. 27, 2012) (statement of Rep. Bachus) (striking Title III of H.R. 3606 and adopting Senate amendments to the Title). The SEC has been charged with drafting regulations to enact the crowdfunding provisions and is currently soliciting recommendations on how to enact the provisions.

⁷⁹ See 158 CONG. REC. H1222, 1226 (daily ed. Mar. 7, 2012) (statement of Rep. Sessions) (explaining that startup firms less than five years old created almost forty million jobs in a thirty-year period and 90% of this job creation occurred after the company went public). *But see* John Haltiwanger et al., *Who Creates Jobs? Small vs. Large vs. Young* 3 (U.S. Census Bureau Ctr. for Econ. Studies, Paper No. CES-WP-10-17, 2010), available at <http://ssrn.com/abstract=1666157> (explaining that, once firm age is controlled for, there is no relationship between size of the business and growth).

⁸⁰ See, e.g., 158 CONG. REC. S1886–87 (daily ed. Mar. 21, 2012) (statement of Sen. Merkley) (explaining that the Internet provides new opportunities for capital to reach small businesses and gives folks equal opportunity to invest in early-stage businesses that may be the new Starbucks, for example); see also 157 CONG. REC. S8458–59 (daily ed. Dec. 8, 2011) (statement of Sen. Merkley) (explaining that crowdfunding, so long as it is done with proper oversight, is “American entrepreneurship at its best”).

⁸¹ See Luis A. Aguilar, Comm’r, U.S. Sec. & Exchange Comm’n, Investor Protection Is Needed for True Capital Formation: Views on the JOBS Act (Mar. 16, 2012), available at <http://www.sec.gov/news/speech/2012/spch031612laa.htm> (explaining that H.R. 3606 would hurt investors by reducing transparency and investor protection and is based on the faulty premise that securities regulations reduce capital raising, when evidence shows regulations enhance capital formation).

unregulated market—to massive potential fraud and abuse.”⁸² Specifically, the House Bill was criticized for allowing companies to raise up to \$1 million from the public without providing any financial information to investors and without a registered intermediary.⁸³ Further, the House Bill placed no limits on how much any one investor could invest in a crowdfunding, lacked any advance public notice requirement to give the SEC an opportunity to investigate before securities were sold and allowed anonymous stock promoters to engage in “pump and dump” schemes.⁸⁴

These concerns led to the introduction in the Senate of the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 (CROWDFUND Act).⁸⁵ The Senate Bill added significant investor protections not included in the House Bill:

- required financial statements whose depth and level of review would vary depending on the size of the offering;⁸⁶
- specified company information “relevant or germane to the conduct of the company;”⁸⁷
- liability for failure of the company to stand behind the accuracy of this information;⁸⁸

⁸² 158 CONG. REC. S1726 (daily ed. Mar. 15, 2012) (statement of Sen. Levin).

⁸³ 158 CONG. REC. S1675 (daily ed. Mar. 14, 2012) (statement of Sen. Merkley) (“That is not an investment market; that is a scam.”).

⁸⁴ *Id.* (explaining “pump and dump” means promoters push the security with wonderful comments, but fail to identify themselves as having a connection with the company offering the stock).

⁸⁵ 158 CONG. REC. S1806 (daily ed. Mar. 19, 2012); *id.* at S1794 (Senate Bill 1884, introduced by Senators Merkley, Bennett and Brown). The proposed CROWDFUND Act was meant to provide “significant regulatory relief to very small issuers without unreasonably compromising the investor protection provisions on which the federal securities laws are grounded and the long-term success of the U.S. securities markets has been based.” 158 CONG. REC. S1878 (daily ed. Mar. 21, 2012) (letter of Mercer Bullard, President and Founder, Fund Democracy). The CROWDFUND Act was said to offer a solid foundation for crowdfunding, compared to the original crowdfunding provision of H.R. 3606, which was characterized as “a path to predatory schemes.” *Id.* at S1887–88 (comments of Sen. Merkley).

⁸⁶ 158 CONG. REC. S1887 (comments of Sen. Merkley) (explaining that if the offering is for less than \$100,000, the CEO of the company may certify the financial statements; if the offering is between \$100,000 and \$500,000, a CPA must review the financial statements; and if the offering exceeds \$500,000, financial statements must be audited).

⁸⁷ *Id.*

⁸⁸ *Id.* (explaining that for a capital market to work well there must be disclosure of information and one has to stand behind the accuracy of their information); *see also infra* Part II.B.

- a required intermediary “portal” so investors would “know they are getting straightforward information, not something that is spun;”⁸⁹
- a cap on how much individual investors could invest in a crowdfunding based on their income;⁹⁰
- a three-week waiting period beginning with the company’s listing of an offering until its closing;⁹¹
- disclosure by paid promoters of their connection to the company;⁹² and
- a mandate that the SEC ensure early investors are not “diluted in a fashion in which they are basically written out of their share of the ownership.”⁹³

In addition, the CROWDFUND Act introduced a requirement that intermediaries provide investor education materials “determined appropriate by the SEC” to ensure investors understand the risks associated with investing in a startup.⁹⁴ The investor education requirement recognizes that the risks of investing in a startup cannot be mitigated through normal means, such as diversification.⁹⁵ The requirement is meant to discourage “fraudulent operators” by ensuring crowdfunding investors are educated enough to process the issuer’s sales efforts.⁹⁶

The Senate’s CROWDFUND Act passed the Senate without significant revision⁹⁷ and was sent to the House, where it received immediate

⁸⁹ 158 CONG. REC. S1887 (explaining that the registration process to become a portal is less onerous than to become a broker dealer).

⁹⁰ *Id.* (explaining that if a person makes less than \$40,000, their investment cap is \$2000; if their income is between \$40,000 and \$100,000, their investment cap is 5% of their annual income; and if their income is over \$100,000, their investment cap is 10% of their annual income).

⁹¹ *Id.*

⁹² *Id.* (explaining that this is intended to prevent “classic boiler room” where “pump and dumps” cause everyone who invested to lose out).

⁹³ *Id.*

⁹⁴ *See id.* S1886; 158 CONG. REC. S1749 (daily ed. Mar. 15, 2012) (text of amendment SA 1884 proposed to Bill H.R. 3606).

⁹⁵ 158 CONG. REC. S5474, S5476 (daily ed. July 26, 2012) (statement of Sen. Merkley) (explaining that crowdfunding investors may not fully understand the level of risk involved in this type of investment even with the mandated investor education).

⁹⁶ 158 CONG. REC. S2229–30 (daily ed. Mar. 29, 2012) (statement of Sen. Brown) (explaining that because proper investor education and “crowdvetting” of opportunities by impartial third parties discourage fraudulent operators, issuers should not be allowed to encourage investment outside of the intermediary).

⁹⁷ 158 CONG. REC. S1884.

attention.⁹⁸ Some in the House expressed the view that the Senate amendments undermined the non-regulatory intent of the original House Bill.⁹⁹ But others argued that the protections of the Senate Bill were for “the classic widows and orphans out there that are not necessarily financially sophisticated.”¹⁰⁰ In the end, the House discussion centered on the Bill’s bipartisan nature, the support by the White House and the aim to promote job growth for small businesses.¹⁰¹ The House concurred 380-to-41 with the Senate crowdfunding amendments, leaving for another day further tinkering with the legislation.¹⁰²

2. *Crowdfunding Under the JOBS Act*

Under the JOBS Act, “crowdfunding” is available to non-reporting, non-investment companies organized in the United States seeking to raise annually up to \$1 million in securities offerings, primarily over the Internet.¹⁰³ Under new section 4(6) of the Securities Act, crowdfunding offerings need not be registered with the SEC—and state registration,

⁹⁸ See 158 CONG. REC. H1588 (daily ed. Mar. 27, 2012) (statement of Rep. Bachus) (“I . . . urge the House to approve this bill today”); 158 CONG. REC. S2083 (daily ed. Mar. 27, 2012) (indicating that the message was delivered to the Senate at 5:25 P.M. on March 27 and that H.R. 3606 was signed by the Speaker of the House).

⁹⁹ See 158 CONG. REC. H1590 (statement of Rep. Schweikert) (“The Senate has amended [the crowding portion of the bill] in such a way that I believe it does great damage to the goal of a much more egalitarian, technologically advanced, using-the-Internet way for people to invest”); *id.* at H1592 (statement of Rep. McHenry) (“Rather than recognizing that crowdfunding could create new markets and opportunities for small businesses and start-ups, these misguided Senators simply saw crowdfunding as unregulated activities.”).

¹⁰⁰ *Id.* at H1590 (statement of Rep. Himes).

¹⁰¹ See *id.* at H1592 (“I very much appreciate the intent of this legislation. We had good support from both sides of the aisle. The President is supportive.”); *id.* (statement of Rep. Bachus) (“[This debate] shouldn’t distract from the fact that this is a major piece of legislation that will cause, I think, a great deal of new competition, innovation of new products and services.”); *id.* (statement of Rep. Biggert) (“Many of these changes in this bill have bipartisan backing and have been endorsed by the President’s Council on Jobs and Economic Competitiveness”); see also President Barack Obama, Address Before a Joint Session of Congress (Sept. 8, 2011) (indicating that President Obama supported the crowdfunding exemption); Hazen, *supra* note 60, at 1751. *But see* Cohn, *supra* note 60, at 1434 (“Congress’s rush to action resulted in a statute that appears to have failed in its primary purpose”).

¹⁰² 158 CONG. REC. H1598 (daily ed. Mar. 27, 2012). *But see id.* at H1590 (statement of Rep. Schweikert) (“We still should be voting for this bill. . . . We’re making progress. But there are things we have to do to fix this for the future.”).

¹⁰³ CIFRINO ET AL., *supra* note 66, at 27.

documentation and offering requirements are preempted.¹⁰⁴ Individual investors are limited in the aggregate annual amount of securities they may purchase in crowdfunding offerings based on their annual income and net worth.¹⁰⁵

In addition, there are a bevy of further conditions and requirements for companies seeking to raise capital through a crowdfunding offering:

- The crowdfunding offering must be conducted only through either a registered broker or a “funding portal” registered with the SEC.¹⁰⁶
- Investors must be provided certain disclosures about the company and the offering, such as a description of the company’s officers, directors and shareholders; the company’s business and business plan; limited financial information, which varies from only disclosure of the company’s tax returns to audited financial information, based on the size of the offering; how the offering’s proceeds will be used; the offering price and method by which the price was determined; and the company’s capital structure.¹⁰⁷
- A company engaging in a crowdfunding may not advertise the offering, except by referring investors to the broker or funding portal. The brokers and funding portals may be compensated, as allowed by SEC rules.¹⁰⁸
- Securities sold through a crowdfunding cannot be resold for one year, unless to the issuer, an accredited investor, a family member or as part of a registered offering.¹⁰⁹

¹⁰⁴ Bradford, *supra* note 59 (manuscript at 16) (explaining that securities sold pursuant to section 4(6) crowdfunding exemption are “covered securities” under section 18(4) of the Securities Act).

