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Financial Contracting with the Crowd

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ABSTRACT

Equity crowdfunding is broken. The current model imposes too many burdens on entrepreneurs in exchange for too little money. For alternative models, this Article looks to the time-tested venture capital financial contract and the recent experience of initial coin offerings (ICOs). ICOs made headlines over the past two years as the means by which blockchain technology companies raised billions of dollars to launch new cryptocurrency ventures. Although their novelty as a monetary and investing device is well known, ICOs also presented significant, unappreciated insights into financial contracting.

ICOs furnished an unprecedented experiment into how bargains would look if entrepreneurs raised money for a venture directly from the general public without government regulation. Although the setting was novel, the financial contracts of the blockchain replicated mechanisms familiar from the venture-capital context that protect investors against uncertainty, information asymmetry, and agency costs. ICO financial contracts suggest that familiar venture capital contractual provisions such as vesting of founder ownership interests, voting rights, and redemption rights are versatile tools that can protect investors in a variety of settings—including equity crowdfunding. Thus, even if ICOs may not prove a lasting phenomenon, regulators can apply their financial contracting lessons to capital-raising from the crowd. Doing so has the potential both to increase entrepreneurial access to capital and to democratize the investing playing field.

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INTRODUCTION

Pabst Blue Ribbon Inc. (PBR) was up for sale in 2009, and two loyal patrons wanted to prevent the iconic American company from suffering the same fate as Budweiser, which had been sold to Belgian-Brazilian InBev the year before.[1] The two men tried to crowdsource a bid for the company, creating a site called BuyaBeerCompany.com.[2] The pair obtained over $200 million in pledges from approximately five million Americans, but the Securities Exchange Commission (SEC) prohibited the campaign.[3] According to the SEC, PBR's would-be acquirers were offering a security, and U.S. securities laws prohibit the sale of a security to the general public to finance a firm without registering with the SEC (in an initial public offering, or IPO), or qualifying for an exemption from registration.[4]

Indeed, before 2012, "crowdfunding" was limited to Kickstarter-like funding campaigns[5] that rewarded funders with a nominal gift such as a T-shirt or baseball cap. There was no way to raise money from the general public—or the "crowd," as this Article will sometimes call it—in exchange for a stake in the underlying business.[6] This limitation dates back to the Securities Act of 1933, which requires firms to register for an IPO before selling their securities to the crowd.[7] Any offer to sell shares in an actual business was thus off-limits—including soliciting offers to buy a beer company.[8]

The somewhat whimsical PBR plan inspired U.S. Representative Patrick McHenry (R-NC).[9] He wanted to counter U.S. securities law's "paternalistic view that average investors can't make these decisions for themselves."[10] The

[1] Michael J. de la Merced, *S.E.C. Stops Would-Be Buyers of Pabst Beer*, N.Y. TIMES (June 8, 2011, 3:52 PM), https://dealbook.nytimes.com/2011/06/08/s-e-c-thwarts-would-be-buyers-of-pabst-beer/; William Spain & Steve Goldstein, *Anheuser-Busch Accepts $52 Billion InBev Offer*, MARKETWATCH (July 14, 2008, 5:39 PM), https://www.marketwatch.com/story/anheuser-busch-accepts-52-billion (discussing the Budweiser takeover).

[2] Merced, *supra* note 1.

[3] *Id.*; Danielle Sacks, *Shaking Up Crowdfunding*, FAST COMPANY (May 14, 2012), http://www.fastcompany.com/1835677/shaking-crowdfunding; *SEC Cans Web Campaign to Buy Pabst Brewing*, DENVER POST (June 8, 2011, 3:39 PM), https://www.denverpost.com/2011/06/08/sec-cans-web-campaign-to-buy-pabst-brewing/.

[4] 15 U.S.C. §§ 77c–e (2012); *see* Sacks, *supra* note 3.

[5] *See infra* note 255 and accompanying text.

[6] Larissa Lee, Note, *The Ban Has Lifted: Now Is the Time to Change the Accredited-Investor Standard*, 2014 UTAH L. REV. 369, 371 (noting that the pre-JOBS Act regulation "banned general advertising and general solicitation").

[7] 15 U.S.C. §§ 77a–aa.

[8] *See* Sacks, *supra* note 3.

[9] *Id.*

[10] *Id.*; Steve King, *Congressman McHenry Promotes His Crowdfunding Bill and Trashes Competing Senate Legislation*, iPeopleFINANCE (Feb. 24, 2012), https://isellerfinance.wordpress.com/2012/02/24/

problem McHenry sought to address was a simple one: How can companies—especially small ones—raise equity financing from the general public?[11] He introduced a three-page bill that allowed ordinary investors to invest the lesser of $10,000 or 10% of their annual income in companies seeking to raise up to $5 million.[12] McHenry's straightforward bill ultimately became Title III of the Jumpstart Our Business Startups Act of 2012 (JOBS), but along the way Congress amended it to impose substantial requirements on aspiring crowdfunding entrepreneurs.[13] The SEC layered on even more requirements in its final rule, which weighed in at 228 pages and over 1,700 footnotes.[14] As a result, equity crowdfunding, capped at only $1.07 million, is widely regarded as not being worth the effort.[15]

As Part I describes, private fundraising has long offered an alternative funding source to the IPO, for those entrepreneurs willing to seek out funds from a more limited group of accredited (i.e., wealthy) investors,[16] and able to meet the requirements of a "private offering" to raise funds. These private offerings allow for experimentation precisely because they occur outside the gaze of securities regulators.

Accredited and institutional investors can invest in private offerings because they are deemed able to "fend for themselves"[17]—and fend for themselves they must. Investors contemplating investing in a fledgling venture confront significant problems of uncertainty, information asymmetry, and agency costs.[18] They are free to contract as they see fit to address these issues, without regulatory intervention. As Part II.B will describe, a rich literature has detailed financial

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congressman-mchenry-promotes-his-crowdfunding-bill-and-trashes-competing-senate-legislation/ (noting that McHenry discusses the need to loosen the rules in this space).

[11] *Cf.* King, *supra* note 10 (noting McHenry's statement that "[o]nerous regulation is holding back businesses seeking to raise capital").

[12] H.R. 2930, 112th Cong. § 2(a) (2011).

[13] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 301–305, 126 Stat. 306, 315–23 (2012).

[14] Crowdfunding, 80 Fed. Reg. 71,387 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, & 274).

[15] *See infra* Part I.C.

[16] Rule 506 of Regulation D describes several categories of accredited investors, including certain banks, charitable organizations, and certain high net worth individuals, who may invest in securities that are not registered. 17 C.F.R. § 230.501(a) (2017). Most notably, for the purposes of this Article, individuals with a net annual income of over $200,000 or a total net worth of over $1 million may invest in securities that are not registered, provided that those securities meet the general disclosure requirements of Rule 502. *Id.* §§ 230.251(d)(2)(C), 230.501(a)(5)–(6) (allowing such persons to invest in unregistered securities). This division explains why average investors cannot invest in hedge funds, nor in private companies such as Airbnb or Chick-fil-A until they go public.

[17] Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3420 (2013).

[18] *See infra* notes 150–152 and accompanying text.

contracting terms in the venture financing realm—like the vesting of founder equity, and staged financing—that strike the appropriate balance between entrepreneur capital-raising and investor protection.[19] The literature argues that venture capital's (VC) financial contracting aligns the incentives of company and investor,[20] and helps explain the success of VC-backed companies ranging from Apple to Google to Lyft in raising hundreds of millions of dollars while avoiding burdensome IPO requirements.

On the public side, however, the securities laws and the SEC create a choke point. There is little room for private ordering between investors and entrepreneurs because any offer of a security for sale to the general public must pass muster with the SEC.[21] The SEC will occasionally allow for experimentation,[22] but these instances are at the regulators' whim. Thus, any experiments are at best an imperfect approximation of the contractual terms the public market might desire, if left to its own devices, to contract for its own protection.[23]

Without the possibility of such experimentation, Congress and the SEC are left to articulate rules that both foster capital formation and provide adequate investor protection. While the crowdfunding rules and regulations might not strike the proper balance between disclosure, regulatory burden, and investor protection, there generally has been no way of knowing what *would* work. Yet two examples offer as-yet unexplored models for what investor protection might look like in the equity crowdfunding context.

The financial contracting of venture capital funding and initial coin offerings (ICOs) offer examples of what kinds of investor protections equity crowdfunding might offer. An ICO is an offering of specialized crypto tokens,[24]

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19 *See infra* Part II.B.

20 *See infra* Part II.B.

21 *See* 15 U.S.C. § 77e(a), (c) (2012) (prohibiting the sale of unregistered securities to the public).

22 *See, e.g.*, Anita Balakrishnan, *Snapchat Officially Files for IPO*, CNBC (Feb. 2, 2017, 4:37 PM), https://www.cnbc.com/2017/02/02/snap-ipo-s-1-filing.html (stating that Snapchat "noted that unlike almost every public offering on the market, the two co-founders will control 'all stockholder decisions'").

23 To be more precise, of course, the general public is a dispersed group of individuals that could not "bargain" for its own protection with the firm, in the sense of dickering over terms. But entrepreneurs looking to raise capital from the crowd, unmediated by state actors, would inevitably include certain contractual investor-protection mechanisms in their offerings, to entice potential investors. Over time, we could determine which protections command a premium, presumably because the crowd perceived them to be the most valuable in terms of protecting them and ensuring the overall venture's success.

24 These offerings are generally referred to as initial coin offerings because the early offerings were of coins—that is, actual cryptocurrency. *See* Ivona Skultetyova, *Short History of ICOs: From Crypto Experiment to Revolution in Startup Financing*, MEDIUM (Feb. 2, 2018), https://medium.com/@ehvLINC/short-history-of-icos-from-crypto-experiment-to-revolution-in-startup-financing-709c23839ffc (noting the initial idea was to

with the promise that those tokens will operate as a medium of exchange when the blockchain venture is complete.[25] The funds raised in the ICO are used to continue to develop the blockchain technology and bring it to market.

It is worth pausing here to underline the radical break that ICOs represent. Using the blockchain, early ICO promoters were able to evade SEC regulation entirely. For the first time since the advent of federal securities regulation in 1933, entrepreneurs could raise significant money—in some cases the equivalent of hundreds of millions of dollars in cryptocurrency—within a matter of weeks, without investment bank intermediaries, the SEC, or accountants.[26] In July 2013, MasterCoin launched what is regarded as the first initial coin offering,[27] which raised about $500,000 in bitcoin.[28] Just three years later, the decentralized autonomous organization (DAO) raised $150 million worth of cryptocurrency.[29] The SEC has moved to stem the tide of ICOs, and that regulatory intervention, coupled with an overall drop in cryptocurrency values,[30]

issue "Mastercoins"). New cryptocurrencies later evolved that allowed coders to layer different contracts on top of a single cryptocurrency platform. *Id.* For example, the Ethereum blockchain launched with an ICO in 2014, with a currency called ether. *From Crowdfunded Blockchain to ICO Machine: An Ethereum Price History*, SFOX (Apr. 5, 2018), https://blog.sfox.com/from-crowdfunded-blockchain-to-ico-machine-an-ethereum-price-history-ddb31c3134c4 [hereinafter *Ethereum Price History*]. It permitted entrepreneurs to code projects on the blockchain, exchanging ether for so-called "tokens" to be used in those projects built on top of the Ethereum blockchain. Ameer Rosic, *What Is an Ethereum Token: The Ultimate Beginner's Guide*, BLOCKGEEKS, https://blockgeeks.com/guides/ethereum-token/ (last visited Oct. 24, 2019).

25 THOMAS BOURVEAU ET AL., INITIAL COIN OFFERINGS: EARLY EVIDENCE ON THE ROLE OF DISCLOSURE IN THE UNREGULATED CRYPTO MARKET 3–4 (2018).

26 Antonio Madeira, *The DAO, the Hack, the Soft Fork and the Hard Fork*, CRYPTOCOMPARE (Mar. 12, 2019), https://www.cryptocompare.com/coins/guides/the-dao-the-hack-the-soft-fork-and-the-hard-fork/ (noting that the DAO crowdfunded $150 million worth of cryptocurrency).

27 Chance Barnett, *Inside the Meteoric Rise of ICOs*, Forbes (Sept. 23, 2017, 1:21 AM), https://www.forbes.com/sites/chancebarnett/2017/09/23/inside-the-meteoric-rise-of-icos/; *see* Dominik Zynis, *A Brief History of Mastercoin*, OMNI (Nov. 29, 2013), https://blog.omni.foundation/2013/11/29/a-brief-history-of-mastercoin/ (noting that Mastercoin launched July 2013).

28 Laura Shin, *Here's the Man Who Created ICOs and This Is the New Token He's Backing*, FORBES (Sept. 21, 2017, 12:06 PM), https://www.forbes.com/sites/laurashin/2017/09/21/heres-the-man-who-created-icos-and-this-is-the-new-token-hes-backing/#5b8658231183.

29 Madeira, *supra* note 26; PERRIE M. WEINER, CHRISTOPHER C. PACI & KIRBY HSU, CRYPTOCURRENCIES AND ICOS: AN SEC ENFORCEMENT PERSPECTIVE 1 (2018), https://www.dlapiper.com/~/media/files/people/weiner-perrie/508486_0_perrie-weiner-dla-piper-article---cyrptocurrencies-and-icos---an-sec-perspective.pdf?la=en&hash=EEEA9DB6205D34435089A5C44C8A996A874F63D8; Kai Sedgwick, *46% of Last Year's ICOs Have Failed Already*, BITCOIN (Feb. 23, 2018), http://news.bitcoin.com/46-last-years-icos-failed-already/; Andrew Tar, *SEC Ruling on the DAO and ICO, Explained*, COINTELEGRAPH (July 27, 2017), https://cointelegraph.com/explained/sec-ruling-on-the-dao-and-ico-explained. Ethereum, an early ICO success story, raised about $18 million in bitcoin. *Ethereum Price History*, *supra* note 24. Similar early successes led the way for the ICO explosion that occurred in 2017. Barnett, *supra* note 27. ICOs raised about $3.7 billion in 2017, through more than 900 sales.