¹⁰⁵ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat 306 (2012) (to be codified in scattered sections of 15 U.S.C.) (providing that investors whose annual income or net worth is less than \$100,000 are capped at the greater of \$2,000 or 5% of annual income or net worth while investors whose annual income or net worth is higher than \$100,000 are capped at 10% of their annual income or net worth, not to exceed \$100,000). *But see id.* § 401 (questioning the ability of a portal to ensure that investors do not exceed the aggregate maximum).

¹⁰⁶ *Id.* § 302. A broker or funding portal that facilitates crowdfunding offerings must also register with applicable self-regulatory organizations. *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

The JOBS Act directs the SEC to adopt implementing rules within 270 days of its enactment, and the agency solicited pre-rule comments on April 11, 2012.¹¹⁰

The crowdfunding mechanism, as outlined in the JOBS Act, has led some commentators and practitioners to doubt whether it can succeed as a low-cost investment mechanism to fund small businesses.¹¹¹ Some have argued that issuers that used the donational crowdfunding model to raise small amounts of money may find the new investment model cost-prohibitive.¹¹² For example, given the requirement of audited financials for crowdfunding offerings over \$500,000, issuers planning offerings of this size may turn to other exemptions to raise capital.¹¹³ The crowdfunding investment model must also confront the challenge of large numbers of unsophisticated investors, who will likely be unknown to the issuer.¹¹⁴ Whether intermediaries emerge to identify and promote viable crowdfunding opportunities also remains an open question, particularly given the uncertainty of the disclosure requirements and liability risks. The SEC's implementing rules—as has happened with other exemptions authorized by Congress—may determine the fate of crowdfunding as a viable financing tool.

3. *Investor Education in Crowdfundings*

In the JOBS Act, Congress (for the first time) required investor education as condition of an investment. Under section 4A(a),

¹¹⁰ Press Release, U.S. Sec. & Exch. Comm'n, SEC Seeks Public Comment Prior to JOBS Act Rulemaking (Apr. 11, 2012), available at <http://sec.gov/news/press/2012/2012-60.htm>.

¹¹¹ See CIFRINO ET AL., *supra* note 66, at 28 (concluding that crowdfunding costs as percentage of proceeds may be too high to make mechanism useful); Anna Denton, *How the JOBS Act Impacts Offerings*, DLA PIPER (June 27, 2012), <http://www.dlapiper.com/how-the-jobs-act-impacts-offerings/> (“If the regulations and ensuing controls do not result in prohibitive cost and burdensome disclosure, this exemption could result in an efficient system of raising small amounts of money to fund entrepreneurs); Cohn, *supra* note 60, at 1434 (asserting that “heavy-handed” additional requirements of Senate amendments likely will prevent many small issuers from using crowdfunding).

¹¹² See Cohn, *supra* note 60, at 1444 (explaining that there may be a use for offerings around \$250,000, but smaller offerings will likely not be able to use the model).

¹¹³ *Id.* at 1444–45 (explaining that issuers who would normally make use of the crowdfunding model may have to resort to other avenues, such as Rule 504 or the Intrastate exemption, to raise money because of the costs in a crowdfunding offering).

¹¹⁴ CIFRINO ET AL., *supra* note 66, at 28 (explaining that the costs and responsibilities of having a large number of unsophisticated investors will consume time of the issuer and potentially impair long-term strategies of the company).

crowdfunding intermediaries must provide potential investors “investor education materials and disclosures regarding risk,” as specified by the SEC.¹¹⁵ In addition to providing investors these education materials, intermediaries must ensure each investor (1) reviews the materials,¹¹⁶ (2) affirms he or she understands the risk of losing the entire investment,¹¹⁷ and (3) answers questions demonstrating an understanding of the level of risk generally applicable to investments in small issuers, the risk of illiquidity and such other matters as the Commission determines appropriate.¹¹⁸

To date, the SEC has not specified what disclosures or education materials that intermediaries will be required to provide investors. Nonetheless, a recent SEC study on financial literacy among investors gives some clues.¹¹⁹ The study found four key content areas to promote financial literacy: (1) different types of risk; (2) the fees and costs associated with investing; (3) proactive steps for avoiding fraud; and (4) general investment knowledge, including topics such as compound interest.¹²⁰ The study also set a goal to promote a website (Investor.gov) “as the ‘first stop’ for investing information,” suggesting that investor education materials may be centralized to ensure uniformity.¹²¹

While the SEC’s rules on investor education are not due until January 2013, there seems to be a consensus that requiring investor education will be useful in a crowdfunding offering.¹²² In fact, for small business

¹¹⁵ Securities Act of 1933 § 4A(a)(3)–(4), 15 U.S.C. § 77d-1 (2006), *amended by* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat 306 (2012) (to be codified at 15 U.S.C. § 77d-1).

¹¹⁶ *Id.* § 4A(a)(4)(A).

¹¹⁷ *Id.* § 4A(a)(4)(B).

¹¹⁸ *Id.* § 4A(a)(4)(C).

¹¹⁹ See FINANCIAL LITERACY STUDY, *supra* note 62, at 179–82 (explaining strategies the SEC identified to improve financial literacy of investors).

¹²⁰ *Id.* at 180.

¹²¹ *Id.* at 182. By requiring that investors visit a centralized site to take an investor education test, the SEC may be better able to ensure that investors actually understand the education materials given them. See Letter from Occupy the SEC to Mary Shapiro, Chairman, U.S. Sec. & Exch. Comm’n 4–5, (July 31, 2012), available at <http://www.sec.gov/comments/jobs-title-i/general-193.pdf>.

¹²² See Heminway & Hoffman, *supra* note 67, at 936 (quoting Dale A. Oesterle, *The High Cost of IPOs Depresses Venture Capital in the United States*, 1 ENTREPREN. BUS. L.J. 369, 379 (2006)) (explaining that better investor education and stronger enforcement makes any increase in attempted fraud in crowdfunding bearable); Letter from Occupy the SEC, *supra* note 121, at 4 (arguing that the investor education provision ensures that investors have sufficient knowledge and understanding of financial markets to make prudent investments); Anton Root, *Crowdfunding Investor Education: A Discussion with EarlyShares Chairman Stephen Temes*, CROWDSOURCING (June 21, 2012, 2:08 AM), <http://www.crowd>

entrepreneurs who turn to crowdfunding, education in the basics of corporate finance may be useful in pricing their companies' securities offerings. Education in the crowdfunding space will undoubtedly be a two-way street, with entrepreneurs often having as much to learn as investors. Some crowdfunding websites (perhaps preparing for their roles as portals) have already begun offering investor education about crowdfunding, with education for crowdfunding entrepreneurs no doubt soon to follow.¹²³

B. *Crowdfunding Liability: New Section 4A(c)*

In addition to conditions and requirements an issuer must meet to be eligible for a crowdfunding offering, the JOBS Act also introduced new liability for deception in a crowdfunding in new section 4A(c) of the Securities Act (section 4A(c)).¹²⁴

1. *Legislative History of Crowdfunding Liability Provisions*

The crowdfunding liability provisions added by the Senate, permit investors in a crowdfunding to bring an action at law or in equity if an issuer makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary to make the statements not misleading, based on a standard of reasonable care. From appearances, crowdfunding liability is in addition to liability that might otherwise arise under state and federal antifraud laws. The crowdfunding liability scheme was seen as an important basic protection for investors, particularly given the absence in the House Bill of either disclosure requirements or liability provisions.¹²⁵

sourcing.org/editorial/crowdfunding-investor-education-a-discussion-with-earlyshares-chairman-stephen-temes/16014 (explaining that there is a huge need for portals to make an educational push because a lot of individual investors have never been able to invest in start-up companies directly and they need to learn what it really means).

¹²³ See *Peoples VC Offers 1st Investor Ed Class for Crowdfunding Investors*, PR NEWSWIRE (June 13, 2012), <http://www.prnewswire.com/news-releases/peoples-vc-offers-1st-investor-ed-class-for-crowdfunding-investors-158885945.html> (announcing Peoples VC as the first Crowdfunding site to offer online "education and certification" classes for crowdfunding investors).

¹²⁴ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat 306 (2012) (to be codified at 15 U.S.C. § 77d(a)(6)(B)).

¹²⁵ The original version of H.R. 3606 left state enforcement authority in place for "securities or securities transactions, with respect to[:] (1) fraud or deceit; (2) unlawful conduct by a broker or dealer; and (3) . . . unlawful conduct by an intermediary, issuer, or custodian." H.R. 2930, 112th Cong. § 4 (2011); see 158 CONG. REC. H1591 (daily ed. Mar. 27, 2012) (statement of Rep. Bachus) ("It is also important to know that all the antifraud protection, we didn't take any of that

The liability provision of the Senate Bill received scant attention. The Bill's sponsor, Senator Merkley, in discussing the difference between the House and Senate versions, pointed out that the House version not only failed to require that issuers provide disclosure to investors, but included no accountability for false or misleading information in a crowdfunding.¹²⁶ Senator Merkley explained that the Senate Bill corrected this deficiency—in a way that balanced low-cost capital formation and investor protection—by requiring issuers to disclose only “information [that is] relevant or germane to the conduct of the company” and by imposing “basic liability” on issuers subject to due diligence protection.¹²⁷ The only other reference to the added liability provisions came in Senate deliberations eight days after the Senate passed its crowdfunding bill when another of the Bill's sponsors, Senator Brown, stated:

[I]ssuers should not be held liable for misstatements or omissions that were made by mistake. The standard of liability for issuers as described in Section 4A(c) should be “due diligence . . .” [meaning] issuers must do their “due diligence” to make sure the information that they are providing to potential investors is accurate. This is a widely accepted liability standard.¹²⁸

After passing the Senate, the liability provisions of section 4A(c) received no specific attention in the House during its hurried deliberations on the Senate amendments.¹²⁹ Although some House members complained that the Senate Bill diminished the intended goal of the House Bill to allow small businesses greater access to capital, there was no mention of the

away.”). In debating H.R. 3606, amendments to add liability provisions were offered to the bill to “improv[e] the underlying bill in the area of investor protection.” 158 CONG. REC. H1256 (daily ed. Mar. 7, 2012) (statement of Rep. Waters) (discussing her amendment to H.R. 3606 which aimed to hold securities firms acting as underwriters to stricter liability in a crowdfunding). Amendments seeking to add liability provisions into H.R. 3606, however, were harshly criticized, and none made it into the bill the House presented to the Senate. H.R. Con. Res. 3606, 112th Cong. (2012); *see also* 158 CONG. REC. H1257 (statement of Rep. Garrett) (“This information can and should get out there; but at the end of the day, we want to make sure that the liability . . . imposed on the dissemination of information is not so grave and dangerous . . . to destroy that overall purpose of the legislation.”); *id.* at H1256 (statement of Rep. Hensarling) (“to add yet another level of liability, one that . . . for all intents and purposes . . . would simply gut this bill”).