30 *See, e.g.*, Brad Tuttle, *Bitcoin Prices Just Hit a New Low. Here's How Much You Would Have Lost If You Bought at the 2018 Peak*, MONEY (Nov. 15, 2018), http://money.com/money/5455877/bitcoin-price-2018-

means that ICOs have become less prevalent and less successful.[31] Indeed, regulators have proved deeply suspicious of ICOs because their early success also attracted fraudsters.[32] Part IV of this Article will explain ICOs further, but for present purposes all that matters is that ICOs offered—for a limited time, before the SEC cracked down on them—an example of financial contracting for funds from the general public, unfettered by government intervention.

This Article is the first to take the financial contracting of ICOs seriously. The literature of venture capital financial contracting, detailed in Part III, has offered deep insights into how contractual mechanisms can protect investors from risk, but focused on *private* capital-raising. ICOs offer many of the same protections in the context of *public* capital-raising. These twin models, though unlike in many ways, nonetheless can each offer insights into possibilities for crowdfunding.

One major takeaway from comparing the contracting of venture financing to that of ICOs is the universality of the risks of uncertainty, information asymmetry, and agency costs.[33] These problems plague both public and private investors.[34] Unsurprisingly, given this universality of concerns, ICO contractual terms echo the very terms venture investors include—terms like enforced vesting of founder ownership interests, voting rights, and exit rights.[35] But ICO financial contracts also include terms tailored to the particular needs of the blockchain (like limitations on supply)[36] and terms that reflect the special concerns that accompany fundraising from the crowd (like a requirement that fundraising reach a certain threshold level before being released).[37]

Equity crowdfunding can, but to date has not, employ some of these

peak-low/.

31 *See* Sritanshu Sinha, *IEOs, ICOs, STOs and Now IDOs—How to Raise Funds for Crypto in 2019?*, COINTELEGRAPH (Sept. 1, 2019), https://cointelegraph.com/news/ieos-icos-stos-and-now-idos-how-to-raise-funds-for-crypto-in-2019 (noting the "decline of initial coin offerings").

32 A *Wall Street Journal* study of 1,450 ICOs revealed 271 with signs of fraud, including "plagiarized investor documents, promises of guaranteed returns and missing or fake executive teams." Shane Shifflett & Coulter Jones, *Buyer Beware: Hundreds of Bitcoin Wannabes Show Hallmarks of Fraud*, WALL ST. J. (May 17, 2018, 12:05 PM), https://www.wsj.com/articles/buyer-beware-hundreds-of-bitcoin-wannabes-show-hallmarks-of-fraud-1526573115. Many are tempted to view these efforts as attempts to sell the Brooklyn Bridge to the gullible. Stephen T. Black, *Psst! Wanna Buy a Bridge? IP Transfers of Non-Existent Property*, 31 GA. ST. U. L. REV. 523, 576 (2015).

33 *Cf.* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1076 (2003) ("All financial contracts respond to three central problems: uncertainty, information asymmetry, and opportunism in the form of agency costs.").

34 *See id.* (noting that such problems are central to "[a]ll financial contracts").

35 *See infra* Part III.B.

36 *See infra* Part III.B.2.

37 *See infra* Part III.B.4.

mechanisms to protect investors and facilitate capital raising. This Article advocates exploring the escrow mechanism as a means to introduce staged financing, with its concomitant empowering of investors by delaying the follow-on investment decision, as well as other protections.

ICOs may have waned in popularity but concerns about wealth disparities and financial inequity have not. Equity crowdfunding was meant to make it easier for small businesses to raise capital, while at the same time allowing the general public for the first time to invest in private firms. Yet currently crowdfunding is hampered by burdensome regulation and risks becoming, if it is not already, a market for lemons.[38]

The takeaway from the contracting of both ICOs and venture financing suggests that investors face common risks and use common strategies to mitigate them. Current equity crowdfunding fails to implement these strategies, but this Article argues that these mechanisms would improve crowdfunding and enable Congress to more safely raise the $1.07 million limit.[39] After acknowledging some potential limitations to the ICO model, Parts V & VI will describe the various paths Congress, the SEC, and state regulators might take should they choose to apply financial contracting lessons to make crowdfunding a viable source of capital for small firms, and at the same time a safer investment for the crowd.

I. THE CRUMBLING OF THE TRADITIONAL PUBLIC/PRIVATE DIVIDE

This Article will focus on financial contracting in the venture capital and ICO context as a counterpoint to the above-described crowdfunding regulations. But first, this Part will provide the context to understand how unique the crowdfunding opportunity to experiment with private ordering in the public markets was. It will also explain how the traditional limitations on private investments—prohibitions against general solicitation, resale limitations, limits on the number of private company investors and on the amount they can raise—have gradually fallen by the wayside. As private companies start to look more and more like public ones, the old arguments for keeping the public markets separate from the private ones may no longer hold as much water.

Section A of this Part will describe how traditionally investors faced a trade-off between private and public capital raising. Raising money from the general public was expensive and complicated, but it allowed fundraising from the

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[38] *See infra* Part I.C.

[39] *See infra* note 114 and accompanying text.

crowd and the ability to resell securities freely.[40] On the flip side, private capital raising was cheaper and easier, but generally restricted sale to the wealthy and limited the right of resale.[41] Section B of this Part will describe how the lines between these two forms of capital raising have blurred considerably, allowing private offerings to look much more public. Section C will describe equity crowdfunding and its attendant problems.

A. The Public/Private Divide

For years, an equilibrium of sorts existed in the securities world, one rooted in a strict divide between two markets.[42] On one side of the divide lay private markets, policed by fraud, which allowed for relatively small-scale fundraising from wealthy individuals and institutions.[43] Resale of securities was both legally and practically difficult.[44] On the other side lay public markets, policed by disclosure, which allowed companies to raise millions of dollars and enjoy a liquid secondary market.[45] Entry into those public markets was costly and came by way of an intermediary, an investment bank that shepherded a company through an initial public offering.[46] For the entrepreneur seeking to raise capital by selling a security, there were two options: (1) register the security with the SEC in an IPO or (2) shoehorn the offering into an exemption from the registration requirement, and conduct a private offering, with all its attendant limitations.

Before describing the public/private divide further, it is worth noting the potential—in theory, at least—of a third path. Rather than registering a security offering with the SEC or finding a way to exempt it from registration, enterprising entrepreneurs have repeatedly tried to argue that what they are selling does not qualify as a security at all.[47] If not a security, no registration is needed.[48] In fact, ICO developers attempted this very argument,[49] and ultimately failed to convince the SEC for one reason: the *Howey* test.

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40 C. Steven Bradford, *Expanding the Non-Transactional Revolution: A New Approach to Securities Registration Exemptions*, 49 EMORY L.J. 437, 483 (2000).

41 *See supra* note 16 and accompanying text.

42 *See* Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 453 (2017) (noting that law creates a "sharp divide" between the two markets).

43 Bradford, *supra* note 40, at 452.

44 *Id.* at 483–84.

45 De Fontenay, *supra* note 42, at 461.

46 *See infra* note 67 and accompanying text.

47 *See infra* note 225 and accompanying text.

48 *See* 15 U.S.C. § 77f (2012) (requiring registration only for securities).

49 *See infra* note 225 and accompanying text.

The Securities Act defines a security as a laundry list of financial instruments, most of them familiar ("stock, … bond") and some more exotic ("debenture, … fractional undivided interest in oil, gas, or other mineral rights…").[50] In the middle of the list is the phrase "investment contract,"[51] an undefined term that has become a catchall provision, capturing pay phones,[52] earthworms,[53] chinchillas,[54] and other questionable assets offered for sale.

Courts could hold that such disparate assets qualified as securities because of the power and flexibility of a test the Supreme Court enunciated in 1946 in *SEC v. W. J. Howey Co.*[55] The *Howey* test first required that the investment be "solely from the efforts of others."[56] Courts have not interpreted "solely" literally, but instead have inquired as to whether "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[57] Second, *Howey* required that there be an expectation of profit,[58] which the Court later defined as (1) "capital appreciation resulting from the development of the initial investment" or (2) "participation in earnings resulting from the use of investors' funds."[59] Third, an investment contract requires a "common enterprise."[60]

Any attempt to raise funds in a common enterprise where profits will be derived solely from the efforts of others winds up getting classified as an investment contract, and thus a security, under the capacious *Howey* test.[61] Thus, *Howey* has thwarted countless efforts to find an end-run around the securities laws—including, most importantly, the ICO.[62]

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[50] 15 U.S.C. § 77b(a)(1).

[51] *Id.*

[52] SEC v. Edwards, 540 U.S. 389, 392 (2004).

[53] Smith v. Gross, 604 F.2d 639, 643 (9th Cir. 1979).

[54] Miller v. Cent. Chinchilla Grp., 494 F.2d 414, 418 (8th Cir. 1974).

[55] 328 U.S. 293 (1946).

[56] *Id.* at 301.

[57] SEC v. Glenn W. Turner Enter., 474 F.2d 476, 482 (9th Cir. 1973).

[58] *Howey*, 328 U.S. at 301.

[59] United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975). The Supreme Court interpreted *Howey*'s requirements more broadly over time. For example, in *SEC v. Edwards*, it held that the promise of a fixed rate of return qualified as an expectation of profit. 540 U.S. 389, 395 (2004).

[60] *Howey*, 328 U.S. at 298–99. Courts agree that horizontal commonality, which looks at the relationships between an individual investor and the pool of other investors, meets the *Howey* test, but are less clear on whether the relationship between the investor and the promoter is enough to satisfy the common enterprise element. *See* Brodt v. Bache & Co., 595 F.2d 459, 460, 462 (1978). These need not concern us, however.

[61] In *SEC v. Lauer*, Judge Richard Posner found that a scheme involving only one investor could qualify as a common enterprise, because the promoter represented that the investment would be pooled with others. 52 F.3d 667, 670–71 (7th Cir. 1995).

[62] *See infra* Part III.B.

Having disposed of the putative "third way" of avoiding securities regulation, we can return to the dichotomous world of public and private capital raising. Access to the public markets comes via the IPO, which Robert Thompson and Donald Langevoort call a "rite of passage."[63] What a rite of passage it is. Public offerings are subject to regulations even before they are sold to the public.[64] Gun-jumping rules provided by the SEC work to tamp down public excitement before the offering itself.[65] Entrepreneurs must register with the SEC before going public, a lengthy and expensive process that helps ensure that investors have a sufficient quantity of information before the sale.[66] By assigning underwriters and experts with strict liability for misstatements in the prospectus, subject to a limited due diligence defense, the securities laws put the deep pockets and reputation of investment banks on the hook.[67] They effectively deputize the investment banks conducting the offering to police the prospectus for fraud.[68]

In the end, however, the payoff is substantial. Once public, issuers can sell to anyone.[69] The securities laws subject public companies to ongoing reporting requirements of increasing rigor and complexity, ensuring that post-IPO purchasers of securities are kept well-informed.[70] These disclosures occur at regular intervals (supplemented with updates as needed), and follow a standard formula, ensuring investors can assess risks uniformly.[71] Their purchasers can resell freely, and do so knowing that the company is subject to ongoing reporting requirements.[72] This promise of continual disclosure makes for a robust secondary market.[73] The promise of subsequent liquidity on the secondary

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63 Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 352 (2013).

64 *See id.*

65 *See infra* notes 133–134 and accompanying text.

66 *See* de Fontenay, *supra* note 42, at 448.

67 Merritt B. Fox, *Regulating Public Offerings of Truly New Securities: First Principles*, 66 DUKE L.J. 673, 688–89 (2016).

68 *See* Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1636 (2010) (discussing the liability—subject to a due diligence defense—of these "gatekeepers").

69 *See* de Fontenay, *supra* note 42, at 461.

70 *See Public Companies*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/basics/how-market-works/public-companies (last visited Sept. 20, 2019) (providing a brief overview of ongoing disclosure requirements); *cf.* Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1361 (1999) (discussing the heightened disclosure requirements created by the law).

71 *See Public Companies*, *supra* note 70 (providing brief overview of disclosure by public companies and noting that "[p]ublic companies must continue to keep their shareholders informed on a regular basis"); *see also* Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135, 146–48 (2009) (discussing different views on whether standard, uniform disclosures, as required by the law, are better than disclosures crafted by a firm's discretion).

72 Bradford, *supra* note 40, at 483.

73 Rodrigues, *supra* note 17, at 3427.

markets correspondingly boosts the price of the initial offering—people will pay more for something they know they can resell.[74] And companies can return to the public capital markets to conduct secondary offerings at far less expense than the original IPO.[75]

For firms that preferred not to undergo this rite of passage, traditionally the private markets remained. These provided quicker access to capital, at a cheaper price.[76] But the market was limited largely to those investors who could fend for themselves.[77] Private offerings were—and still largely are—reserved for accredited investors[78]—i.e., the wealthy.[79]

Securities laws also constrained the manner in which private firms could advertise for investors.[80] Before the JOBS Act, sellers of securities in private offerings could not even advertise offers to the general public, a practice termed *general solicitation*.[81] No billboards, no magazine ads, no internet banners, no tweets.[82] In part because of this limitation, even the existence of these kinds of investments was largely hidden from the average investor.

This private securities market was policed mainly by fraud, and was relatively illiquid, both because of regulatory impositions, and because of the lack of ongoing disclosure.[83] In brief, you had two choices. You could sell to the private markets cheaply and quickly, but with limits on general solicitation, the total number of investors, and resale rights for the securities sold. Or you could list publicly, which would take time and money, but would enable general solicitation to the public capital markets and your shares to be sold to an unlimited number of investors who would enjoy unlimited liquidity. It was a choice between a difficult offering process that created easy resale, or an easy offering process that imposed more limitations on the firm's fundraising post-offering.

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[74] *Id.* at 3393.

[75] Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and "Negative" Property Rights in Information*, 87 VA. L. REV. 1229, 1265 (2001).

[76] Joseph F. Jacob, Note, *The Impact of the Euro on the United States Equity Markets*, 13 ST. JOHN'S J. LEGAL COMMENT. 399, 413–14 (1998).

[77] *See supra* note 16 and accompanying text.

[78] *See supra* note 16 and accompanying text.

[79] 17 C.F.R. § 230.501 (2017) (currently defined as those with over $1 million of liquid assets or income of $200,000 for each of the past two years).

[80] Lee, *supra* note 6, at 369.

[81] *See id.* (noting that in 2013, the "Securities and Exchange Commission lifted an eighty-year ban on general solicitation and general advertising").

[82] *See id.* (discussing the ban on general solicitation).

[83] *Id.* at 378–79.

The typical justification for this stratified investment landscape is that it makes good sense for the wealthy—and only the wealthy—to have access to private offerings.[84] Privately traded securities may be illiquid for years and are complicated to understand. For these reasons, they generally pose more risk than public securities. While higher risk is often accompanied by higher return, that is not always the case—and the law judges wealthy investors to be the more appropriate bearers of the heightened risk private offerings present by reserving them for accredited investors.

B. Cracks in the Wall: Private Fundraising Moves Public

As we will see in Section C, the JOBS Act introduced equity crowdfunding—for the first time, the general public could invest in shares of still private companies. On the flip side, shrewd political advocacy led by Silicon Valley introduced measures to allow private companies to become larger than ever before, raising more and more money from more and more people with more and more opportunities for resale on the secondary markets.[85] This Section will highlight only a few aspects of this blurring, those that make today's private offerings look a lot more public than those of the past.

The JOBS Act allowed for general solicitation in two new areas: Reg A+[86] and Rule 506(c).[87] Rule 506(c) created a new exemption that loosened the strictures against general solicitation.[88] Under the old Rule 506, an issuer needed a reasonable belief that any *offeree* qualified as an accredited investor.[89] The JOBS Act directed the SEC to lift the prohibition against general solicitation provided that "all purchasers of the securities are accredited investors."[90] The SEC created guidelines for the reasonable steps that companies must take to ensure that all purchasers are, in fact, accredited.[91]

At the same time, the JOBS Act also enabled private companies to stay

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[84] *See* Rodrigues, *supra* note 17, at 3395 ("[P]rivate firms are only able to sell their shares to a subset of the public—the wealthy.").

[85] Donald Langevoort and Robert Thompson have thoughtfully chronicled this blurring of the public and private spheres. *See* Langevoort & Thompson, *supra* note 63, at 338–39 (discussing Facebook's economic tactics and the government's interest in helping the "high-tech" companies).

[86] Technically the Section 3(b)(2) Exemption, but commonly referred to as Reg A+. Reg A+ is discussed in the next Section. *See infra* Part I.C.

[87] Christian W. Borek, Comment, *Regulation A+: Navigating Equity-Based Crowdfunding Under Title IV of the JOBS Act*, 47 CUMB. L. REV. 143, 154–55 (2016); *see* 17 C.F.R. § 230.251(a) (2017) (amending Regulation A pursuant to the JOBS Act).

[88] Borek, *supra* note 87, at 154–55.

[89] 17 C.F.R. § 230.506(b)(ii) (2012), *repealed by* 17 C.F.R. § 230.506(c)(ii) (2017).

[90] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a)(1), 126 Stat. 306, 313 (2012).

[91] *See* 17 C.F.R. § 230.506(c)(2)(ii) (2019).

private longer, keeping them out of the public's reach for years. Until the JOBS Act, Section 12(g) of the Securities Exchange Act of 1934 (Exchange Act) had required that firms with assets of over $10 million, and a class of securities held by over 499 shareholders of record, register their securities under the Exchange Act.[92] This "500 shareholder rule" functioned as a de facto limit on how large a company could get—at least, on how many shareholders it could have.[93] Section 12(g) explains why Google and Facebook went public when they did—although these firms did not require the money from their IPOs when launched, they would have been subject to disclosure requirements under the Exchange Act after crossing the 500 shareholder mark.[94] They therefore made the calculus that they "might as well" go public.[95] The JOBS Act raised this number to 2,000, so long as no more than 500 are unaccredited.[96] Thus, firms like Airbnb could raise money without being forced into an IPO as Google and Facebook were.

Moreover, these bigger companies raising money from more investors can now sell shares that offer far more liquidity than in the past.[97] The Southern District of New York in *United States v. Sherwood* suggested that a two-year holding period would ensure that purchasers of securities had an investment intent as opposed to having a view towards resale.[98] Rule 144 originally enshrined that two-year holding period in regulation, but now has reduced it to as little as six months for companies that are subject to the Exchange Act's reporting requirements.[99] Langevoort and Thompson point out how a combination of technological innovation and the regulatory loosening under Rule 144 has permitted, as a functional matter, far more liquidity in the private markets than used to be the case.[100]

On the flip side, this blurring also manifests by making public companies take on characteristics more often seen in private firms. When these bigger

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[92] U.S. SEC. & EXCH. COMM'N, REPORT ON AUTHORITY TO ENFORCE EXCHANGE ACT RULE 12G5-1 AND SUBSECTION (B)(3), at 1 n.3 (2012), http://www.sec.gov/news/studies/2012/authority-to-enforce-rule-12g5-1.pdf.

[93] Usha R. Rodrigues, *The Price of Corruption*, 31 J.L. & POL. 45, 48 (2015).

[94] *Id.* at 51.

[95] *See* Usha R. Rodrigues, *The Once and Future Irrelevancy of Section 12(g)*, 2015 U. ILL. L. REV. 1529, 1537–38 (noting that Facebook went public sooner than it otherwise would have because of § 12(g)).

[96] 15 U.S.C. § 78l(g)(1)(A) (2015); Rodrigues, *supra* note 95, at 1549. It also exempted crowdfunding investors from the shareholder count. *Id.* at 1530 n.3.

[97] Langevoort & Thompson, *supra* note 63, at 347.

[98] 175 F. Supp. 480, 483 (S.D.N.Y. 1959).

[99] Revisions to Rules 144 and 145, 72 Fed. Reg. 71,546, 71,546–47 (Dec. 17, 2007) (to be codified at 17 C.F.R. pts. 230 & 239). Issuers not subject to the reporting requirements are subject to a one-year holding period before public resale. *Id.* at 71,546.

[100] Langevoort & Thompson, *supra* note 33, at 350–51.

companies finally choose to access the public markets, they are increasingly choosing to retain a key feature of many private firms: control.[101] The founders of Google, Facebook, Lyft, Roku, Spotify, and Dropbox each retained a special class of supervoting shares, meaning that they were ensured voting control of the company even if they only retained a minority of shares.[102] Snap went the farthest down this path, selling shares to the public that lacked a vote entirely.[103] This phenomenon of going public while retaining a key feature of private firms further illustrates the blurring of the boundary between public and private.

C. More Cracks in the Wall: Equity Crowdfunding and Reg A+

Further blurring the definition of a "private" firm, equity crowdfunding has allowed the general public to invest in private offerings since 2016, thus theoretically democratizing capital on two fronts.[104] For the first time, average investors had a chance to directly invest in private firms, an opportunity that used to be only open to the wealthy.[105] At the same time, entrepreneurs now have access to funding from the general public, thus offering alternatives outside of the rarefied venture capital world for start-ups to raise funding.[106]

At least, this is the theory. Obtaining equity crowdfunding under the SEC's rules and regulations is an arduous process. This Section will describe that process in painful detail, to underscore its daunting complexity for entrepreneurs and its unworkability. But first, it will briefly describe a perhaps more promising

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[101] Rani Molla, *More Tech Companies Are Selling Stock that Keeps Their Founders in Power*, VOX (Apr. 11, 2019, 10:14 AM), https://www.vox.com/2019/4/11/18302102/ipo-voting-multi-dual-stock-lyft-pinterest; James Royal, *The Hidden Risk in Many Tech IPOs*, BANKRATE (May 21, 2019), https://www.bankrate.com/investing/hidden-risk-investing-tech-ipos/; *see* Zoe Condon, Comment, *A Snapshot of Dual-Class Share Structures in the Twenty-First Century: A Solution to Reconcile Shareholder Protections with Founder Autonomy*, 68 EMORY L.J. 335, 349–50 (2018) (noting that firms are using dual-class shares to insulate from short-term market pressure).

[102] Molla, *supra* note 101; Royal, *supra* note 101.

[103] Kurt Wagner, *One Way Snapchat's IPO Will Be Unique: The Shares Won't Come with Voting Rights*, VOX (Feb. 21, 2017, 8:30 AM), https://www.vox.com/2017/2/21/14670314/snap-ipo-stock-voting-structure.

[104] Howard Marks, *What Is Equity Crowdfunding?*, FORBES (Dec. 19, 2018, 8:00 AM), https://www.forbes.com/sites/howardmarks/2018/12/19/what-is-equity-crowdfunding/#7185f0ee3b5d.

[105] Michael Vignone, *Inside Equity-Based Crowdfunding: Online Financing Alternatives for Small Businesses*, 91 CHI.-KENT L. REV. 803, 806 (2016). One caveat is in order: Currently, much of the public's investment in the public markets is by way of intermediaries such as pension funds and mutual funds. Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 BROOK. J. CORP. FIN. & COM. L. 339, 347–48 (2008). Similar intermediaries could, in theory, allow for retail investment in startups and earlier stage private ventures. Currently, a small percentage of mutual funds offer some exposure to such investments, although most cap their exposure at 2%. Jeff Benjamin, *Some Mutual Fund Investors Might Unwittingly Already Own Shares of Lyft*, INVESTMENTNEWS (Mar. 28, 2019, 2:26 PM), https://www.investmentnews.com/article/20190328/FREE/190329924/some-mutual-fund-investors-might-unwittingly-already-own-shares-of.

[106] Vignone, *supra* note 105, at 806.

move to facilitate fundraising from the crowd—Reg A+.[107]

Reg A+ provided for offerings of up to $50 million with more relaxed disclosure requirements (and allowed for general solicitation).[108] Some commentators have gone so far as to call Reg A+ offerings "mini-IPOs."[109] Since general solicitation is permitted, others have treated Reg A+ as equivalent to crowdfunding.[110] Although each of these analogies misses the mark, Reg A+ offerings and equity crowdfunding do pose similar challenges to investors. Part VI.A will address how ICO insights might apply specifically to the Reg A+ context, but until then this Article will treat them as functionally equivalent.

While these provisions made it easier for private corporations to raise funds from the public, Reg A+ offerings still require "audited financial statements, a description of the issuer's business operations, its financial condition, its corporate governance principles, its use of investor funds, and other appropriate matters."[111] These disclosures typically necessitate hundreds of thousands of dollars in fees.[112] So while these offerings theoretically provide a way for a start-up to raise money, they require significant pre-offering investment. Because of this handicap, public support has been tepid.[113] Part VI.A will suggest that the financial contracting lessons gleaned from ICOs and venture financing can address this hurdle. But for now, we turn to equity crowdfunding.

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107 Lou Bevilacqua, *So What's Wrong with Reg A+?*, BEVILACQUA PLLC (Jan. 20, 2017), https://www.bevilacquapllc.com/whats-wrong-reg/.

108 *Id.* The JOBS Act provided for both, and more. Borek, *supra* note 87, at 185–86. Whereas in the past, private offerings could not even be advertised to the general public, Section 506(c) permitted general solicitation, as long as any eventual sale was only to an accredited investor. *Id.* at 155. Crowdfunding for the first time allowed private investors the access to public capital, but it capped investment at $1 million and came with regulations so onerous as often not to be worth the effort. *See* Paige M. Lager, Note, *The Route to Capitalization: The Transcendent Registration Exemptions for Securities Offerings as a Means to Small Business Capital Formation*, 94 TEX. L. REV. 567, 599 n.233 (2016) (discussing investment caps). Regulation A+ allowed for up to $50 million to be raised with disclosures less onerous than the traditional IPO. *Id.*

109 *See, e.g.*, Houman B. Shadab, *Henry Manne and Nonpublic Company Disclosure*, 12 J.L. ECON. & POL'Y 361, 367 (2016); Louis Anthony Steiner, *The Right Deed for the Wrong Reason: A Critical Examination of Regulation A+ and Its Rationales*, 22 FORDHAM J. CORP. & FIN. L. 155, 162 (2017).

110 Andrew A. Schwartz, *Inclusive Crowdfunding*, 2016 UTAH L. REV. 661, 664 n.16; Tyler Stewart, *More Info on New SEC Crowdfunding Rules: What Regulation A+ Means for Real Estate*, REALCROWD, https://www.realcrowd.com/blog/2015/04/more-on-what-sec-regulation-a-means-for-real-estate-crowdfunding/ (last visited Aug. 23, 2019).

111 15 U.S.C. § 77c(b)(2)(G)(i) (2012).

112 *See* ANZHELA KNYAZEVA, REGULATION A+: WHAT DO WE KNOW SO FAR? 13 (2016) (showing that the median cost of a Reg A+ filing is approximately $205,000).