¹²⁶ 158 CONG. REC. S1884, S1887 (daily ed. Mar. 21, 2012).

¹²⁷ *Id.* at S1887.

¹²⁸ 158 CONG. REC. S2230 (daily ed. Mar. 29, 2012) (statement of Sen. Brown).

¹²⁹ *See generally* 158 CONG. REC. H1586 (daily ed. Mar. 27, 2012).

Senate's added liability provisions.¹³⁰ This may have been because of the brevity of the House debate or the view (expressed by the Senate sponsors) that the liability provision balanced access to capital and investor protection. As one of the House Bill's sponsors, Representative Bachus, explained: "[W]hat gave us more concern than anything else . . . about the Internet [was] people making an investment subject to fraud. That is a concern, and the Senate addressed those concerns [W]e will continue to look at crowdfunding."¹³¹

2. *Elements of Liability Under New Section 4A(c)*

Under new section 4A(c),¹³² purchasers have a private right of action against a company that engages in a crowdfunding offering by means of

¹³⁰ *Id.* at 1590–91. *See generally id.* at H1856 (no reference to the new section 4A(c)).

¹³¹ *Id.* at 1591 (statement of Rep. Bachus).

¹³² Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat 306 (2012) (to be codified at 15 U.S.C. § 77d-1). As added by the JOBS Act, new section 4A(c) of the Securities Act specifies:

LIABILITY FOR MATERIAL MISSTATEMENTS AND
OMISSIONS.

(1) ACTIONS AUTHORIZED

(A) IN GENERAL. Subject to paragraph (2), a person who purchases a security in a transaction exempted by the provisions of section 4(6) may bring an action against an issuer described in paragraph (2), either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if such person no longer owns the security.

(B) LIABILITY. An action brought under this paragraph shall be subject to the provisions of section 12(b) and section 13, as if the liability were created under section 12(a)(2).

(2) APPLICABILITY. An issuer shall be liable in an action under paragraph (1), if the issuer—

(A) by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by any means of any written or oral communication, in the offering or sale of a security in a transaction exempted by the provisions of section 4(6), makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading, provided that the purchaser did not know of such untruth or omission; and

(B) does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.

material misstatements or omissions (written or oral) in connection with the offering.¹³³ Liability in section 4A(c) is “as if the liability were created under Section 12(a)(2) of the Securities Act.”¹³⁴ The cause of action under section 4A(c) is subject to the statute of limitations of section 13 of the Securities Act, the same one that applies to actions under section 12(a)(2).¹³⁵

Section 12(a)(2) liability. To understand the section 4A(c) liability scheme created by Congress, it is useful to understand the contours of section 12(a)(2) liability. By its terms, section 12(a)(2) imposes liability on any person who “offers or sells” any security (except government securities) “by means of a prospectus or oral communication” that is materially false or misleading.¹³⁶ Plaintiffs may rescind the transaction and get their money back with interest or recover rescissory damages if they have resold their securities. The Supreme Court has interpreted this language to reach only public offerings, thus excluding liability under section 12(a)(2) for exempt private placement or market trading.¹³⁷

(3) DEFINITION. As used in this subsection, the term ‘issuer’ includes any person who is a director or partner of the issuer, and the principal executive officer or officers, principal financial officer, and controller or principal accounting officer of the issuer (and any person occupying a similar status or performing a similar function) that offers or sells a security in a transaction exempted by the provisions of section 4(6), and any person who offers or sells the security in such offering.

Id.

¹³³ Bennett et al., *supra* note 65, at 8.

¹³⁴ *Id.*

¹³⁵ Bradford, *supra* note 59 (manuscript at 19–20). Section 13 of the Securities Act provides that an action must be brought “within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . [I]n no event . . . more than three years after the sale.” Securities Act of 1933 § 13, 15 U.S.C. § 77m (2006).

¹³⁶ Securities Act of 1933 § 12(a)(2); *see also* CIFRINO ET AL., *supra* note 66, at 87–88.

¹³⁷ By its terms, section 12(a)(2) applies to sales and offers of securities (except government securities) “by means of a prospectus or oral communication.” Securities Act of 1933 § 12(a)(2). The Supreme Court has interpreted this language to reach only public offerings, thus excluding liability for exempt private placement or market trading. *Gustafson v. Alloyd Co.*, 513 U.S. 561, 584 (1995) (holding that contract of sale between sophisticated parties could not constitute a “prospectus” under section 12(a)(2) because it was not the prospectus filed in a registered public offering). The Court’s reading of section 12(a)(2) to cover only “public” offerings is laden with ambiguity. It is unclear whether small public offerings (such as those under Regulation A or Rules 504 and 505 of Regulation D) are covered by section 12(a)(2). The Court’s understanding that “prospectus” in section 12(a)(2) refers to a section 10 prospectus that “must include the information contained in the

Section 12(a)(2) liability extends not only to those who pass title, but also to those who solicit securities sales to further their own or the issuer's financial interest.¹³⁸ Thus, except for those who give gratuitous advice, section 12(a)(2) covers any persons involved in the selling effort.¹³⁹ Plaintiffs need not prove the defendant's culpability, but instead section 12(a)(2) gives defendants a "reasonable care" defense if they show they did not know (and "in the exercise of reasonable care" could not have known) of the misinformation.¹⁴⁰ Some courts have understood this "due care" defense to create a duty of due diligence similar to that applicable to registered public offerings.¹⁴¹

Under section 12(a)(2) the plaintiff need not show that he relied on the alleged misinformation. Rather, recovery is conditioned only on "the purchaser not knowing" of the challenged misinformation. Nonetheless, courts have made reliance an issue by insisting on proof of a causal connection between the misinformation and the transaction.¹⁴² Although the purchaser need not have received the misinformation—such as false disclosure documents distributed by the issuer—the misinformation must

registration statement" suggests the section might cover "prospectus-like" offering circulars in such exempt offerings. *Id.* at 569.

¹³⁸ *Pinter v. Dahl*, 486 U.S. 622, 648 (1988).

¹³⁹ In effect, section 4A(c) adopts the same liability contours. Collateral participants in a crowdfunding, such as accountants and lawyers, would appear not to be liable even though they may be a "proximate cause" or "substantial factor" in the offering. *See Pinter*, 486 U.S. at 651 (rejecting such tests for liability under section 12(a)(1), which shares the same operative language as section 12(a)(2)).

¹⁴⁰ *CIFRINO ET AL.*, *supra* note 66, at 87–88.

¹⁴¹ *See Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1228–29 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981). The court rejected "reasonable care" as a defense by a securities firm that acted as underwriter for a commercial paper offering exemption from the Securities Act registration for failing to investigate issuer's financial soundness, even though financials had been audited by outside accountant). *Id.*; *see also* David McMahon & Jeevan Subbiah, *The JOBS Act & Crowdfunding—Is It for You?*, JD SUPRA (July 23, 2012), <http://www.jdsupra.com/legalnews/the-jobs-act-crowdfunding-is-it-for-39186/>. The Nuveen "due diligence" standard has been criticized. For example, in his dissent from the Supreme Court's denial of certiorari in the case, Justice Powell argued that that the lower court's reading of section 12(a)(2) imposed an even greater investigation duty than that applicable to underwriters under section 11 with respect to audited financials. *Sanders v. John Nuveen & Co.*, 450 U.S. 1005, 1005–06 (1981) (Powell, J., dissenting).

¹⁴² *See* Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2006) ("by means of" false or misleading prospectus or oral communication).

have been “instrumental” in the sale, such as when the misinformation bolsters a market in the purchased securities.¹⁴³

Loss causation—a causal link between the misinformation and the plaintiff’s loss—has become an affirmative defense in section 12(a)(2) actions.¹⁴⁴ A defendant in a section 12(a)(2) action may defend by proving that a portion (or all) of the amount recoverable “represents other than the depreciation in value . . . resulting from” the false or misleading statement on which liability is based.¹⁴⁵

Elements of section 4A(c) liability. Section 4A(c) imposes liability on “issuers” in an exempt crowdfunding offering that make any materially false or misleading statement “by means of any written or oral communication.”¹⁴⁶ By its terms, the action may be brought only by purchasers who actually purchased the security from the issuer in the initial crowdfunding offering and not subsequent purchasers.¹⁴⁷ As under section 12(a)(2), plaintiffs in a section 4A(c) action have a right to restitution and may recover the consideration paid for the security, minus any income they may have received.¹⁴⁸ Purchasers who no longer own the security are entitled to recover damages, presumably on a restitutionary basis.¹⁴⁹

Only “issuers” are liable in a section 4A(c) action. For purposes of the section, an “issuer” is defined to include:

[A] director or partner of the issuer, and the principal executive officer or officers, principal financial officer, and controller or principal accounting officer of the issuer (and any person occupying a similar status or performing a similar function) that offers or sells a security in a transaction exempted by the provisions of section 4(6), and any person who offers or sells the security in such offering.¹⁵⁰

¹⁴³ See *John Nuveen & Co.*, 619 F.2d at 1227 (finding sufficient link, even though some plaintiffs were unaware of defendant’s “risk-free” representations, because had the market known the truth it would have collapsed).

¹⁴⁴ See Securities Act of 1933 § 12(b), amended by Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (2006) (codified at 15 U.S.C. §§ 77a–aa).

¹⁴⁵ *Id.*

¹⁴⁶ Securities Act of 1933 § 4A(c), amended by Jumpstart Our Business Startups Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012).

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* § 4A(c)(1)(A).