113 *See, e.g.*, Rutheford B. Campbell, Jr., *The SEC's Regulation A+: Small Business Goes Under the Bus Again*, 104 KY. L.J. 325, 343 (2015) (noting that there were few Tier 2 filings even after Reg A+); Neal Newman, *Regulation A+: New and Improved After the JOBS Act or a Failed Revival?*, 12 VA. L. & BUS. REV. 243, 278 (2018).

By design, firms can raise only a limited amount from the public—no more than $1,070,000 of securities in any twelve-month period.[114] Would-be crowdfunding investors face a corresponding limitation, and can only invest in any twelve-month period: (i) the greater of $2,200 or 5% of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $107,000; or (ii) 10% of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $107,000, if both the annual income and net worth of the investor are equal to or more than $107,000.[115] Regardless of annual income or net worth, one's investment may not exceed $107,000.[116] As we will see, equity crowdfunding requires much effort for would-be entrepreneurs to raise only limited sums from the crowd.

First, of course, a company must qualify. Only certain companies are eligible to seek crowdfunding in the first place.[117] It must next select a crowdfunding platform.[118] Crowdfunding rules require offerings to be conducted exclusively through an online platform operated by an intermediary broker-dealer or funding portal (a new kind of intermediary created by the Act) that is registered with the SEC and the Financial Industry Regulatory Authority.[119] Start-ups may rely on the intermediary's efforts in calculating the aggregate amounts of investments in order to comply with the investment limits described above.[120]

After selecting a platform, crowdfunding entrepreneurs must draft and file a Form C , the required offering statement, with the SEC and the online platform intermediary.[121] Form C requires the issuer to fill out basic information about the company, including information about the officers, directors, and large shareholders; a description of the business and use of the proceeds; the price of

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114 *Investor Bulletin: Crowdfunding Investment Limits Increase*, U.S. SEC. & EXCHANGE COMMISSION (May 5, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_crowdfundingincrease (increasing cap due to inflation). Section 4(a)(6) was redesignated Section 4(a)(6) of that Act by Pub. L. No. 112-106, § 201(b)(1), (c)(1), 126 Stat. 314 (2012), and is codified as amended at 15 U.S.C. § 77d(a)(6) (2012).

115 *Investor Bulletin*, *supra* note 114 (raising caps due to inflation); *see also* 15 U.S.C. § 77d(a)(6)(B) (2012).

116 17 C.F.R. § 227.100(a)(2) (2017); *Investor Bulletin*, *supra* note 114 (raising cap due to inflation). Spouses may calculate their net worth and annual income jointly with the investor. 17 C.F.R. § 227.100(a)(2).

117 *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, U.S. SEC. & EXCHANGE COMMISSION (May 13, 2016), https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm#2. Excluded companies include non-U.S. companies and companies that have no specific business plan or that have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies. *Id.*

118 *Id.*

119 15 U.S.C. § 77d-1(a)(1)–(2); 17 C.F.R. §§ 227.100(a)(3), 227.300.

120 *See generally Regulation Crowdfunding*, *supra* note 117.

121 17 C.F.R. § 227.203.

the securities and the target offering amount; and the company's financial condition and financial statements.[122]

Selecting the target amount is an important choice in terms of regulatory repercussions and will emerge as an important concept later, so it merits close attention. The SEC requires disclosing both the offering target and the deadline to reach the target offering amount.[123] The offeror must include a statement that if the target offering amount is not reached or exceeded by the deadline, "no securities will be sold in the offering, investment commitments will be cancelled and committed funds will be returned."[124] Thus, equity crowdfunding is an all-or-nothing proposition. A would-be crowdfunder must raise a minimum amount or return all the funds raised. The target amount sets the floor at which an offering can be viable. It also creates a perverse incentive for crowdfunders to lowball the target amount they claim required for viability.[125]

After reaching 50% and 100% of the target offering amount, the start-up must update the SEC, investors, and the intermediary on its progress within five business days.[126] If the start-up receives investments in excess of the target offering amount, it must file another form reporting the total securities sold in the offering.[127]

The target amount also determines the type of financial statements required to be filed with the SEC. For instance:

- If the issuer is offering $107,000 or less of securities, the issuer must provide its financial statements and information from the issuer's federal income tax return, both of which must be certified by the principal executive officer.[128] If the issuer's financial statements have been reviewed or audited by a public accountant that is independent of the issuer, then it must provide such financial statements.[129]
- If the issuer is offering between $107,000 and $535,000 of securities, it

122 *Form C Under the Securities Act of 1933*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/about/forms/formc.pdf (last visited Oct. 26, 2019).

123 17 C.F.R. § 227.201(g).

124 *Id.*

125 CCH FEDERAL SECURITIES LAW REPORTS NO. 2766, 13 (2017) [hereinafter FSLR NO. 2766] ("Because funding is an all-or-nothing proposition, there is an incentive to set a small minimum of about $20,000 to $50,000 and leave the ceiling at the regulatory maximum of $1 million. This may work from the point of view of a company desperate for money, … but it may not be as good for investors if the company really did need a large amount of money to do what it wanted to do.").

126 17 C.F.R. § 227.203(a)(3). The update is provided through Form C-U. *Id.*

127 *Id.*

128 *Id.* § 227.201(t)(1).

129 *Id.*

must provide financial statements audited by a public accountant that is independent of the issuer, or, if no such audit occurred, then financial statements reviewed by a public accountant that is independent of the issuer.[130]

- If the issuer is offering more than $535,000 of securities and is offering under the Regulation Crowdfunding exemption for the first time, the financial statements must be audited or, if unavailable, reviewed by an independent public accountant.[131]
- If the issuer is offering more than $535,000 of securities and has previously sold securities using the Regulation Crowdfunding exemption, the financial statements must be audited by an independent public accountant.[132]

Concern about a speculative frenzy in advance of the IPO necessitates so-called gun-jumping laws that limit what the firm communicates to the public during the IPO process.[133] In a nod to these anti-gun-jumping rules, the SEC requires that crowdfunders limit advertising to the general public. Crowdfunders must be careful not to advertise the terms of their offering unless it is in a notice that directs investors to the intermediary's platform and describes no more than: (1) that the issuer is conducting an offering pursuant to Section 4(a)(6), the name of the intermediary, and a link to the intermediary's platform; (2) the terms of the offering; and (3) certain limited facts about the business.[134]

Start-ups may compensate their promoters through communication channels provided by the intermediary, but only if the start-up takes reasonable steps to ensure that the promoter is clearly disclosing the compensation with each communication.[135]

Even after a crowdfunding company successfully sells shares to the public, restrictions continue to apply to the investors. The securities sold through the crowdfunding exemption cannot be sold for one year unless the securities are transferred (1) back to the issuer; (2) to an accredited investor; (3) as part of an

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[130] *Id.* § 227.201(t)(2).

[131] *Id.* § 227.201(t)(3).

[132] *Id.*

[133] A.C. Pritchard, *Revisiting* "Truth in Securities" Revisited*: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE U. L. REV. 999, 1003 (2013).

[134] 17 C.F.R. § 227.204(a)–(b); Carl M. Loeb, Rhoades & Co., Exchange Act Release No. 5870, 38 SEC Docket 843, 852–53 (Feb. 9, 1959) ("[T]he danger to investors from publicity amounting to a selling effort may be greater in cases where an issue has 'news value' since it may be easier to whip up a 'speculative frenzy' concerning the offering by incomplete or misleading publicity and thus facilitate the distribution of an unsound security at inflated prices.").

[135] 17 C.F.R. § 227.205(a).

offering registered with the SEC; or (4) to a family member "of the purchaser or the equivalent, to a trust controlled by the purchaser, to a trust created for the benefit of a [family member] or the equivalent, or in connection with the death or divorce of the purchaser or other similar circumstance."[136]

The old adage has it that "it takes money to make money."[137] Given these restrictions and requirements, perhaps it is unsurprising that only 3% of business owners believe that the crowdfunding rules will increase their likelihood of raising capital.[138] Commentators believe crowdfunding will be underused because of the "realities of crowdfunding"—that is, "small startups generally lack access to venture capital funds, underwriters, broker-dealers, and legal counsel necessary to help them comply with the JOBS Act's rules and regulations."[139] The estimated cost to an issuer seeking to raise $100,000 in securities is at least $17,967,[140] making crowdfunding a fairly expensive way to raise capital. The North American Securities Administrators Association, Inc. (NASAA) noted that it will likely be difficult for start-ups to keep track of the individual investment requirements and thresholds (especially the individual net worth and annual income requirements).[141] Start-ups risk being liable for their brokers' or crowdfunding portals' illegal acts or for failing to pay back investors.[142]

All these requirements may be too burdensome for an entrepreneur to realistically take advantage of them.[143] Additionally, the $1 million limit may be too low for the typical start-up company. For example, the average and median seed-stage financing were around $1.8 million in the fourth quarter of 2014.[144] The limit, "an unnecessary restriction on a company's ability to grow," forces companies to conduct parallel or multiple offerings to raise money under Title

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136 *Id.* § 227.501(a).

137 Robert Hockett, *A Jeffersonian Republic by Hamiltonian Means: Values, Constraints, and Finance in the Design of a Comprehensive and Contemporary American "Ownership Society"*, 79 S. CAL. L. REV. 45, 90 (2005).

138 Lawrence A. Hamermesh & Peter I. Tsoflias, *An Introduction to the Federalist Society's Panelist Discussion Titled "Deregulating the Markets: The JOBS Act"*, 38 DEL. J. CORP. L. 453, 468 (2013).

139 *Id.* at 470.

140 Max E. Isaacson, *The So-Called Democratization of Capital Markets: Why Title III of the JOBS Act Fails to Fulfill the Promise of Crowdfunding*, 20 N.C. BANKING INST. 439, 457 (2016).

141 North American Securities Administrators Association, Inc., Comment Letter on Proposed Regulation Crowdfunding (Feb. 3, 2014), nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-on-Regulation-Crowdfunding-Final.pdf.

142 *See* Peter C. Sumners, *Crowdfunding America's Small Businesses After the JOBS Act of 2012*, 32 REV. BANKING & FIN. L. 38, 46 (2012).

143 *Id.* at 47.

144 Isaacson, *supra* note 140, at 454.

III.[145] In response to concerns about the paltriness of the $1 million ceiling, Patrick McHenry, the author of the original JOBS Act crowdfunding bill, introduced the Fix Crowdfunding bill in 2016 that sought to increase the limit to $5 million.[146]

Worse yet, equity crowdfunding as envisioned by Congress and executed by the SEC may have created a "lemons problem."[147] If crowdfunding is so burdensome, then only low-quality start-ups that cannot find funding by other means will use it, as a funding type of last resort.[148] Even quality start-ups seeking crowdfunding would be tainted by the overall market reputation, and would not be able to distinguish themselves from bad ones.[149] There are some indications, as Part IV.E will further describe, that some of the securities being offered for crowdfunding offer very little upside to investors, thus reinforcing market-for-lemons concerns.

In sum, equity crowdfunding has been a reality for almost three years, but it is far from perfect. In some sense, these imperfections are unsurprising. Given the nature of our securities laws, Congress was in the best political position to initiate equity crowdfunding. It had less to lose than the SEC, which would inevitably bear the brunt of criticism should average investors be defrauded by crowdfunding investments. But Congress is hardly the ideal body to task with creating an optimal equity crowdfunding regime. It has no special expertise in securities, and it makes policy based on conflicting reports and testimony from various groups, each with their own concerns. Even without descending into an assessment of special interests and public choice theory, it is clear that any legislative attempt to allow the general public—without the sophistication or sheer resources of private investors—to invest in private companies would be fraught. When allowing the general public for the first time to participate in risky and illiquid private investments, the balance inevitably tilted towards investor protection and away from facilitating capital formation. The SEC, an agency with a lot to lose if average investors are defrauded in a private crowdfunding scheme, layered on still more regulations. The unwieldy Regulation

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145 *Id.* at 454–55.

146 *Disrupter Series: Improving Consumers' Financial Options with Fintech: Hearing Before the Subcomm. on Dig. Commerce & Consumer Prot. of the Comm. on Energy & Commerce H.R.*, 115th Cong. 88 (2017); *see* Fix Crowdfunding Act, H.R. 4855, 114th Cong. (2016).

147 *See* Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. 561, 564 (2015).

148 *See* Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493, 517–20 (2014) (discussing certain restrictions and requirements that lead entrepreneurs to choose options other than equity crowdfunding if they have the choice).

149 Ibrahim, *supra* note 147, at 591. Michael Dorff predicted the same in Dorff, *supra* note 148, at 508.

Crowdfunding was perhaps an inevitable result.

Because of the nature of U.S. securities law, experimentation on how best to raise funds from the general public has not been common. This Part described the initial trade-off between private and public capital raising. Recent reforms have loosened the restriction on private capital raising. On the public side, the corresponding loosening has been limited to the relatively unsatisfying equity crowdfunding and Reg A+ described in this Section. But the recent wave of ICOs proved a rare moment of experiment in unfettered capital raising from the crowd. The next Part will look for lessons from the literature on private capital financial contracting, which will provide useful context and counterpoint for evaluating ICOs' financial contracting in Part IV.

II. FINANCIAL CONTRACTING IN THE VENTURE CAPITAL CONTEXT

This Part will look more closely at traditional private offerings. Investors here, lacking the protections of federal disclosure requirements and the liquidity of a vibrant secondary market, face acute risks when contemplating investing in private firms. This Part will first describe these risks, and then describe the financial contracting venture investors have used to address them. These features provide one model of investor protection crowdfunding can fruitfully draw upon.

A. The Risks Investors Face

As we have seen, the lines are blurring so that private offerings appear much more like public ones. On the public side, *Howey*'s broad definition of what constitutes a security, coupled with the requirement that any public offering be registered with the SEC, dampens the prospects for creativity in contracting to raise funds from the public. Given that an oft-skeptical SEC necessarily interpolates between the company and its public investors, contractual experimentation is relatively rare for public offerings.

No such limitation exists on the private side. As long as the offering can qualify as a private offering under an exemption from registration requirements, experimentation is feasible. Such freedom to contract has led to contractual mechanisms that address the most common problems facing firms looking to raise money: uncertainty, information asymmetry, and agency costs.

To concretize these common problems, let's take a simple scenario. A would-be entrepreneur has a promising idea. She needs an investor to help her develop it and is willing to split any resulting profits from the project. The financial contracting literature has addressed this problem extensively. It begins with the insight that all contracts are necessarily incomplete, including financial contracts.[150] No one contract can at the outset anticipate all of the eventualities that might unfold over time.[151] Parties need a contract that will fill in the gaps that will arise in the course of their relationship. Uncertainty is a core problem they share; how will the project fare? Future exigencies are inherently unpredictable to both parties. But the investor also suffers from a separate information asymmetry problem: Presumably the entrepreneur will know more about the merits and promises of the project. The potential investor will find it hard to separate realistic assurances from mere puffery from unscrupulous or simply deluded entrepreneurs.[152] Finally, the ever-present danger of agency costs lurk—the fear that the entrepreneur will shirk or appropriate private benefits to herself rather than faithfully serving the needs of the entity as a whole.[153]

The financial contracting literature has focused on the private markets, typically on venture contracts.[154] For the uninitiated, a venture capital fund typically raises capital from accredited investors for a ten-year duration.[155] The fund is structured as a limited partnership, with the manager serving as the general partner (GP) and managing the investment portfolio.[156] The accredited investors serve as the limited partners, enjoying limited liability, and generally providing passive capital.[157]

The GP evaluates investment opportunities on behalf of the fund.[158] Early in

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150 Brian J. Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH L. REV. 461, 463.

151 *See id.* at 478 (noting that contractual incompleteness makes it impossible to have a protective provision that could cover all possible instances of controlling party opportunism).

152 In the words of George Triantis, "information is too soft to be communicated to investors in a credible manner." George G. Triantis, *Financial Contract Design in the World of Venture Capital,* 68 U. CHI. L. REV. 305, 307 (2001) (reviewing PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE (1999)); *see also* Fox, *supra* note 67, at 680 ("When an issuer first contemplates making a public offering of truly new securities, there exist particularly large information asymmetries.").

153 *See* Gilson, *supra* note 33, at 1076 ("All financial contracts respond to three central problems: uncertainty, information asymmetry, and opportunism in the form of agency costs."); *see also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

154 *See, e.g.*, Oliver Hart, *Financial Contracting*, 39 J. ECON. LITERATURE 1079, 1084–85 (2001).

155 Usha Rodrigues & Mike Stegemoller, *Exit, Voice, and Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. L. 849, 861, 863 (2013).

156 *Id.* at 861–62.

157 *Id.*

158 *See id.* at 861 ("[T]alented venture capital managers spot promising companies and (arguably) provide advice that helps pave the road to success.").

the fund's life, it will make investments in portfolio companies.[159] This part of the financial contract—i.e., the relationship between VC fund and portfolio company—teaches the most important lessons in financial contracting for crowdfunding because it deals with the problem of how an investor can contract to protect herself against the entrepreneur. Whether the potential investor is crowd or capitalist, the basic problems are the same.

The venture financing context is instructive because there are sophisticated parties on each side,[160] relatively free to order their contractual relationship as they see fit. Early-stage companies pose a great deal of uncertainty because "[v]irtually all of the important decisions bearing on the company's success remain to be made, and most of the significant uncertainties concerning the outcome of the company's efforts remain unresolved."[161] Compounding the uncertainty is the unproven nature of the start-up's management team, and that so much of the company's value depends on management's decisions.[162]

The same lack of operating history also contributes to information asymmetry: "[I]ntentions and abilities are far less observable than actions already taken."[163] It is unclear to the investor how the entrepreneur will respond to the crucible of internal and external pressures of growing a business. Moreover, the entrepreneur, as the individual on the ground working for the business, will have far more knowledge of its growth prospects than an investor on the outside looking in.[164]

Finally, agency costs are a perennial concern in any business organization.[165] They are a product of the fact that the entrepreneur, as the residual claimant, has in effect an option on the future growth of the firm.[166] The entrepreneur will share in the firm's eventual profits, but only if they are big enough to provide the investor with a healthy return on her investment.[167] In this setting, agency costs manifest in the temptation for the manager to slack off or divert profits

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[159] *Id.* at 866.

[160] Even first-time entrepreneurs are usually represented by lawyers deeply embedded in the venture capital world. *See* Mark C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 L. & SOC. INQUIRY 679, 683 (1996) (discussing the significance of Silicon Valley attorneys' interactions with both investors and entrepreneurs).

[161] Gilson, *supra* note 33, at 1076–77. Gilson argues that the high-tech setting exacerbates these costs. *Id.* at 1076 ("[I]nvesting in early stage, high technology companies presents these problems in an extreme form."). The uncertainty problem is one all start-ups share.

[162] *Id.* at 1077.

[163] *Id.*

[164] *Id.* at 1081–83.

[165] Jensen & Meckling, *supra* note 153, at 309.

[166] Gilson, *supra* note 33, at 1077.

[167] *See id.*

(enjoying 100% of the return on such efforts in the form of increased leisure or perquisites like foosball tables), rather than striving for future uncertain gains, which she would be forced to share with her investors.

B. Contractual Protections for the Venture Investor

Venture financing contracts have well-established mechanisms for addressing the perennial risks of uncertainty, asymmetric information, and agency costs. This Section will address these mechanisms.

1. Staged Financing

Say an entrepreneur pitches a venture capitalist an idea that requires a $30 million investment. The VC is intrigued but—given the above-described uncertainty, information asymmetry, and risk of agency costs—reluctant to commit such a large sum of money up front. To address this reluctance, the typical early-stage venture contract allows for staged financing, where investments occur over multiple rounds of financing.[168]

At the initial stage of financing, the financial contract will provide the cash-hungry entrepreneur with only, say, $2 million, and will articulate a particular milestone, a deliverable that provides a point at which the investor can judge the project's interim success or failure.[169] If and when the firm reaches that milestone, the investor will feel more comfortable committing, say, $10 million.

The achieved milestone mitigates the uncertainty problem by deferring further financial commitment until more time has passed. But this delay also mitigates information asymmetry problems in two ways.[170] First, it gives the investor the chance to evaluate the firm's progress towards market without having to rely on the entrepreneur's assurances about future occurrences.[171] More subtly, the investor will also have had the chance to observe the CEO's managerial and work habits, providing more data points for assessing the venture's future success. Staged financing favors those entrepreneurs willing to

[168] J.K. Sharma & Smita Tripathi, *Staged Financing as a Means to Alleviate Risk in VC/PE Financing*, 19 J. PRIV. EQUITY 43, 43–45 (2016). Michael Klausner and Kate Litvak call staged financing the "[m]ost important" of all the VC's risk-reduction techniques. Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING GOVERNANCE WITH REGULATORY POLICY 54, 56 (Michael J. Whincop ed., 2001) ("Most important among these contract terms is the staged nature of the venture capital investment.").

[169] Gilson, *supra* note 33, at 1078–79.

[170] Guarav Jetley & Xinyu Ji, *Appraisal Arbitrage—Is There a Delaware Advantage?*, 71 BUS. LAW. 427, 430 (2016).

[171] *Id.* at 430.

commit to milestones as a check on the credibility of the projections they have promised their investors.[172]

Not only does staged financing reduce uncertainty and information asymmetry, it also reduces agency costs by motivating the entrepreneur to perform in order to receive future funding. Entrepreneurs have less room to slack because they only receive a portion of their needed funds up front.[173]

2. *Control*

As part of their initial investment, venture funds bargain for control rights disproportionately larger than their ownership share.[174] Venture capitalists negotiate for seats on the board of directors, giving them a window into the portfolio company's finances, policies, and prospects.[175] But more than transparency on these questions, board representation also gives venture capitalists a voice in the ongoing management of the firm. The power to exert this type of control goes a long way towards reassuring VCs *ex ante* that their interests will be protected.

In addition to having a positive say in the firm's management, these investors also bargain for contractual limitations on the entrepreneur's discretion.[176] Venture firms negotiating an investment in a portfolio company often obtain separate vetoes at the board level and the shareholder level.[177] For example, before incurring more than $50,000 in debt, the corporation may need the affirmative vote of both the venture directors (separate and apart from overall board approval) and the vote of the preferred shareholders.[178]

Granting board representation rights assuages the problems of information

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[172] Gilson, *supra* note 33, at 1081 ("[T]he entrepreneur obviously has better information concerning the accuracy of the business plan's projections of timing, costs, and likelihood of success. Without more, the entrepreneur has an obvious incentive to overstate the project's prospects. By accepting a contractual structure that imposes significant penalties if the entrepreneur fails to meets specified milestones based on the business plan's projections—the venture capital fund's option to abandon then becomes exercisable—the entrepreneur makes those projections credible."); *see also* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 304 (2003) (discussing VCs' use of staged financing).

[173] *See supra* notes 168–169 and accompanying text.

[174] Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 53 (2006).

[175] D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 325 (2005).

[176] *See* Gilson, *supra* note 33, at 1085 (discussing this as an effect of board control).

[177] Bartlett, *supra* note 174, at 53–54.

[178] This separate shareholder vote protects against a situation where a director representing a venture fund might be constrained by her fiduciary duties into voting to permit an action. The venture fund as shareholder, operating without such fiduciary constraints, operates as a separate backstop in such cases.

asymmetry by inviting the investor into the company itself. As a board member, the venture investor converts into a company insider who has access to inside information about the company's current situation and future prospects. By giving the investor both positive (i.e., a seat on the board) and negative (i.e., itemized vetoes) control rights, the financial contract diminishes the threat of uncertainty at the initial investment stage. These mechanisms reduce the risk of agency costs by restricting the entrepreneur's discretion. In particular, the negative covenants tie the entrepreneur's hands by putting limits on how much she can borrow, spend, or pay out without the investor's permission.

3. Compensation/Vesting

The CEOs of VC-backed firms typically receive relatively low salaries, coupled with large grants of stock options or, more commonly, outright grants of restricted stock.[179] This combination means that the size of the entrepreneur's compensation depends on the overall success of the venture.[180] Moreover, a four-year cliff-vesting schedule is common, whereby the entrepreneur must work for a solid year before being rewarded with any equity at all in the venture.[181] Under this schedule, if a CEO is fired even eleven months into the job, she will only have received a relatively low salary for her labor.[182] Even after a year, only one-quarter of her ownership interest vests. Her remuneration remains tied not only to the eventual success of the venture, but also to her continued commitment to work for the organization.

The compensation structure of the venture-funded company thus incentivizes the entrepreneur to maximize the long-term growth of the company. Founders who slack will be summarily fired and left with nothing. Even those who survive the first year will only receive a fraction of the total equity available to them, and that fraction will only be valuable if the overall value of the company continues to grow. Indeed, even the diligent entrepreneur who increases the company's value through her hard work will likely only receive a tangible return upon exit—either an IPO or an acquisition. Thus, the compensation provisions work to align the incentive of investor and entrepreneur to grow the company towards a successful exit.

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[179] Gilson, *supra* note 33, at 1083.

[180] *Id.* ("[T]he overwhelming percentage of management's compensation is dependent on the portfolio company's success.").

[181] Joseph L. Lemon, Jr., *Don't Let Me Down (Round): Avoiding Illusory Terms in Venture Capital Financing in the Post-Internet Bubble Era*, 39 TEX. J. BUS. L. 1, 45 (2003).

[182] Gilson, *supra* note 33, at 1083.

4. *Redemption Rights*

Redemption occurs when the company repurchases shares from investors pursuant to a contract.[183] In effect, then, redemption rights function as a "refund" right for investors. These provisions fulfill two functions: (1) they give the investor a way to recoup her original investment from a stagnant or failing company; and (2) they "provide the venture capitalist with leverage over the entrepreneur based on the credible threat of withdrawal."[184] Not all venture contracts provide for redemption rights, and their incidence varies by region.[185]

Redemption rights, in essence a right for investors to get their money back, tend not to be immediately exercisable.[186] This fact is an implicit acknowledgement that an immediate redemption right would create a different kind of cost. It is only fair to require a venture capital fund to do enough due diligence up front to commit to an investment of several years. But after several years have passed, such a right can be a potent tool, or at least threat, for the investor.[187] "The threat of using a redemption right, which would create a horrible financial strain on the company, focuses founders and management on the fact that venture capital investors want out of their investment quickly, and after five years they are getting impatient."[188]

5. *Reputation as an Extra-Contractual Discipline on Investors*

The above contractual rights, by cabining the discretion of the entrepreneur to protect the investor against uncertainty, information asymmetry, and agency costs, create a concomitant risk of opportunistic exploitation by the investor.[189] A key insight from Gilson is that a reputation market constrains this investor opportunism.[190]

Because the venture community is relatively tight-knit, and venture funds

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183 Smith, *supra* note 175, at 348. Mandatory redemption provisions require the company to repurchase shares at a specified date, while put options give the investor the option to sell the shares back to the company whenever she chooses. *Id.* at 348–49.

184 *Id.*

185 Redemption rights are much more common in deals on the East Coast of the United States and relatively rare on the West Coast. Dana M. Warren, *Venture Capital Investment: Status and Trends*, 6 OHIO ST. ENTREPRENEURIAL BUS. L.J. 505, 521 (2011).

186 *See* Smith, *supra* note 175, at 349.