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* In relevant part, an “issuer” is defined as:

[A]ny person who is a director or partner of the issuer, and the principal executive officer or officers, principal financial officer,

The specification of section 4A(c) defendants, like many aspects of the new crowdfunding provisions, includes a host of tantalizing ambiguities. For example, it is unclear whether all officers fall on the enumerated list of non-issuer defendants or only “principal executive officers.” Also unclear, as noted by Professor Bradford,¹⁵¹ is whether the parenthetical “(and any person occupying a similar status or performing a similar function)” is intended to apply only to the controller or principal accounting officer or to all listed defendants.¹⁵² Thus, it is unclear whether the term “partner” is limited to equity participants in a partnership or includes managing members of a functionally equivalent LLC. Further, it is unclear whether the phrase “that offers or sells a security in a transaction exempted by the provisions of section 4(6)” modifies the word “issuer” or the enumerated defendants.¹⁵³ If it modifies “issuer,” as seems more logical, then the officers, directors and partners are not required to offer or sell the securities to be liable, they must only be connected to an issuer in a crowdfunding offering.¹⁵⁴ But if it modifies the full list of potential defendants, an inquiry into their selling effort would be necessary for liability under section 4A(c).¹⁵⁵

Finally, there is no indication whether listed defendants are liable for their own misstatements or omissions that are actionable under section 4A(c), or whether they are liable for all such statements in connection with the offering.¹⁵⁶ If the listed defendants are only liable for their own material misstatements or omissions, then section 4A(c) will likely have a very limited effect, given the Supreme Court’s recent restrictive interpretation of what it means to “make” a statement.¹⁵⁷ The interpretation that would give the liability more efficacy would be one that makes the listed defendants

and controller or principal accounting officer of the issuer (and any person occupying a similar status or performing a similar function) that offers or sells a security in a transaction exempted by the provisions of section 4(6), and any person who offers or sells the security in such offering.

Id.

¹⁵¹ Bradford, *supra* note 59 (manuscript at 18–19).

¹⁵² *Id.* at 19.

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ Bradford, *supra* note 59 (manuscript at 19) (citing *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011)).

liable for any actionable misstatements or omissions of the collective “issuer.”¹⁵⁸

As with section 12(a)(2), the new section 4A(c) does not make culpability, reliance or causation elements of the cause of action, but instead defenses. Defendants have a “due care” defense, which is worded identically to that under section 12(a)(2).¹⁵⁹ In addition, plaintiffs who had knowledge of the untruth or omission—presumably based on proof by the defendants—are expressly barred from recovering under section 4A(c).¹⁶⁰ Also, defendants have a negative causation defense if they can prove the plaintiff’s losses did not result from the alleged misstatement or omission.¹⁶¹

3. *Materiality of Pricing Disclosure Under Section 4A(c)*

Central to liability and the disclosures implicitly required under section 4A(c)—like that of the other antifraud provisions of the federal securities laws—is the meaning of “material facts” under the new liability scheme: what information must issuers (and others participating in the crowdfunding) provide to investors?¹⁶² The classic definition of materiality—information a reasonable investor would consider important in his investment decision¹⁶³—leads to the further question of who are

¹⁵⁸ *Id.* (explaining that the collective “issuer” includes all listed defendants, and such an interpretation would explain how directors, partners and officers who did not themselves offer or sell the securities would be liable under section 4A(c)).

¹⁵⁹ Plaintiffs need not prove the defendant acted with scienter, but “defendants may avoid liability by proving that they ‘did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.’” *Id.* at 18 (citing the Securities Act of 1933 § 4A(c)(2)(b), *amended by Jumpstart Our Business Startups Act*, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012)) (pointing out that “due care” defense of section 4A(c) is worded identically to that under section 12(a)(2) of the Securities Act).

¹⁶⁰ *Id.*

¹⁶¹ CIFRINO ET AL., *supra* note 66, at 86–88; Bradford, *supra* note 59 (manuscript at 18) (pointing out that JOBS Act incorporates negative causation defense of section 12(b) of the Securities Act, which places proof of absence of loss causation on defendant).

¹⁶² *See* Jumpstart Our Business Startups Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1). Materiality functions as a “gatekeeper” to ensure companies disclose the right amount of information by separating essential information to an informed investment choice from less important information. *See* Yvonne Ching Ling Lee, *The Elusive Concept of “Materiality” Under U.S. Federal Securities Laws*, 40 WILLIAMETTE L. REV. 661, 662 (2004).

¹⁶³ A fact is material if
there is a substantial likelihood that a reasonable shareholder
would consider it important in deciding how to vote Put

“reasonable investors” in a crowdfunding. Specifically, must disclosure provided in a crowdfunding recognize the unsophisticated (and non-intermediated) nature of investors for whom the crowdfunding mechanism is aimed?

Materiality, as interpreted by both the courts and the SEC, is contextual. Information already available to sophisticated investors in public trading markets is not material, while the same information unavailable to unsophisticated investors in private markets may well be material. Pricing disclosure fits this bill. While investors in public trading markets have few reasons to be informed about the pricing models used to price the securities offered them, unsophisticated investors in private markets have significant needs to know about the pricing models used for the securities offered them. Crowdfunding to unsophisticated investors, in the absence of intermediation, is a case in point.

One tantalizing requirement of the crowdfunding provisions—possibly suggesting that the legislation specifically identified the materiality of pricing information—is the requirement that issuers disclose to investors “the price to the public of the securities or the method for determining the price.”¹⁶⁴ On a superficial read, the provision could be understood to require disclosure of pricing methods (such as earnings multiples, comparables and discounted cash flow) and the assumptions used in fixing the price of the offered securities. But the phrase, written in the disjunctive, is better understood to require *either* disclosure of the fixed price at which securities are offered *or* the formula by which the price can be determined. This same formulation is used in other disclosure rules—such as under Item 505 of Regulation S-X and Reg A—and has not been understood to impose on issuers the task of full-blown pricing disclosure, including of the valuation/pricing methodology used by the issuer in the offering.

Materiality of pricing disclosure. Is pricing disclosure in crowdfunding material information? That is, would a reasonable investor consider important the information about the pricing model used by the issuer to determine the offering price and the assumptions incorporated into that model? An answer comes from two sources. First, the courts have

another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.

TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976). Under this standard, courts must determine whether a proposal (in the case, a voting decision) would have been favored without the alleged misstatement, but the Court acknowledged “such matters are not subject to determination with certainty.” *Id.* at 448.

¹⁶⁴ Jumpstart Our Business Startups Act § 302(b).

made clear that materiality is contextual¹⁶⁵ and that pricing information can be material when investors rely on the issuer to give guidance.¹⁶⁶ For example, the Supreme Court has accepted that forward-looking statements by an issuer's board of directors about the price of securities in a merger are material to shareholders. According to the Court, such opinions—which are based on information available to the board and derived from the expertise of the directors—are highly relevant to shareholders, who understandably rely on the board. Moreover, such statements are actionable if knowingly false and unsupported.¹⁶⁷ That is, where shareholders rely on an issuer to provide guidance on the fairness of price in a securities transaction, disclosure about price is material. False or misleading price disclosures are actionable if the issuer knows the price is not fair and substantive support for the price is lacking.

Second, the SEC rules on pricing disclosure reflect the agency's view that price-related information is material to investors and that the disclosure varies according to the context.¹⁶⁸ In a registered public offering, the SEC has accepted bare-bones disclosure of pricing factors, given that the

¹⁶⁵ *TSC Indus.*, 426 U.S. at 450 (“The determination [of materiality] requires delicate assessments of the inference a [reasonable investor] would draw from a given set of facts and the significance of those inferences to him.”); *see also* Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 132 (1999) (explaining that materiality varies according to context, with courts requiring price effects in market cases while only requiring subjective relevance in face-to-face transactions).

¹⁶⁶ Pricing disclosure is a sub-category of disclosure. *See* Dale A. Oesterle, *The Overused and Under-Defined Notion of “Material” in Securities Law*, 14 U. PA. J. BUS. L. 167, 190 (2011) (explaining that the evolution of sub-doctrines is based on the context, such as puffery, bespeaks caution, truth on the market and zero price change); *see also* Sec. & Exch. Comm'n v. Hasho, 784 F. Supp. 1059, 1084–85 (S.D.N.Y. 1992) (holding that promised returns of 100–200% annually and a promise that the investment was no-lose were material, even though reasonable investor would likely know this was not possible).

¹⁶⁷ *Va. Bankshares v. Sandberg*, 501 U.S. 1083, 1093 (1992) (concluding that the statement by the board that merger price constituted “high” value was material to shareholders asked to vote on the merger); *Helwig v. Vencor*, 251 F.3d 540, 555 (6th Cir. 2001), *abrogated by* *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007) (explaining that while forecasts can only be material if they can be calculated with substantial certainty, the information may be material if the figures are false or misleading). *But see* Oesterle, *supra* note 166, at 180–81 (criticizing the *Virginia Bankshares* standard for departing from the common law, which refuses to recognize the materiality of opinions because opinions are understood to be puffery, too indefinite or vague and too easy to contest).

¹⁶⁸ Courts have sometimes followed the SEC's lead on when information is material, refusing to find materiality if SEC rules do not require the information. *See* Lee, *supra* note 162, at 670 (explaining that some courts have refused to find information material when the SEC does not require it).

offering price is determined in negotiations with the underwriter based on market conditions and perceptions about the issuer and its securities.¹⁶⁹ But in exempt public offerings, where investors generally lack sophistication and intermediation by securities professionals is lacking, the SEC has required specific pricing disclosures, including of such valuation metrics as price-earnings ratios and net assets per share. Thus, the SEC recognizes that price disclosure depends on context: the type of offering, the existence of intermediaries and the nature of the investors targeted by the offering. Where investors are unprotected by intermediaries (whether securities professionals or efficient markets) and are otherwise unable to fend for themselves, the need for pricing disclosure is heightened.

“Reasonable” crowdfunding investor. The “reasonable investor” standard—part of the materiality definition—is also contextual and balances the importance to investors of adequate disclosure and the adverse consequences of too low a threshold.¹⁷⁰ It is generally viewed as an objective measure of the capacity of investors to absorb and respond to disclosure, thus to advance the goals of the securities laws to protect investors from fraud and promote market integrity.¹⁷¹ As such, investors in a crowdfunding—given their presumptive lack of sophistication and the absence of intermediation by underwriting firms or informationally efficient markets—are exposed to fraudulent pricing, a risk to these new private markets.