187 Warren, *supra* note 185, at 521 ("[I]f the company is doing well, investors do not want to be redeemed. If the company is doing poorly, it typically does not have the resources to complete a redemption without committing a fraud on its creditors.").

188 *Id.*

189 Gilson, *supra* note 33, at 1085–86.

190 *Id.* at 1086.

tend to invest in close geographic proximity to their fund office,[191] a company seeking to raise funds will have access to a great deal of information about would-be investors. A successful fund will create reputational benefits for the fund manager, who can then go on to raise subsequent, ideally larger, pools of capital on the strength of the earlier strong performance. The success of these future funds is contingent upon persuading likely portfolio companies to accept the future fund's investment. As Gilson observes:

> Credible accounts of opportunistic behavior by particular GPs can be expected to circulate quickly among members of the entrepreneur community, who must select a GP with whom to deal, and among members of the GP community, who must compete among themselves for the opportunity to invest in the most promising portfolio companies and therefore have an interest in noting and transmitting to the entrepreneur community instances of misbehavior by a rival.[192]

In short, having a reputation as an opportunistic or unfair investor will limit a fund's ability to invest in future companies. Knowing that, VCs generally behave themselves.

III. FINANCIAL CONTRACTING WITH THE CROWD

As we have seen, parties have developed mechanisms on the private side to protect investors from the threats of future uncertainty, asymmetric information, and agency costs. No such experimentation traditionally has occurred in the public market context.[193] Public fundraising, since 1933, has developed in response to congressional fiat, as modulated by the SEC.[194] Title III of the JOBS Act did introduce equity crowdfunding,[195] but Congress and the SEC engaged in what might generously be called educated guessing when striking a balance between protecting investors and fostering capital raising. As we saw in Part II.C, equity crowdfunding remains an unattractive mode of fundraising for most entrepreneurs.

ICOs permitted, at least for a brief time, a way for entrepreneurs to raise capital quickly via equity securities, using blockchain technology to evade the

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[191] Jason Rowley, *Where Venture Capitalists Invest and Why*, TECHCRUNCH (Nov. 9, 2017, 11:45 AM), https://techcrunch.com/2017/11/09/local-loyalty-where-venture-capitalists-invest-and-why/.

[192] Gilson, *supra* note 33, at 1087.

[193] Jack Wroldsen published a survey of crowdfunding investment contracts, but these contracts represent financial contracting within the cramped confines of what Congress and the SEC has permitted. Jack Wroldsen, *Crowdfunding Investment Contracts*, 11 VA. L. & BUS. REV. 543 (2017).

[194] *See generally Regulation Crowdfunding*, *supra* note 117.

[195] *Id.*

reach of the SEC.[196] A veritable ICO explosion occurred in 2017.[197] ICOs raised about $7 billion in that year,[198] through nearly 600 sales.[199] Section A of Part IV will describe an early ICO called a decentralized autonomous organization (DAO), which launched in 2016.[200] The DAO foundered on the shoals of flawed coding, but while it flourished, it provided a short-lived end-run around U.S. securities laws. After describing the DAO, Section B will turn to a survey of later ICOs to glean further common ICO financial contracting terms. Some of these, such as vesting, are already familiar, but there were also blockchain-specific terms, such as limits on supply, to provide restraints that traditional organizations contract for in their organizational documents. Finally, Section C will address some objections to looking to the ICO experience for guidance in crowdfunding.

A. *Voice and Exit: the DAO*

The DAO developers envisioned a kind of alternative business organization that, once launched, could run on the Ethereum blockchain without directors, officers, partners, or other human actors.[201] Instead, the code of the blockchain itself would dictate the rules and relationships between the DAO's owners, the so-called tokenholders.[202] During an initial funding phase, investors could send ether, the cryptocurrency coin of the Ethereum realm, to the DAO's account, receiving DAO "tokens" in return.[203] These tokens bought into a kind of "automated investment fund."[204] This scheme may seem somewhat implausible, but the DAO initial offering was a tremendous success.[205] It raised over $150 million of cryptocurrency in a matter of months and served as the model for future ICOs.[206]

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196 *See supra* notes 24–32 and accompanying text.

197 DANIEL DIEMERS ET AL., INITIAL COIN OFFERINGS & A STRATEGIC PERSPECTIVE 3 (2018).

198 *Id.*

199 *Id.*

200 Madeira, *supra* note 29.

201 Usha R. Rodrigues, *Law and the Blockchain*, 104 IOWA L. REV. 679, 699 (2019). Building upon the success of Bitcoin, the Ethereum blockchain allowed so-called "smart contracts" to be layered on top of transactions, which are automatically executed upon the fulfillment of the terms contained in the code. *Id.* at 698–99. Thus, whereas the Bitcoin blockchain records transactions such as "A paid B 12 bitcoin," the Ethereum blockchain's code allows transactions such as "A will pay B 12 ether if the Green Bay Packers win the Super Bowl."

202 *Id.* at 699, 701.

203 *See id.* at 680.

204 *The DAO of Accrue*, ECONOMIST (May 19, 2016), https://www.economist.com/finance-and-economics/2016/05/19/the-dao-of-accrue.

205 Madeira, *supra* note 29.

206 *Id.*; Andrew Tar, *SEC Ruling on the DAO and ICO, Explained*, COINTELEGRAPH (July 27, 2017), https://cointelegraph.com/explained/sec-ruling-on-the-dao-and-ico-explained. The projects were funded with

With the pool of $150 million in investable funds amassed, the next step was for the DAO tokenholders to vote on particular projects proposed to the fund. An early proposal was to develop a physical lock that could be opened remotely, to allow Airbnb-style access to homes for rent.[207] Just as a corporation's shareholders receive the right to one vote per share they hold, each token gave a tokenholder a right to vote on whether to fund each project.[208] After being proposed to the DAO tokenholders, the project was debated for a minimum of two weeks, followed by a vote on the proposal.[209] After the debate period concluded, any tokenholder could require the DAO to verify that a quorum was reached and a majority of votes were cast in favor of the proposal.[210]

The DAO developers, quite self-consciously, coded in both voice[211] and exit[212] as protective mechanisms, the self-same mechanisms that venture capitalists also use.[213] Indeed, one could call the DAO a virtual venture-capital fund, because its main purpose was to invest in new projects. And because it could sell ownership interest on the blockchain using cryptocurrency, it was able (for a time, at least) to avoid the choke hold of the SEC and sell securities to the general public.[214]

The DAO organizers provided not only for voice, but also for exit. Christoph Jentzsch, one of the DAO's developers, was particularly concerned that the minority would become vulnerable to majority oppression once a fund was raised.[215] Jentzsch proposed an exit mechanism to protect the minority from this type of oppression: a split.[216] If a tokenholder disagreed with a proposal that the

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the DAO's accrued ether.

207 Ian Allison, *Ethereum-Based Slock.it Reveals First Ever Lock Opened with Money*, INT'L BUS. TIMES, http://www.ibtimes.co.uk/ethereum-based-slock-reveals-first-ever-lock-opened-money-1527014 (last updated Dec. 17, 2015, 1:15 PM); *see also Decentralized Smart Devices with Stephan Tual from Slock.it*, POSTSCAPES, https://www.postscapes.com/iot-voices/interviews/smart-devices-ethereum-stephan-tual (last visited Oct. 26, 2019).

208 Christoph Jentzsch, Decentralized Autonomous Organization to Automate Governance 1–2 (unpublished white paper) (on file with Emory Law Journal).

209 *Id.* at 2.

210 *Id.* Quorum requirements were initially set at 20%, unless a proposal was for the transfer of all ether the DAO had ever received, in which case a quorum of 53.33% was required. *Id.* If a proposal was approved, the DAO would send ether to a small contract representing the proposed project to fund the project. *Id.*

211 *See supra* notes 208–210 and accompanying text.

212 *See infra* notes 215–219 and accompanying text.

213 *See supra* Parts II.B.2 and II.B.4.

214 *See* Tar, *supra* note 206 (noting that the SEC declared on July 25, 2017 that Blockchain companies are required to follow federal securities laws).

215 Jentzsch, *supra* note 208, at 2. His specific concern was a "majority robs minority attack." *Id.* An investor who acquired 51% could easily propose to send all the funds to herself. *Id.* As the majority holder, they would be able to pass this proposal and appropriate the DAO's funds. *Id.*

216 *Id.*

majority proposed, or simply wanted to withdraw its ether before the proposal was funded, it could propose to form a new DAO, termed a "split DAO" or "child DAO."[217] Tokenholders that voted to split could move their portion of the DAO's ether to a new DAO.[218] There was no quorum requirement, allowing any single tokenholder to exit the DAO on his or her own.[219]

Some readers might already have spotted the similarity between the "split DAO" right of exit and the redemption rights VCs sometimes receive. These rights of exits also resemble the appraisal rights found in mergers. We will revisit these rights in Part V.B.

All these carefully thought-out forms of investor protection came to naught. Ultimately, the DAO foundered on a coding flaw—a so-called "recursive bug" that allowed a tokenholder to siphon off $50 million worth of cryptocurrency from the DAO.[220] The organizers were able to unwind the transactions that led to this debacle, through a process known as "hard forking" the blockchain, and the DAO investors received their cryptocurrency back.[221]

The DAO, then, was a failure. But it signaled an appetite for this kind of offering to the general public, with certain contractual protections in place. The DAO also had effects on the evolution of ICOs, as the next Section will describe. For that, we must return to securities law and the *Howey* test.

B. Post-DAO ICOs

Recall that the *Howey* test defines the catchall "investment contract" category of securities requiring registration under the Securities Act, or exemption from it.[222] The SEC issued a post-mortem report of investigation fifteen months after the DAO's unwinding, classifying the DAO tokens as securities under the *Howey* test.[223] This classification should not have been surprising—the DAO was an investment of money in a common enterprise (the

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[217] *Id.* at 2, 9; *see also* David Siegel, *Understanding the DAO Attack*, COINDESK (June 25, 2016, 4:00 PM), https://www.coindesk.com/understanding-dao-hack-journalists (referring to a split off DAO as a "child DAO").

[218] Jentzsch, *supra* note 208, at 2.

[219] *Id.* at 3.

[220] *See* Rob Price, *Digital Currency Ethereum Is Cratering Because of a $50 Million Hack*, BUS. INSIDER (June 17, 2016, 5:34 AM), https://www.businessinsider.com/dao-hacked-ethereum-crashing-in-value-tens-of-millions-allegedly-stolen-2016-6.

[221] Jeffrey Berns, *Understanding Ethereum and the DAO Conundrum*, ETH NEWS (July 5, 2016, 6:12 PM), https://www.ethnews.com/understanding-ethereum-and-the-dao-conundrum.

[222] *See supra* notes 55–60 and accompanying text.

[223] SEC. & EXCH. COMM'N, RELEASE NO. 81,207, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934: THE DAO 1 (2017) [hereinafter DAO REPORT OF INVESTIGATION].

DAO itself), to which profits derived from the efforts of others. The SEC did not pursue an enforcement action because investors received their money back,[224] but the agency had nevertheless drawn a line in the sand. ICOs were fair game, and the SEC's position was that they were investment contracts under *Howey*, and thus securities under the Securities Act.

After the SEC's DAO Report, ICO entrepreneurs spent countless hours and dollars trying to evade the reach of *Howey*, and thus of the SEC and U.S. securities law. They turned back to that familiar argument for evading the reach of U.S. securities law, claiming that their offerings were not securities at all.[225] They tried to distinguish their offerings from the DAO by stripping them of governance and ownership features and characterizing them as mere tokens[226] meant for consumption (utility or consumption tokens), rather than investment contracts over which the SEC could legitimately claim jurisdiction.[227] By analogy, imagine a musician who sells tickets to a future concert well in advance in order to raise money for the venue and cost of production. The ticket does not represent an ownership right, but instead a right to consume the concert at a future date.[228] ICO issuers had good reason to try to claim the tokens and coins they sell are not securities: Buyers of securities sold without an exemption from the Securities Act's registration requirements are entitled to rescission—that is,

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224 *Id.*

225 Rodrigues, *supra* note 201, at 726.

226 A word of explanation is perhaps in order. "Coins" technically refer to cryptocurrencies like bitcoin, ether, and litecoin. The Commodity Futures Trading Commission and the SEC are on record as saying these assets are not securities, but instead are currency. Neeraj Agrawal, *SEC Chairman Clayton: Bitcoin Is Not a Security*, COIN CTR. (Apr. 27, 2018), https://coincenter.org/link/sec-chairman-clayton-bitcoin-is-not-a-security. Some coins, like ether, function as platforms that allow for smart contracts to be coded on top of them, creating decentralized applications that work on their blockchains. *See supra* note 201. The DAO, one of the first of these, took in ether in exchange for tokens that worked within the DAO. *See supra* note 203 and accompanying text. Tokens work only within a single project's ecosystem. *Cf.* Shermin Voshmgir, *Tokenized Networks: What Is a DAO?*, BLOCKCHAINHUB, https://blockchainhub.net/dao-decentralized-autonomous-organization/ (last updated July 2019) (discussing "native … tokens" to the networks). While they can serve as means of exchange (i.e., currency), they can also allow for features like vote, distribution rights, and use rights. *See supra* Part III.A. Confusingly, many ICOs, although acronyms for initial *coin* offerings, could more properly be referred to as token offerings. The SEC's guidance avoids this terminological thicket by using the term "digital assets" to refer to both tokens and coins. *Framework for "Investment Contract" Analysis of Digital Assets*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_edn2 (last updated Apr. 3, 2019) ("The term 'digital asset,' as used in this framework, refers to an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called 'virtual currencies,' 'coins,' and 'tokens.'").

227 Jonathan Rohr & Aaron Wright, *Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets*, 70 HASTINGS L.J. 463, 486 (2019).

228 This analogy carries us only so far, because a reputable musician on tour would refund the concertgoers' money for a canceled concert. According to the ICO offerors, there is no right of rescission. All you are buying is the right to use something in the future—and you bear the risk of loss if it fails to develop into something of worth.

a refund of the full purchase price.[229] Utility token issuers seek to evade this possibility of rescission by claiming that they are not selling securities at all.

The market trend of reconfiguring tokens from equity offerings into so-called consumptive goods faced two problems: (1) in general, the public bought tokens or coins not to use them, but as an investment,[230] and (2) the SEC has reiterated that utility tokens are in fact securities, and therefore subject to regulation.[231] Moreover, the market move towards the fiction of utility tokens is unfortunate for our purposes—a misguided (and ultimately doomed) attempt to skirt securities laws.

In short, because the SEC characterized the DAO tokens as securities, future entrepreneurs avoided the ownership features of the DAO in an attempt to argue that they were not securities under the *Howey* test. I will ignore this attempt to describe ICO offerings as “consumptive goods” as disingenuous and ineffective. In other words, no matter what ICOs are calling themselves, I will assume that people bought them primarily for speculative investment purposes rather than as consumptive goods.[232] What concerns us, to the extent that these tokens represented an ill-fated attempt at investment opportunities masquerading as something else, is that they offered certain contractual protections to their would-be investors. The point for our purposes is that entrepreneurs viewed these contractual mechanisms as attractive to the crowd, and the crowd agreed, at least in theory.

Entrepreneurs promised that these protections were coded into the blockchain itself.[233] Conveniently, Shaanan Cohney et al. have described key protective mechanisms of ICOs.[234] Their survey compares the promises

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[229] Securities Act of 1933 § 12(a)(1), 15 U.S.C. § 77l (2012 & Supp. III 2015).

[230] Anna Irrera, Steve Stecklow & Brenna Hughes Neghaiwi, *Special Report: Backroom Battle Imperils $230 Million Cryptocurrency Venture*, REUTERS (Oct. 18, 2017, 6:06 PM), https://www.reuters.com/article/us-bitcoin-funding-tezos-specialreport/special-report-backroom-battle-imperils-230-million-cryptocurrency-venture-idUSKBN1CN35K.

[231] Jack Mathis, *ICOs Are Securities, ‘Don’t Know How Much More Clear I Can Be’: SEC Chairman*, CCN, https://www.ccn.com/icos-are-securites-dont-know-how-much-more-clear-i-can-be-sec-chairman/ (last updated June 14, 2018, 2:00 AM).

[232] In April 2019, the SEC issued a framework for analysis of the *Howey* test, focusing most of its guidance on the requirement of a reasonable expectation of profits derived from efforts of others. Bill Hinman, *Statement on “Framework for ‘Investment Contract’ Analysis of Digital Assets”*, U.S. SEC. & EXCHANGE COMMISSION (Apr. 3, 2019), https://www.sec.gov/news/public-statement/statement-framework-investment-contract-analysis-digital-assets.

[233] Shaanan Cohney et al., *Coin-Operated Capitalism*, 119 COLUM. L. REV. 591, 630 (2019).

[234] *Id.* at 630–31, 634. This article describes a further attribute of ICOs, modifiability. *Id.* at 630. A key promise of the ICOs is that the blockchain is a “trustless” mechanism. *Id.* at 612. Because protections are coded into the smart contracts of the blockchain, investors need not trust the entrepreneur. *See id.* (discussing promise of trustless market). A chief protection, then, is the immutability of the blockchain code itself—but at the same

contained in the white papers (text documents that ICO promoters typically release to describe and promote their projects)[235] with the actual blockchain code that supposedly made good on the developers' promises.[236] Unfortunately, the authors found that, whether due to mistakes in the code or outright fraud, ICO promises often did not match reality.[237] It goes without saying, and yet bears saying, that a contractual protection coded into the blockchain is only as strong as the code itself.[238] The DAO itself is a reminder of that. But the Cohney study's finding of flawed coding, troubling as it might be for individual ICO investors, does not affect the usefulness of ICO contracts as guidance for our purposes. Even if the ICOs did not actually *deliver* on the promised contractual protections they offered the crowd, their presence means either the crowd valued the protections or the entrepreneurs presumed they would. Thus, they may serve as a useful guide to what contractual features would best serve a more conventional company seeking to raise funds from the general public.

1. *Voice and Exit*

The SEC's report described how DAO tokenholders' voting rights resembled those of public company shareholders, and it used this fact to bolster its argument that DAO tokens were securities under the *Howey* test.[239] As we have seen, post-DAO ICOs largely eschewed granting voting rights in order to distinguish them from the DAO tokens.[240] But, as I argued above, it would be a mistake to interpret the post-DAO utility tokens' lack of voting rights as a dismissal of the value of a vote. On the contrary, the DAO's relatively strong voice and exit rights are best understood as an acknowledgement of the power of these tools to protect investors and constrain managers. As described above, post-DAO tokens evolved without these rights in response to U.S. securities laws. The example of the DAO (as well as the history of democratic and corporate governance) points to their potency as a protective mechanism for the crowd. It would be unwise to discount them.

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time, some flex is needed to accommodate future uncertainty. Modifiability in traditional corporations is easily handled by way of the certificate of incorporation (much as Part III.B.2 will suggest that supply limits are), so this Article will not focus on promises of modifiability or lack thereof.

235 For an example, see Jentzsch, *supra* note 208.

236 Cohney, *supra* note 233, at 634.

237 *Id.* at 596, 639–40.

238 *Id.* at 615. The authors found that of the fifty largest ICOs of 2017 whose code they examined, thirty-six promised some type of vesting, but only eleven hard-coded it in the tokens' smart contract. *Id.* at 634, 638.

239 DAO REPORT OF INVESTIGATION, *supra* note 223, at 15.

240 *See supra* note 226 and accompanying text.

2. *Limitation on Supply*

At base, a security is the right to a share of the future profits of a project. As a matter of basic math, the more securities an entity issues, the less value each share will be worth. To use a time-worn but apt analogy, the more pieces into which the pie is sliced, the smaller each piece becomes.

Corporate law hardwires a constraint on the number of shares that can be issued in a corporation's certificate of incorporation.[241] The certificate lists the authorized number of shares, and that number represents a ceiling on the number of shares that can be issued—issuing more requires a board recommendation and shareholder approval.[242]

Similarly, in an ICO the number of tokens in circulation directly affects the value of each individual token.[243] "The value of a token, like the value of a stock, can be diluted through new issuance."[244] The blockchain itself must be coded to prevent "wanton inflation of supply" in order to protect investors from dilution.[245] Given the theoretically limitless supply of cryptocurrency that can be generated, it is unsurprising that "almost all issuers promise[d] a supply restriction in their marketing documents."[246]

What is notable for the purposes of financial contracting and innovation is that this protection was so widespread. The risk of dilution is easy to comprehend. The market responded uniformly to this potential threat with contracting to constrain it.

3. *Vesting/Compensation*

Recall that, in the venture capital context, the concern was that a founder, upon whose work rests the success of the venture, will shirk once he or she has an ownership interest secured.[247] Vesting is an elegant mechanism that ties the founders' efforts to the overall venture's ultimate success.

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[241] Corporations remain the entity of choice for going public, although LLCs and other entities can complete initial offerings as well. *See* Gregg D. Polsky & Adam H. Rosenzweig, *The Up-C Revolution*, 71 TAX L. REV. 415, 415, 427 (2018) (discussing continued persistence of corporations).

[242] *See* Karen Rogers, *Difference Between Authorized & Outstanding Shares*, AZCENTRAL, https://yourbusiness.azcentral.com/difference-between-authorized-outstanding-shares-14977.html (last visited Oct. 27, 2019) ("Shareholders must approve any increase or decrease in the number of authorized shares through a vote.").

[243] Cohney, *supra* note 233, at 612.

[244] *Id.* at 613.

[245] *Id.*

[246] *Id.* at 637.

[247] *See supra* Part II.B.3.

ICOs also generally employed vesting in their financial contracts.[248] These locked up (or purported to lock up) portions of the founders' tokens over a period of time.[249] Founders typically reserved a healthy portion of tokens for themselves before an ICO. If founders could access these tokens immediately after the ICO, the unscrupulous could promptly sell them on the secondary market, pocket the proceeds, and abscond without ever delivering on the promised technology. Instead, the code itself imposed constraints on when founders could gain access to their token allocation.[250] This "token vesting" solves the problem of ICO founders taking the money, dumping the tokens on the open market, and running.[251] Cohney et al. quote Aragon's CEO: "[V]esting is a must. There are no excuses not to do it. It aligns everyone's incentives and ensures that no founder dumps happen."[252]

It is worth noting, however, that vesting in the ICO context is a crude phenomenon. There is rarely a performance component to "earning" the tokens—instead, the passage of time alone is what causes a founder's tokens to vest.[253] The agency cost that such vesting protects against is the fly-by-night situation where a fraudulent promoter markets a new token, assigns herself a percentage of the tokens as a founder's share, and then hastily converts her tokens into cash and exits stage right. This type of vesting does not prevent founders from profiting from inaction—at most, it merely delays it. To be sure, that delay in itself may deter the most egregious fraudsters and slackers. After all, if a founder does not do enough work to further the project to make it at least seem viable before vesting begins, she will be left holding vested tokens in a worthless network. But, as an incentive-alignment tool, it pales in comparison to the cliff-vesting of the venture world, where entrepreneurs face a real threat

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[248] Cohney et al., *supra* note 233, at 615. According to Cohney et al., ICOs "often" claim to code vesting into their smart contracts. *Id.* In this study, Shaanan Cohney, David Hoffman, Jeremy Sklaroff, and David Wishnick conducted an empirical study of 2017 ICO smart contracts, revealing that not all vesting claims in white papers manifest in the smart contracts of the offerings themselves. *Id.* at 638. ICOcheck.io includes, in its evaluation criteria for ICOs, a vesting schedule defined as over two years vesting with a six-month cliff. *Background Checks and Due Diligence for Crypto Projects*, ICOCHECK, https://icocheck.io/past.html (last visited Aug. 13, 2018).

[249] *See supra* note 248.

[250] This was done through smart contracts. *See supra* note 248.

[251] Commonly, every six months, a certain amount of tokens is released to the founders. This prevents them from dumping the tokens post-ICO. Vedran Kajic, *How To Protect ICO Investors: Auto-Refunds If Milestones Aren't Met*, VENTUREBEAT (Dec. 1, 2017, 12:05 PM), https://venturebeat.com/2017/12/01/how-to-protect-ico-investors-auto-refunds-if-milestones-arent-met/.

[252] Cohney et al., *supra* note 233, at 614 (quoting Luis Cuende, *Aragon Network Token Sale Terms: Founder Vesting, Simple Pricing and Distribution*, ARAGON: ARAGON BLOG (Apr. 21, 2017), https://blog.aragon.org/aragon-network-token-sale-terms-8998f63a3429/.

[253] *Id.* at 628. Aragon purports to impose additional conditions on vesting, but these appear to be actualized through a future token distribution. *Id.* at 628 n.185.

of being fired and losing all claim to a firm's equity if they do not perform well.

4. *Threshold Raise*

In a capital-raising campaign open to the general public that takes place over the course of weeks or months, early investors risk being the first investors in an offering that will draw only tepid support from the market as a whole. If a project needs $5 million to succeed, they will be wary of committing their $1,000 until they know the threshold goal is met, or close to being met, lest they be the "sucker" that commits to a failed cause and loses money. In response, ICOs often set a minimum amount to be raised as a condition to completing the offering.[254] If an ICO fails at the funding stage, then the ICO's terms usually provide that the funds that were raised will be returned back to investors.[255] This mechanism encourages early supporters to contribute without risking being "suckers" who lose the money they invest in a project that never gets off the ground.

For example, when an ICO by OnPlace failed to reach its minimum fundraising goal, it posted instructions for investors on how to execute a smart contract to retrieve the cryptocurrency they had invested.[256] These instructions were posted on Steemit, another social media and blogging website, as well as their own website, and provided step-by-step instructions on how to use a smart contract to withdraw the invested funds by executing a "safeWithdrawal" function.[257]

Similarly, when Swapy, a blockchain technology focused on providing universal credit access,[258] failed to meet its fundraising goal through its ICO, it

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[254] For example, the DAO itself created a "minimum … [c]reation goal," a minimum amount to be raised in order for the offering to be successful. Jentzsch, *supra* note 208, at 2.

[255] *See, e.g.*, *id.* Kickstarter, a crowdfunding website, uses a similar "all or nothing" approach. *What Are the Basics?*, KICKSTARTER, https://help.kickstarter.com/hc/en-us/articles/115005028514-What-are-the-basics (last visited Oct. 27, 2019). When a project uses funds through Kickstarter, the creators set a minimum fundraising goal, and no funds will be dispersed by Kickstarter to creators unless that minimum goal is reached. *Id.* If the goal is not reached, Kickstarter refunds all the money raised. *See id.* In this sense, Kickstarter is essentially acting as an escrow agent.

[256] *OnPlace ICO Fails to Reach Minimum Funds: Refund Your ETH Using Parity*, STEEMIT, https://steemit.com/ico/@kermee/onplace-ico-fails-to-reach-minimum-funds-refund-your-eth-using-parity (last visited Oct. 27, 2019).

[257] *Id.*; OnPlace Team, *Refund Instruction*, TELEGRAPH (July 6, 2017), https://telegra.ph/Refund-Instruction-07-06. Since its failed ICO in July 2017, OnPlace has launched a pre-sale of tokens which met its "soft-cap," demonstrating that a failed fundraising effort is not the death of a project. *See* Natasha Mascarenhas, *OnPlace Resumes Pre-Sale, Soft Cap Reached*, BLOCKCHAIN NEWS (Feb. 20, 2018), https://www.the-blockchain.com/2018/02/20/onplace-resumes-pre-sale-soft-cap-reached/.