To understand the “reasonable investor” in a crowdfunding, the definitions for “reasonable investors” in public trading markets offer guidance. In such markets, the reasonable investor is described as a rational market participant¹⁷² who relies on the sophisticated, information-absorbing

¹⁶⁹ *See id.*

¹⁷⁰ *TSC Indus.*, 426 U.S. at 445. *But see* Lee, *supra* note 162, at 664 (explaining that the “reasonable investor” threshold often becomes a “wild card,” determined after the fact by judges and regulators based on policy).

¹⁷¹ Joan MacLeod Heminway, *Female Investors and Securities Fraud: Is the Reasonable Investor a Woman?*, 15 WM. & MARY J. WOMEN & L. 291, 328 (2009) (explaining that securities laws are not intended to protect investors from bad decisions, they are only intended to promote market integrity); *see also* William A. Sahlman, *How the NY Times Got the JOBS Act Wrong*, XCONOMY (Mar. 15, 2012), <http://www.xconomy.com/boston/2012/03/15/how-the-ny-times-got-the-jobs-act-wrong> (explaining that as long as people “don’t lie, cheat or steal,” they should be able to form enterprises and people who invest in these enterprises may lose money).

¹⁷² A popular model for defining the “reasonable investor” is *homo economicus*, a rational (and perhaps imaginary) market participant whose main goal is to maximize wealth and utility. *See* Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing “the Reasonable Investor” with “the Least Sophisticated Investor” in Inefficient Markets*, 81 TUL. L. REV. 473, 490–91 (2006); *see also* Denis J. Brion, *Norms and Values in Law and Economics*, in 1

capacity of the markets in which the investor trades.¹⁷³ Given the variety of investors in public trading markets, there is no one “reasonable” investing style—but instead a mix that includes fundamental analysis, technical analysis and even speculation.¹⁷⁴ The reasonable investor in public trading markets—an idealized potpourri of rational actors—is the greatest common denominator capable of weighing all available information that affect the returns and risks of an investment, and choosing the proper course of action.¹⁷⁵

Importantly, the “reasonable investor” in public trading markets is assumed to be part of—and thus, protected by—sophisticated markets that themselves grasp market pricing fundamentals, such as the time value of money, the trade-off between risk and return and the value of diversification.¹⁷⁶ These sophisticated markets, and with them the reasonable investors that participate in them, are assumed to be informed of all available public information and to be able to discount information that may be incomplete or inaccurate.¹⁷⁷ In public trading markets, given the assumption that investors are sophisticated and behave rationally, courts have accepted defenses against claims of material falsehoods and omissions—specifically the defenses of mere puffery,¹⁷⁸ truth-on-the-market¹⁷⁹ and bespeaks caution.¹⁸⁰

ENCYCLOPEDIA OF LAW AND ECONOMICS 1041–42 (Boudewijn Bouckaert & Gerrit de Geest eds., 2000) (stating that law and economics “defines the basic agent of economic action in terms of a *homo economicus* understanding of human nature—that the individual is a self-interested actor, competitive in nature, who undertakes to achieve the rational maximization of personal utility”); Peter H. Huang, *Moody Investing and the Supreme Court: Rethinking the Materiality of Information and the Reasonableness of Investors*, 13 SUP. CT. ECON. REV. 99, 111 (2005) (explaining the “reasonable investor” standard as metaphor for the market, similar to the Capital Asset Pricing Model—that is, something that does not actually exist, but serves as a useful reference).

¹⁷³ Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 699 (1996) (pointing out that the idea behind disclosure laws is that if issuers provide sufficient and accurate information, investors will be willing and able to use information wisely).

¹⁷⁴ Heminway, *supra* note 171, at 298–301 (quoting *Sec. & Exch. Comm’n v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)) (“[S]peculators and chartists of Wall and Bay Streets are . . . ‘reasonable’ investors entitled to the same legal protection afforded conservative traders.”).

¹⁷⁵ *Id.* at 300–01.

¹⁷⁶ *Id.* at 301; *see also* *Flamm v. Eberstadt*, 814 F.2d 1169, 1175 (7th Cir. 1987) (explaining that reasonable investors are not “nitwits,” do not have “a child-like simplicity” and are not “babes in the woods”).

¹⁷⁷ Sachs, *supra* note 172, at 490–91.

¹⁷⁸ Mere puffery is vague and optimistic statements that contain no concrete factual or material misrepresentation. *In re Ford Motor Co. Sec. Litig.*, 381 F.3d 563, 570

The assumptions that underlie the “reasonable investor” standard in sophisticated public markets dissolve when looking at retail investors in unsophisticated markets. Such investors, according to the recent SEC Study Regarding Financial Literacy Among Investors, lack basic financial literacy and do not understand the pricing fundamentals for securities.¹⁸¹ This lack of knowledge reduces the ability of retail investors to protect themselves from fraud or to evaluate the risks and price in a securities offering.¹⁸² The “reasonable investor” standard used in sophisticated public markets is poorly suited to identifying relevant information for retail investors in unsophisticated markets—in particular, those in which crowdfunding is to operate.

Given the absence of sophisticated markets for crowdfunding offerings, the “reasonable investor” in such offerings has a different set of informational needs than one in a sophisticated market. As others have noted, the high objective threshold for investors in modern public trading markets is inappropriate for unsophisticated investors in unsophisticated

(6th Cir. 2004) (“Statements that are ‘mere puffing’ . . . may be forward-looking or ‘generalized statements of optimism that are not capable of objective verification.’” (citing *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1119 (10th Cir. 1997))). Mere-puffery is a defense against materiality because the reasonable investor “knows to be somewhat wary of a selling agent’s oral representations and to check them against the written materials.” *Brown v. E.F. Hutton Grp.*, 735 F. Supp. 1196, 1202 (S.D.N.Y. 1990).

¹⁷⁹ Under the truth-on-the-market defense, “reasonable investors” are assumed to be able to counter-balance any misleading impression, thus rendering false information immaterial. Huang, *supra* note 172, at 118–19 (explaining the truth-on-the-market defense is based on the assumption that securities markets are informationally efficient). When the context is atomistic voting, rather than trading in information-absorbing markets, the truth-on-the-market defense is unavailable. *See Va. Bankshares v. Sandberg*, 501 U.S. 1083, 1097 (1992) (acknowledging that deceptive information, though countered by truthful disclosures, can still be materially deceptive “[i]f it would take a financial analyst to spot the tension between the one and the other”).

¹⁸⁰ Under the bespeaks-caution defense, the more an issuer qualifies a statement about the security, the more the “reasonable investor” is able to discount the information and not be misled. Heminway, *supra* note 171, at 305 (explaining that a reasonable investor would not find forward-looking statements with meaningful cautionary language significant to the total mix of available information). *But see* Huang, *supra* note 172, at 126 (arguing that “the claim that reasonable investors cannot be misled by caution-laden estimates and projections is probably wrong even with respect to the more sophisticated and rational segment of the investor population”) (citation omitted).

¹⁸¹ FINANCIAL LITERACY STUDY, *supra* note 62, at 15 (explaining that investors do not understand elementary financial concepts, such as compound interest, inflation, diversification or the difference between stocks and bonds).

¹⁸² *Id.*

markets.¹⁸³ Unsophisticated investors who lack a professional adviser may well fall prey to misrepresentations that a sophisticated investor would dismiss as absurd.¹⁸⁴ Furthermore, while the “reasonable investor” standard in a public market is often measured (perhaps appropriately) by the most sophisticated investor in the market, the goals of investor protection and market integrity argue for measuring the “reasonable investor” in a private market by the least sophisticated investor in inefficient markets.¹⁸⁵

By requiring intermediaries to provide further disclosures to crowdfunding investors in the form of investor education materials and disclosures regarding risks, Congress has recognized for the first time that the “reasonable investor” standard applicable to investors in sophisticated markets may not adequately protect investors in unsophisticated markets. Instead, the investor education requirement signals a different context for the “reasonable investor” standard. Whether disclosure is material in a crowdfunding depends on whether the disclosure would significantly alter the “total mix” of information available to the particular investor.¹⁸⁶

The requirement for crowdfunding intermediaries to create and provide investor education materials does not reduce the disclosure burden on issuers, but instead signals “reasonable” crowdfunding investors will require more useful and complete disclosure, particularly on the critical matter of price. Thus, many statements and omissions that would be immaterial in an offering to investors in a sophisticated public trading market become material in a crowdfunding offering. For example, crowdfunding investors will predictably lack (among other things) an understanding of securities pricing fundamentals. The omission in a crowdfunding of information about the pricing model chosen in the offering and the assumptions used in that model—though not material in a public offering where investors can rely on the operation of the market to set a fair price—would significantly alter the total mix of information available to the typical and reasonable crowdfunding investor.

Not only would disclosure of the valuation/pricing methodology be required as material information necessary to prevent the offering documents from being misleading, the disclosure must serve to educate crowdfunding investors—in tandem with the investor education materials

¹⁸³ Sachs, *supra* note 172, at 483–84 (explaining that the “reasonable investor” threshold is higher than previous standards from the 1930s and 1940s which protected investors with less-than-average intelligence).

¹⁸⁴ *Id.* at 476–77 (pointing out that this type of fraud often increases as technology allows for more unsophisticated investors to be reached).

¹⁸⁵ Professor Sachs has argued that the “reasonable investor” standard should be replaced by a “least sophisticated investor” standard, drawn from the “least sophisticated consumer” model in the Fair Debt Collections Practices Act, to better combat fraud in inefficient markets. *Id.* at 503, 507.

¹⁸⁶ *See TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

provided by the crowdfunding intermediaries—in the pricing methodology and assumptions used by the issuer. Beyond the informational function of securities disclosure, pricing disclosure would serve an educative function—similar to the disclosures used increasingly in the direct offering of mutual funds to public shareholders, another instance of a non-intermediated public securities market. Moreover, all pricing disclosure in a crowdfunding—like that in a registered public offering—should be in plain English, to make it functional for the typical crowdfunding investor. Burying price disclosure in technical financial lingo would be tantamount to no disclosure at all.

In sum, the failure of crowdfunding issuers to provide clear, accessible pricing disclosure—of the valuation/pricing methodology used in the offering and the assumptions underlying the method chosen—would be materially false and misleading. In such a situation, investors in the crowdfunding would be entitled to recover from the issuer and its principal insiders, as well as any participating securities firm or Internet portal, an amount that would put them in a position as though they had not invested in the first place.

III. ENFORCEMENT OF CROWDFUNDING LIABILITY

Even if courts successfully were to navigate these new liability waters, the nature of crowdfunding—particularly its dollar caps—makes litigation an unlikely method for fine-tuning pricing disclosure through the new crowdfunding liability regime. Given the relatively small amounts involved in a crowdfunding offering, it is unlikely that high-cost litigation (particularly class action litigation) will provide a workable solution to molding effective pricing disclosure.

Instead, alternative methods of dispute resolution seem better suited to the task. It may be possible that an SEC-regulated arbitration regime could be a low-cost *ex post* regulation of pricing disclosure. It may also be possible that a private “pricing insurance” system might be developed by securities firms and portals, much as private price and quality guarantees work to give confidence to produce and service consumers on the Internet.

If a non-judicial alternative emerges, however, a set of dynamic standards—a synthetic common law—will be in order. If arbitration becomes commonplace, a method must be developed for the system to generate private law for the use of crowdfunding planners and for the arbitration system itself. If a private price guarantee takes hold, whether as an alternative to arbitration or in conjunction with arbitration, it must generate standards of “good practices” in securities valuation and pricing disclosure.

Finally, and perhaps most significantly, the SEC, in generating disclosure rules for crowdfunding offerings and setting out standards for investor education materials, has an important role in laying out the ground rules for the new disclosure regime—especially the methods and guidelines for setting and disclosing price in these novel small business offerings. In fact, given the structural defects (laid out next) inherent in the various possible *ex post* liability schemes to generate workable standards for pricing disclosure in crowdfunding offerings, the SEC's role in creating *ex ante* standards becomes all the more critical. And, as important as such standards will be in giving investors some tools to evaluate the crowdfunding's promises and dangers, the standards create a blueprint for small business entrepreneurs (perhaps assisted by intermediaries required by the crowdfunding mechanism) to evaluate their business, its capital needs and its prospects.

A. *Private Enforcement: Individual (or Class) Litigation*

While the JOBS Act provides a private right of action for investors in a crowdfunding, recovering damages through litigation might prove difficult.¹⁸⁷ Because the crowdfunding mechanism contemplates that businesses will raise necessary capital through small investments by a large number of investors, it is unlikely that any investors, individually, will have sufficient damages to warrant bearing the high costs associated with litigation.¹⁸⁸

As a practical matter, the small amount of money invested by individual investors in a crowdfunding makes a private suit cost-prohibitive.¹⁸⁹ Each investor's recoverable damages will be at most the consideration paid.¹⁹⁰ Further, given the crowdfunding investment caps, individual investors will have at most between \$10,000 and \$100,000 at stake, and often no more than \$2000.

Further, the total size of the crowdfunding offering will likely be too small to make class action litigation a feasible alternative for investors—or

¹⁸⁷ See *Hearing*, *supra* note 71, at 12.

¹⁸⁸ Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth Through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation*, 33 HARV. J.L. & PUB. POL'Y 607, 609 (2010) (arguing that in absence of class action, individual investors have little incentive to litigate securities law violations because they would be forced to bear all costs while receiving only fraction of potential total recovery).

¹⁸⁹ *Id.*

¹⁹⁰ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1).

class action lawyers.¹⁹¹ A crowdfunding class action, given the dollar cap for such offerings, would result in a damages award of at most \$1 million; and because most crowdfunding offerings are likely to be limited to \$500,000 due to auditing requirements for offerings above this amount, the damages award would be even smaller.¹⁹² In either event, the amount available for attorneys' fees would likely not justify the action.

In other securities contexts—such as fraud in trading markets and in large public offerings—class actions provide a mechanism for investors (and their class action counsel) to collectively overcome the litigation impediments faced by individual investors.¹⁹³ Instead of pursuing individual actions, investors take advantage of legal economies of scale by pooling costs and benefits to pursue the action and thus strengthen each investor's opportunity to maximize a settlement.¹⁹⁴ Moreover, such actions increase accountability and deterrence for issuers, which face a real threat of litigation and money judgment as the result of misbehavior.¹⁹⁵

Consider securities fraud class action results in public companies. In such lawsuits, when the class action is not dismissed, management has strong incentives to settle the action, sometimes even regardless of the merits, rather than pursue litigation.¹⁹⁶ On average, settlements of securities fraud class actions between 1998 and 2000 with estimated damages of less than \$50 million settled for 10.5% of estimated damages.¹⁹⁷ Legal fees in

¹⁹¹ *Hearing*, *supra* note 71, at 12 (explaining that “no self-respecting class action plaintiffs’ attorney could be relied upon to know [or] police start-ups that are too small to even be called ‘microcap’”).

¹⁹² *See id.*

¹⁹³ Stephen J. Choi, *The Evidence of Securities Class Actions*, 57 VAND. L. REV. 1465, 1466 (2004).

¹⁹⁴ *Id.* at 1466–67; *see also* Bondi, *supra* note 188, at 609 (explaining that class actions allow individual investors to avoid the risks of going alone in actions by pooling costs and benefits and share proportionally).

¹⁹⁵ Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63, 74 (2008) (explaining that class actions have many positive effects and evidence shows that private enforcement of regulations greatly assists with enforcement and deterrence).

¹⁹⁶ Choi, *supra* note 193, at 1466; *see also* Todd Foster et al., *Recent Trends in Shareholder Class Action Litigation: Filings Stay Low and Average Settlements Stay High—But Are These Trends Reversing?*, HOW MARKETS WORK (Nat’l Econ. Research Assocs.), Sept. 2007, at 7 (explaining that between 2005 and 2007, approximately 39.1% of class actions were dismissed).

¹⁹⁷ *See* ELLEN M. RYAN & LAURA E. SIMMONS, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2011 REVIEW AND ANALYSIS 7 (2011). The median settlement for actions from 2008 to 2011 alleging only a section 12(a)(2) violation was 7.4% of estimated damages. *Id.* at 11 (finding that between 2008 and 2011 only 68 of the securities fraud class actions alleged only a section 11 or section 12(a)(2) violation, with 50% of the cases settling for a median of \$3.3

securities fraud class actions, typically charged as contingency fees subject to court approval, average between 20–30% of the settlement amount.¹⁹⁸ That is, even smaller securities fraud class actions that were settled resulted in awards of attorney fees of more than \$1 million.

B. *Public Enforcement*

The SEC has broad authority under the federal securities laws to pursue violators, including issuers who engage in negligent misrepresentations in a securities offering, whether registered or exempt.¹⁹⁹ Although the SEC cannot use section 4A(c), which by its terms is limited to purchasers in a crowdfunding, the same issues of materiality (and reasonable investor) would be at the heart of an SEC enforcement action. A failure of an issuer to adequately disclose its pricing model (and assumptions) in a crowdfunding could be the basis for an SEC enforcement action—with the advantage that the section 4A(c) culpability, reliance and loss causation defenses would not apply. Thus, the SEC would have significant latitude to seek recovery on behalf of bilked investors in a fraudulent crowdfunding, beyond that which might be available under section 4A(c).

Due to its limited budget, however, the agency must prioritize its enforcement operations.²⁰⁰ Currently, the SEC prioritizes its cases

million, 7.4% of estimated damages). When the class alleges both a violation of section 12(a)(2) and a violation of Rule 10b-5, the median settlement was 3.6% of estimated damages. *Id.* (finding that over the same period of time, 228 class actions were filed alleging a Rule 10b-5 violation along with a section 11 or section 12(a)(2) violation, with a median settlement of \$10.8 million, 3.6% of the estimated damages).

¹⁹⁸ John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 889–90 (1987); see RYAN & SIMMONS, *supra* note 197, at 7. Attorney fees in securities fraud class actions are often charged on a contingency basis which “depends on a number of factors, such as the size of the recovery, the amount of time expended by the attorneys involved in the action, and the complexity of the litigation.” *Frequently Asked Questions About Class Actions*, BERNSTIEN & LIEBHARD, LLP, <http://www.bernlieb.com/FAQs/index.html> (last visited Oct. 30, 2012).

¹⁹⁹ See Securities Act of 1933 § 17(a), 15 U.S.C. § 77q (2006); see also James D. Cox et al., *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 746–47 (2003) (explaining that the Securities Enforcement and Penny Stock Reform Act of 1990 was intended to expand the SEC’s ability and flexibility to attack fraudulent practices by granting the SEC the power to obtain cease and desist orders and the ability to disgorge ill-gotten gains).

²⁰⁰ Cox et al., *supra* note 199, at 751–52, 757–59 (explaining that SEC enforcement staff over the past decade has increased by 16%, while the number of cases commenced over the time period increased 77%); see also Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1020 (2002) (explaining that SEC is particularly focused

according to a number of factors: (1) the message delivered to the industry and public; (2) the amount of investors harm done; (3) the deterrent value of the action; and (4) the SEC's visibility in certain areas, such as insider trading and financial fraud.²⁰¹ Given this weighing of the social benefits of its enforcement choices, the SEC's limited focus on private placements is understandable.²⁰² For example, according to the SEC's Office of Inspector General, the agency does not review the substance of Form D filings, which it treats instead as notice filings.²⁰³

The SEC's lack of enforcement in private transactions is understandable considering the factors the agency applies for bringing an enforcement action.²⁰⁴ For example, the operative assumption of Reg D enforcement has been that the SEC is charged with overseeing offerings on a national scale (Rule 506 offerings), while states are charged with policing smaller offerings (under Rule 504, Rule 505 and Reg A)—hence the preemption of state blue sky law for only Rule 506 offerings.²⁰⁵ This division of labor also fits with the SEC enforcement factors, given that Rule 506 offerings have a more pronounced effect than smaller offerings.

But as many smaller offerings have migrated to Rule 506,²⁰⁶ which offers an exemption from state filing requirements, state regulators are often left with limited options to attack fraud in small offerings.²⁰⁷ Also, the SEC's resources are stretched thin. For example, the SEC office in charge of reviewing the thousands of Form Ds filed each year, the Division of Corporate Finance's Office of Small Business Policy has a staff of five

on boiler room operations and microcap fraud, excessive markups, market manipulation and fraud in connection with hot IPOs).

²⁰¹ Cox et al., *supra* note 199, at 751 (explaining that SEC enforcement is used as a beacon showing what the SEC considers important to preserving the integrity of the financial markets).

²⁰² See Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 153 (2010) (explaining that the theory behind limited enforcement in private placements is that accredited investors, those who most often participate in these offerings, are able to fend for themselves and need only limited disclosure).

²⁰³ OFFICE OF INSPECTOR GENERAL, U.S. SEC. & EXCH. COMM'N, REGULATION D EXEMPTION PROCESS 8 (2009).

²⁰⁴ Johnson, *supra* note 202, at 164.

²⁰⁵ *Id.*

²⁰⁶ Campbell, *supra* note 24, at 919; see also VLAD IVANOV & SCOTT BAUGUESS, CAPITAL RAISING IN THE U.S.: THE SIGNIFICANCE OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION 1 (2012) (stating that the median size of a Reg D offering is approximately \$1 million).

²⁰⁷ Johnson, *supra* note 202, at 179–81 (explaining that states are still able to fine issuers for failing to file Form D, but have limited other options).

attorneys and one secretary.²⁰⁸ The Division only rarely refers Reg D violations to the SEC's Enforcement Division for action.²⁰⁹

The enforcement of Reg D rules, instead, has fallen on the shoulders of the Financial Industry Regulatory Authority (FINRA)—the self-regulatory organization (SRO) that oversees securities firms. In the past several years, FINRA has taken a more visible role in dealing with violations in Reg D offerings.²¹⁰ In April 2010, FINRA issued a regulatory notice to all members regarding Reg D offerings, specifying the amount of due diligence securities firms must undertake in such offerings to avoid liability under the antifraud provisions of the federal securities laws.²¹¹ Among other requirements, securities firms must more thoroughly investigate “securities issued by smaller companies of recent origin” and not blindly rely on information provided by the issuer concerning the company.²¹²

The SRO enforcement model offers some possibilities, though it might well be bifurcated. Securities firms (registered with FINRA as broker-dealers) are subject to FINRA jurisdiction, while portals (registered with an SRO yet to take clear form) will be subject to a different SRO jurisdiction.²¹³ It is possible to imagine coordination between the two SROs

²⁰⁸ *Id.* at 170.

²⁰⁹ OFFICE OF INSPECTOR GENERAL, *supra* note 203, at 13, 18–20 (2009) (explaining that, despite discovering multiple violations in a sample of forty-one Regulation D filings, in the fifteen-month period ending in December 2008, the Division of Corporate Finance's Office of Small Business Policy only referred one Regulation D issue to the Enforcement division).

²¹⁰ See Sara Hansard, *FINRA to Get Tough on Reg D Offerings*, INVESTMENT NEWS (Dec. 13, 2009), <http://www.investmentnews.com/article/20091213/REG/312139913> (explaining that FINRA is conducting a number of investigations of Regulation D private placements and expects to bring cases against brokerage firms regarding violations); Bruce Kelly, *Finra in Reg D Crackdown*, INVESTMENT NEWS (Apr. 7, 2011), <http://www.investmentnews.com/article/20110407/FREE/110409930> (explaining that FINRA unleashed sanctions against broker-dealers and executives of companies who offered Regulation D offerings for a lack of due diligence); David P. Meyer, Esq., *FINRA Continues Reg D Crackdown*, MEYER WILSON (Apr. 13, 2011), <http://www.investorclaims.com/blog/finra-continues-reg-d-crackdown.cfm>.

²¹¹ *Regulation D Offerings: Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings*, 10-22 REGULATORY NOTICE (Fin. Indus. Regulatory Auth.), Apr. 2010, at 2–3.

²¹² *Id.* at 3–4.

²¹³ The JOBS Act requires that portals participating in crowdfunding be registered with an SRO. See Securities Act of 1933 § 4A(a)(1)(A), 15 U.S.C. § 77d-1(a)(1)(A) (2006), amended by Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306 (2012). The nascent crowdfunding industry has already stated support for a new group, the Crowdfund Intermediary Regulatory Advocates (CFIRA). As of April 2012, CFIRA was in the process of determining rules to “protect investors and support a vibrant industry.” *Crowdfunding Industry*

and even uniform standards with respect to many aspects of crowdfunding intermediation, including pricing disclosure.²¹⁴

Coordination, however, could prove difficult. While FINRA requires broker-dealers to exercise due diligence in recommending a security, crowdfunding portals are expressly forbidden from making such recommendations. Nonetheless, the question whether a broker-dealer or portal chooses to intermediate in a crowdfunding could well carry due diligence obligations regarding the issuer, its financials and its pricing of the offering. While not a perfect protection, the SRO model may serve to create disclosure standards and oversight of an industry that begins its young life with a murky reputation.²¹⁵

C. Arbitration

Arbitration offers a possible method for *ex post* enforcement of the disclosure standards of section 4A(c). Its lower cost in both legal fees and time lower the dollar threshold at which claims become viable. The possibility of special arbitral panels—conceivably with expertise in the crowdfunding industry, sensitivity to the needs of crowdfunding investors and working knowledge of the elements of a section 4A(c) action—could

Forms Leadership Group to Pursue Development of Industry Self-Regulatory Organization, BUSINESSWIRE (Apr. 5, 2012, 3:31 PM), <http://www.businesswire.com/news/home/20120405006351/en/Crowdfunding-Industry-Forms-Leadership-Group-Pursue-Development>.

²¹⁴ The SEC staff has suggested that FINRA consider adopting its own crowdfunding rules, even if duplicative of forthcoming SEC rules. *Jumpstart Our Business Startups Act: FINRA Requests Comment on Proposed Regulation of Crowdfunding Activities*, 12-34 REGULATORY NOTICE (Fin. Indus. Regulatory Auth.), July 2010, at 3. FINRA is seeking comments regarding two categories of rules, one that would apply to funding portals and another to members acting as brokers. *Id.* (explaining that FINRA rules would be written specifically for registered funding portals); see also Barbara Black, *FINRA Seeks Comment on Regulation of Crowdfunding Activities*, SECURITIES LAW PROF BLOG (July 7, 2012), <http://lawprofessors.typepad.com/securities/2012/07/finra-seeks-comment-on-regulation-of-crowdfunding-activities.html>.

²¹⁵ See Matt Taibbi, *Why Obama's JOBS Act Couldn't Suck Worse*, ROLLING STONE (Apr. 9, 2012, 11:53 AM), <http://www.rollingstone.com/politics/blogs/taibblog/why-obamas-jobs-act-couldnt-suck-worse-20120409> (stating that the “Jumpstart Our Business Startups Act . . . will very nearly legalize fraud in the stock market . . . this law actually appears to have been specifically written to encourage fraud”); Chasan, *supra* note 61 (describing worries of SEC’s Advisory Committee on Small and Emerging Companies that it would be “too easy for businesses to commit fraud in crowdfunding scenarios”); Davidoff, *supra* note 61 (arguing that U.S. stocks carry a premium over stocks in other countries because of enhanced U.S. antifraud rules and “real risk that Congress’s actions could harm the market” if investors lose faith in U.S. stock markets).

create further efficiencies. And the flexibility of arbitration even opens up the possibility of “group” arbitration, in which opt-out can be avoided by pre-dispute agreement.

Courts would likely embrace arbitration of section 4A(c) claims. Arbitration has become a favored method for dispute resolution of securities claims, ever since the Supreme Court in the 1980s and 1990s elevated the Federal Arbitration Act of 1925 (FAA) to a charter of arbitral freedom.²¹⁶ While the Supreme Court was initially wary of enforcing pre-dispute arbitration agreements in securities regulation,²¹⁷ the Court reversed course in 1986 and held that arbitration in securities law claims was not precluded by the anti-waiver provisions of the securities laws or contrary to public policy.²¹⁸ As the Court explained, “[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum.”²¹⁹

Arbitration’s supporters argue that it offers many advantages over traditional litigation, particularly class actions suits. Arbitration is considered to be faster and less expensive than litigation.²²⁰ In fact, for parties in securities disputes who use the FINRA (formerly NASD) arbitration process as opposed to litigation, arbitral decisions were delivered on average 40% faster.²²¹ Faster arbitration reduces costs compared to

²¹⁶ Stephen A. Hayford & Alan R. Palmiter, *Arbitration Federalism: A State Role in Commercial Arbitration*, 54 FLA. L. REV. 175, 179 (2002); see also Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as well as the Frivolous*, 40 WM. & MARY L. REV. 1055, 1096 (1999).

²¹⁷ *Wilko v. Swan*, 346 U.S. 427, 433–34, 438 (1953) (holding pre-dispute arbitration agreements to be unenforceable under the Securities Act of 1933).

²¹⁸ *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 238 (1987) (holding that investors could not pursue their rights under the Securities Exchange Act if the parties had a valid pre-dispute arbitration agreement). The Court extended its reasoning in *McMahon* to claims arising under the Securities Act of 1933 two years later. See *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 481, 483 (1989).

²¹⁹ *McMahon*, 482 U.S. at 231–34; see also Jill I. Gross, *McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 493, 494–95 (2008) (explaining that the *McMahon* reasoning is based on two basic assumptions: 1) that the streamlined arbitration process does not restrict substantive rights and judicial review is sufficient to ensure protection of these rights, and 2) SEC oversight of the arbitration process ensures fairness throughout the process).

²²⁰ SEC. INDUS. & FIN. MKTS. ASS’N, WHITE PAPER ON ARBITRATION IN THE SECURITIES INDUSTRY 25 (Oct. 2007).

²²¹ *Id.* at 25–26 (explaining that from March 2005 until March 2006, federal courts averaged 22.2 months to reach a decision, while NASD arbitration hearings reached a decision in 13.7 months). Most of the speed improvements came from

litigation, with a former ABA president estimating that litigation costs run three-to-four times more than arbitration costs.²²²

Further, supporters assert that parties in arbitration are more likely to have their dispute decided on the merits compared to traditional litigation.²²³ In traditional litigation, plaintiffs claiming securities fraud must meet heightened pleading requirements to withstand a motion to dismiss.²²⁴ In contrast, such claimants in arbitration need only file a statement of claim, “specifying the relevant facts and remedies requested.”²²⁵ This reduced procedural standard, it is argued, allows arbitrators leeway in seeking fair results and giving relief in cases that might be dismissed by a federal court.²²⁶ While there is conflicting evidence over whether parties feel the arbitration process is actually fair,²²⁷ the leeway given to arbitrators to achieve an equitable result arguably has contributed to half of claimants receiving awards in securities arbitrations from 1980 to 2001.²²⁸

Finally, a key characteristic of securities arbitration is SEC oversight.²²⁹ While the actual arbitrations are administered by FINRA (and before by the NASD), the SEC retains authority to enhance and expand accessibility to the forum for the benefit of investors.²³⁰ Any existing arbitration rules that

procedural practices, such as limited motion practice and narrowly tailored discovery. *Id.* at 26–27.

²²² William G. Paul, Arbitration vs. Litigation in Energy Cases, Presentation at the First Annual Energy Litigation Program 3 (Nov. 7–8, 2002).

²²³ A significant proportion of securities arbitrations are decided by the arbitral panel following a hearing—20% in 2005, and 18% in 2006. SEC. INDUS. & FIN. MKTS. ASS’N, *supra* note 220, at 33. In contrast, from March 31, 2005 to March 31, 2006, only 1.3% of civil cases were heard by a judge or jury. *Id.*

²²⁴ The Federal Rules of Civil Procedure require plaintiffs alleging fraud to do so with particularity, alleging specific facts upon which the claim is based. FED. R. CIV. P. 9. Further, the PSLRA requires plaintiffs alleging fraud under Rule 10b-5 to meet heightened pleading requirements, such as pleading scienter and specific instances of each misleading statement in the sale or purchase of a security. 15 U.S.C. § 78u-4(b)(1) (2006).

²²⁵ CODE OF ARBITRATION P. FOR CUSTOMER DISPUTES § 12302(a)(1) (Fin. Indus. Regulatory Auth. 2012).

²²⁶ SEC. INDUS. & FIN. MKTS. ASS’N, *supra* note 220, at 32.

²²⁷ Black & Gross, *supra* note 200, at 994 (explaining that individuals associated with the securities industry extol the efficiency and low cost of the arbitration system, while investors often object to arbitration on suspicions of the SRO process).

²²⁸ SEC. INDUS. & FIN. MKTS. ASS’N, *supra* note 220, at 34–35.

²²⁹ See *id.* at 47–48 (explaining that oversight by the SEC in one of the main differentiating qualities of securities arbitration as compared to other, more controversial types of arbitration).

²³⁰ Ramirez, *supra* note 216, at 1064.

diluted the effectiveness of crowdfunding arbitration would be subject to SEC review, and any new rules would require SEC approval.²³¹

But securities arbitration also has its dark side. In fact, Congress, in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), mandated that the SEC take a look at securities arbitration of customer-broker disputes.²³² While claimants in a securities arbitration are not supposed to lose their substantive rights by opting for arbitration, the arbitrator need not adhere to the rule of law in making a decision.²³³ Instead, arbitrators have broad power to “do justice as [they] see it, applying [their] own sense of law and equity to the facts . . . and making an award reflecting the spirit rather than the letter of the agreement”²³⁴ Nor is there any requirement that arbitrators, who may or may not be lawyers, receive adequate training to grasp the complexities of securities regulation—or the needs of claimants (typically unsophisticated individuals) in securities arbitration.²³⁵

In fact, the industry extols the “standard-less” nature of securities arbitration, which is said to be guided by principles of fairness and justice.²³⁶ To compound the problem that arbitration need not adhere to legal standards, arbitrators are not required to provide a written decision

²³¹ SEC. INDUS. & FIN. MKTS. ASS'N, *supra* note 220, at 12. SEC involvement in the arbitration rulemaking process includes encouragement by the SEC that SROs adopt the “plain English” requirement in the Code of Arbitration and other investor materials. *Id.* This encouragement led NASD to re-format the Code to make it more “user-friendly,” improvements the SEC found to increase transparency and accessibility of arbitration for pro se claimants. *Id.*

²³² See Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act?*, 13 U. PA. J. BUS. L. 59, 61 (2010) (describing Dodd-Frank’s call on the SEC to look at the fairness of mandatory pre-dispute arbitration provisions).

²³³ See Black, *supra* note 200, at 997 (explaining that the *McMahon* decision was based on the presumption that arbitrators applied federal statutory law in claims, but there is no evidence this is actually the case).

²³⁴ Silverman v. Cooper, 61 N.Y.2d 299, 308 (1984). *But see* SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE 7 (1996) [hereinafter RUDER REPORT].

²³⁵ Black, *supra* note 200, at 1006 (explaining that the Supreme Court obviously assumed that the law regarding securities was so clear that it can be applied to the facts of a specific case with some instruction by the proper SRO and, if needed, will be further clarified by party briefs to the arbitrators).

²³⁶ *The Arbitrator's Manual*, FIN. INDUS. REGULATORY AUTH., Aug. 2012, at 8 (“Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail.” (citations omitted)).

explaining the reasoning behind their award.²³⁷ Therefore, even though parties to an arbitration in theory do not forego their substantive rights, no mechanism exists for a losing party to know what legal standards the arbitration panel followed. Absent fraud or corruption, arbitral awards can be judicially reviewed only if there is a “manifest disregard” for the law, which the Supreme Court has concluded offers sufficient judicial oversight to protect the arbitral parties’ substantive rights.²³⁸

In addition, decisions in securities arbitration do not produce precedential value.²³⁹ This represents a significant drawback for arbitration as the method of crowdfunding enforcement, given that many standards of crowdfunding disclosure will likely (or should) arise from the section 4A(c) duty against making material misstatement or omissions. Further compounding the problems of an arbitration regime that produces neither reasoned decisions nor legal precedent is the likely absence of any judicial decisions on which arbitrators might rely. In short, arbitration could well undermine the development of standards of full and fair disclosure in crowdfunding offerings—particularly, standards applicable to the finer points of setting and disclosing price.

Current arbitration rules also prevent claimants from bringing class action arbitrations.²⁴⁰ But even if the arbitration rules were amended to allow class action arbitration for crowdfunding offerings, it is unclear that the cost savings would be enough to make arbitration a viable enforcement tool.²⁴¹ It seems unlikely that the cost savings of resolving multiple claims with shared common facts, the likely usual case in a crowdfunding

²³⁷ In fact, many in the industry would likely protest a requirement for opinions as the consensus is that that an arbitration panel’s mission is to have a confidential process for granting awards and a written opinion would hamper this process. Black, *supra* note 200, at 1031.

²³⁸ *Montes v. Shearson Lehman Bros., Inc.*, 128 F.3d 1456, 1460 (11th Cir. 1997) (explaining that every Circuit, except the Fifth, has expressly recognized that “manifest disregard of the law” standard as appropriate for reviewing arbitration panel’s decision). *But see* Black, *supra* note 200, at 1014 (explaining that the limited scope of judicial review creates hurdles for parties seeking to vacate arbitral award).

²³⁹ *See* Black, *supra* note 200, at 1001 (pointing out that because most cases are now heard by an arbitration panel, as opposed to a judge or jury, law in the field has matured only slightly since *McMahon*).

²⁴⁰ CODE OF ARBITRATION § 10301(d)(1) (Nat’l Ass’n Sec. Dealers 2002); *see also* Bondi, *supra* note 188, at 624 (explaining that the SEC directed SROs to considered rules for allowing arbitration of class-action cases but SICA unanimously adopted a rule to exclude arbitration in class action lawsuits, which the SEC approved stating that the courts had developed expertise in managing class actions).

²⁴¹ *See* Bondi, *supra* note 188, at 628.

accomplished by widely disseminated misstatements,²⁴² would be enough to justify an arbitration given the relatively small recoveries in a typical crowdfunding offering.

In short, the relatively small amounts involved in a crowdfunding—and thus the relatively small amounts of potential recovery—also render arbitration problematic as a means for effective enforcement and meaningful compensation in crowdfundings. As with court litigation, the numbers do not add up. Assuming a typical \$300,000 crowdfunding, it is difficult to imagine a successful “class” arbitration costing less than \$100,000—given attorney fees, arbitration costs and fund administration. Moreover, the only defendants that would likely be capable of satisfying the judgment would be crowdfunding intermediaries—that is, the securities firm or Internet portal required by the crowdfunding regime. Predictably, they would assert a vigorous defense, whether on the grounds of materiality, culpability or loss causation, thus adding further to the costs of the arbitral procedure.

D. *Insurance*

Crowdfunding thus presents the challenge of any consumer/financial transaction in which the effects of a failed product/service are relatively small, compared to the costs of accountability—whether through public enforcement, private litigation or arbitration. One way of solving the puzzle is to create an insurance system in which a failed crowdfunding is insured.²⁴³ The insurance—which would be a cost of the crowdfunding borne by investors—would avoid the costs of an enforcement system, thus sidestepping the quagmire of identifying materiality, culpability, reliance and loss causation. It would also create a natural gatekeeper (the insurance company) with an incentive to identify potentially fraudulent or mispriced crowdfunding offerings. In fact, pricing discipline in crowdfundings could well come from insurers that—like underwriters in a registered public offering—could decide whether disclosure and pricing to investors was adequate to ensure the offering’s success.

Insurers might also insist that securities firms and Internet portals—as a condition to insuring the offerings in which they participate—provide issuers with expertise on disclosure and pricing methods. No doubt, these crowdfunding intermediaries will vet small business issuers, not only to protect themselves from litigation risk, but also to compete and gain a reputation as a purveyor of solid investment returns—or matching investors and investment risk. To some extent, this is the function of insurers

²⁴² Black, *supra* note 200, at 1014.

²⁴³ See ROBERT J. SHILLER, FINANCE AND THE GOOD SOCIETY 65 (2012) (arguing that insurance pools risk and thus reduces it, thus making investors more willing to take risks).

providing private mortgage insurance, which demand that mortgage originators adopt credit standards for borrowers.

IV. CONCLUSION

Crowdfunding comes with much promise and much danger. Helping investors translate information into price—the fundamental role of securities law—will inevitably fall on issuers and other participants in crowdfunding offerings. Investors in such offerings, who the enabling legislation assumes will be individuals with limited investment sophistication, will have to be guided to understand how (and how much) future returns and risks have present value.

Although the SEC will undoubtedly play a role in creating rules on investor education and pricing disclosure, the liability scheme that emerges for enforcing disclosure in crowdfunding offerings will become critical to the new mechanism's success. Identifying what securities information is material, which in turn depends on the sophistication of the investor and any intermediaries, will become an important task for crowdfunding regulators—the SEC, the self-regulatory organizations overseeing crowdfunding intermediaries, and the courts and others charged with enforcing the crowdfunding liability provisions.

Pricing disclosure—of the methods through which securities pricing happens and of the assumptions underlying those methods—would seem to be highly material. Accountability for mispriced crowdfunding offerings, where the pricing disclosure failed to reveal the risk-return dynamic, will be central to the new regime's success or failure. If crowdfunding turns out to be an over-priced (even fraudulent) racket, we will have squandered an opportunity to democratize our financial markets.

Given the heavy costs of private enforcement (whether through individual or class litigation), public enforcement and even arbitration, it seems that some ingenuity will be necessary for the crowdfunding industry to reassure investors that there will be accountability for failed crowdfunding offerings. A system of private insurance, borrowing to some extent from the underwriting function in registered public offerings, may be a solution.