[258] *Swapy–Using Blockchain to Enable Easy Access to Credit and Affordable Loans*, BITCOINIST (Mar. 12, 2018, 3:30 PM), https://bitcoinist.com/swapy-using-blockchain-enable-easy-access-credit-affordable-loans/.

announced the return of all investor funds through Medium (an online publishing platform).[259] Another failed project, BeOne, a decentralized education platform,[260] announced on Twitter that investors would be refunded when its ICO did not raise enough money to continue.[261] While it is hard to generalize, these and other examples suggest refunding investors is the norm.[262]

It will not have escaped readers' attention that current equity crowdfunding rules already protect against the risk of failing to raise a minimum threshold amount. Recall that equity crowdfunding similarly requires the return of investment funds if the target amount is not reached.[263] The borrowing of this contractual protection from crowdfunding is, in effect, a market validation of equity crowdfunding's use of the target amount concept.[264]

5. *Resale/liquidity*

Although commentators do not focus much on this characteristic, most ICOs sold tokens that were freely transferable on a secondary market.[265] The market for individual tokens could rise or fall, sometimes precipitously, but they could be resold without limitation. This ability to resell quickly presents a type of

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[259] Edmilson Rodrigues, *Swapy's ICO Did Not Reach the Softcap. We Will Return the ETH to All Contributors.*, MEDIUM (May 26, 2018), https://medium.com/swapynetwork/swapys-ico-did-not-reach-the-soft-cap-we-will-return-the-eth-to-all-contributors-6ffbd3b1e492. Swapy announced refunds through investors' TGEApp profile within seven days after the end of the ICO, and, in an effort to fully refund investors, Swapy also provided a form for those who no longer had access to the TGEApp they used to contribute. Edmilson Rodrigues, *Contributed and Don´t Have Access to the TGEApp Profile? Fill this Form.*, MEDIUM (June 1, 2018), https://medium.com/swapynetwork/contributed-and-don-t-have-access-to-the-tgeapp-profile-fill-this-form-ada14f78388e.

[260] *BeOne—ICO Over*, TOKEN MKT., https://tokenmarket.net/blockchain/waves/assets/beone/ (last visited Oct. 27, 2019).

[261] Be One (@beone_co), TWITTER (Oct. 7, 2017, 10:03 PM), https://twitter.com/beone_co/status/916891688458752000.

[262] *See also* Spheris, *Spheris Crowdsale Refund Instructions*, COINSPECTATOR, https://coinspectator.com/news/93554/spheris-crowdsale-refund-instructions (last visited Aug. 30, 2019) (providing refund instructions for Spheris, a failed ICO); *InChain ICO Fails, Investors To Be Reimbursed*, FORKLOG (Nov. 24, 2016), http://forklog.media/inchain-ico-fails-investors-to-be-reimbursed/ (noting that InChain refunded investors after failing to meet fundraising goals); DIGI TOKEN, https://www.digitoken.tech (last visited June 19, 2018) (announcing a refund for all investors on website).

[263] *See supra* note 124 and accompanying text.

[264] It is likely that equity crowdfunding borrowed this concept from Kickstarter, Indiegogo, and other offerings that require a certain amount to "make." Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals Under the CROWDFUND Act*, 13 U.C. DAVIS BUS. L.J. 177, 192 (2013) ("[T]he 'target offering amount' … appears to be an obvious reference to a pre-statutory crowdfunding norm. In the pre-CROWDFUND Act era, the distribution of funds to a business or project in a crowdfunded offering typically was contingent on the attainment of a certain threshold level of funding." (quoting 15 U.S.C. § 77d-1(a)(7) (2012))).

[265] *How to Buy ICO Tokens: Beginner's Guide*, COINTELEGRAPH, https://cointelegraph.com/ico-101/how-to-buy-ico-tokens-beginners-guide (last visited Sept. 20, 2019).

protection not afforded to venture investors, who face contractual limits to resale, as well as legal limitations running from six months to two years, as we have seen.[266] Even if a venture investor held onto the shares for the requisite amount of time, and had bargained for the contractual right to resell, she would face practical difficulties in finding a buyer willing to purchase such a relatively illiquid security.

This survey of the key contractual mechanisms governing ICOs suggests that ICO developers used financial contracting to help protect investors and mitigate risk, just as their counterparts in venture finance do. Some of those contractual mechanisms, such as limits on supply, are not as useful in the equity crowdfunding context because the articles of incorporation form an easy mechanism to prevent dilution in organizations not based on the blockchain. But vesting, voice, and exit hold more promise. At least, they are examples of mechanisms that could apply to crowdfunding. Indeed, equity crowdfunding already employs a threshold amount, and the ICO market validates its usefulness as an investor protection device. But before extrapolating any lessons from the ICO market, it is time to deal with some objections.

C. Caveats

Readers may well be skeptical of the idea of applying the lessons of ICOs to equity crowdfunding. It may be that ICOs do not represent a particularly good model from which to extrapolate. This Section will deal with three criticisms. The first objection is that ICOs were nothing more than a bubble. There is nothing of value to be gained from examining the financial contracts of ICOs, because they were the product of an irrationality, not rational investor choice. The second objection is that the general public should not, as a matter of policy, invest in risky private ventures. The third objection, at least as it pertains to using venture capital financial contracting as a model, is that the lack of a venture capitalist constitutes a major differentiator for ICOs and equity crowdfunding alike.

First, cryptocurrency in general, and ICOs in particular, can fairly be characterized as a bubble, defined as a "rapid run-up [in prices] followed by a

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[266] *See supra* notes 98–99 and accompanying text.

crash."[267] Hysteria began in 2016 and peaked in late 2017.[268] Bitcoin traded at $20,000 on December 17, 2017; in late 2018 it traded at $3,525.05.[269] Indeed, commentators, both at the time and since then, have described a kind of crypto-hysteria based on ephemera and rampant speculation.[270] While the underlying blockchain technology makes it difficult to know who was investing in cryptocurrency and ICOs, it is clear that some percentage of the unsophisticated and unwary, who did not understand the technology, or even what an ICO was, lost money investing in ICOs.[271] Seen in this light, one logical concern is that it would be unwise to look to these contracts for guideposts in financial contracting with the crowd.

The first response to this objection is a pragmatic one. Because of the nature of securities law and the state's regulatory choke hold, as described in Part II.C, ICOs are all we have as evidence of the terms the crowd might want. It may be that these investments were based not on the terms of the financial contracts as described in the white papers, but on hype alone. On this view, if no one was pausing to evaluate those terms, then any terms would have sufficed. Cohney's finding of coding errors certainly suggests a lack of diligence on the part of the crowd.

Yet these promises clearly mattered. The terms converged around a few key protections—threshold raises, supply limits, and vesting. And ICOs did not fail

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[267] Ryan Bubb & Prasad Krishnamurthy, *Regulating Against Bubbles: How Mortgage Regulation Can Keep Main Street and Wall Street Safe—from Themselves*, 163 U. PA. L. REV. 1539, 1551 (2015). There is no consensus on the definition of a bubble. Other descriptions include "marketwide irrational exuberance," *Id.* at 1608; "the irrational characteristic of asset-price bubbles: the unfounded belief that downside risk—in that case, the risk of home prices plummeting—will never be realized," Steven L. Schwarcz, *Securitization and Post-Crisis Financial Regulation*, 102 CORNELL L. REV. ONLINE 115, 126 (2016); "boom-and-bust price behavior," John Patrick Hunt, *Taking Bubbles Seriously in Contract Law*, 61 CASE W. RES. L. REV. 681, 705 (2011); and "high volumes of speculative trading," *Id.*

[268] Sam Ouimet, *Down More than 70% in 2018, Bitcoin Closes Its Worst Year on Record*, COINDESK, https://www.coindesk.com/down-more-than-70-in-2018-bitcoin-closes-its-worst-year-on-record (last updated Jan. 2, 2019, 3:32 PM); Julie Myers Wood, *Regulators Are Catching Up with the Crypto Boom*, FORBES (Sept. 27, 2018, 10:18 AM), https://www.forbes.com/sites/juliemyerswood/2018/09/27/regulators-are-catching-up-with-the-crypto-boom/#14f2731e1b92.

[269] Nigel Chiwaya, *Bitcoin Reached an All-Time High Last Year. Now, You Might Be Digging for Coal.*, NBC NEWS, https://www.nbcnews.com/business/markets/bitcoin-high-2017-decline-2018-data-n949576 (last updated Dec. 19, 2018, 11:07 AM).

[270] *See* Jon Evans, *The Cryptocurrency Bubble Is Strangling Innovation*, TECHCRUNCH (Jan. 7, 2018, 9:00 AM), https://techcrunch.com/2018/01/07/the-cryptocurrency-bubble-is-strangling-innovation/; Kevin Roose, *Is There a Cryptocurrency Bubble? Just Ask Doge.*, N.Y. TIMES (Sept. 15, 2017), https://www.nytimes.com/2017/09/15/business/cryptocurrency-bubble-doge.html.

[271] *See* Kevin Werbach, *Trust, but Verify: Why the Blockchain Needs the Law*, 33 BERKELEY TECH. L.J. 487, 516 (2018) (highlighting the difficulty of the technical and hardware requirements).

to deliver on all promises.[272] Given the dearth of competent developers[273] and the difficulties even billion-dollar companies have with hacking and bugs, these may be sins of omission rather than commission, borne of haste rather than fraudulent intent. Indeed, in the face of such lightning-fast capital raises,[274] the fact that entrepreneurs continued to feel they had to offer these contractual limitations speaks to their importance.

The second response to the bubble criticism, equally as pragmatic, cautions against overstating the safety of the public markets. Two paradigmatic examples of the 2001 Internet stock bubble are Enron and Pets.com.[275] The stock of both companies were high-fliers in the public markets around the late 1990s and early 2000s, and both ended in bankruptcy, costing investors millions of dollars in losses.[276] Investors' losses in Enron were the product of fraud, and those in Pets.com mere folly, but both serve as a stark reminder that the crowd can easily lose its shirt in the public markets—or, for that matter, in a casino.[277]

Another objection might be that public and private investors are fundamentally different. Accredited investors and institutional investors may be more sophisticated than average Joe investors (although there is plenty of evidence otherwise).[278] Even if not any savvier, at least wealthy investors can better afford to lose money in risky investments than the crowd can.[279] As a society, we can allow the affluent the freedom to experiment in private markets, relying only on financial contracting to protect themselves. The general public is a more vulnerable population. The elderly, the ignorant, and the unwary may be seduced by the unscrupulous—and these individuals have much more to lose precisely because they have much *less* to lose. Society should protect them from such risks—even at the risk of paternalism.

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[272] *See* Cohney et al., *supra* note 233, at 637 (noting that 75% of ICOs that promised a supply restriction delivered it).

[273] Sherman Lee, *The Demand for Blockchain Engineers Is Skyrocketing, but Blockchain Itself Is Redefining How They're Employed*, FORBES (Apr. 11, 2018, 5:05 AM), https://www.forbes.com/sites/shermanlee/2018/04/11/the-demand-for-blockchain-engineers-is-skyrocketing-but-blockchain-itself-is-redefining-how-theyre-employed/#35af5f616715.

[274] SingularityNet reportedly raised $36 million in cryptocurrency in less than a minute. JD Alois, *Fastest ICO Ever? SingularityNet Raises $36 Million in 60 Seconds*, CROWDFUND INSIDER (Dec. 22, 2017, 7:28 PM), https://www.crowdfundinsider.com/2017/12/126315-fastest-ico-ever-singularitynet-raises-36-million-60-seconds/. To be fair, they had a two-stage process to comply with anti-money laundering and know-your-customer laws. *Id.*

[275] *See* Lynn A. Stout, *Share Price as a Poor Criterion for Good Corporate Law*, 3 BERKELEY BUS. L.J. 43, 48, 50 (2005).

[276] *See id.* at 48, 50, 52.

[277] Rodrigues, *supra* note 17, at 3428.

[278] *Id.* at 3423–24.

[279] *Id.* at 3424.

This is, at heart, a policy question. As Part II described, traditionally the wealthy had access to riskier, and potentially more profitable, investments, but those investments were limited as to amount and resale, were not advertised to the general public, and effectively could not grow beyond 500 shareholders. Congress has loosened these restrictions. The public is well aware that private fortunes have been made on behemoths like Uber and Airbnb, in which they could not invest while private. On the flip side, equity crowdfunding is currently letting the crowd invest in private companies, but crowdfunding appears to be the resort of those firms that cannot get financing elsewhere.

The third objection is that venture capital financial contracting has an obvious element that neither ICOs nor crowdfunding does: a venture capitalist. When a venture capital fund invests in a company, generally one of the fund's directors sits on the board of that company. Thus, the control rights, exit rights, and redemption rights are focused in an individual representing a small group of individuals minding the till. Equity crowdfunding, as currently conceived, lacks this centralized, motivated monitor. Without that, focused control rights and protections may not mean much.

This objection goes to the heart of the concerns about public capital raising. The public markets substitute disclosure for robust contractual control rights, and trust that the market as a whole—perhaps led by sophisticated investors such as hedge funds and pension funds—can adequately monitor. Mechanisms like vesting and a threshold raise can work without supervision, but venture capital couples these with representation on the board and veto rights at both board and shareholder level. That venture capitalist presence on the board represents a watchful eye looking over the shoulder of a start-up and exercising both soft and hard power when necessary. The crowd context, whether ICO or crowdfunding, lacks that active oversight.

This criticism goes to the crux of the question of to what extent private financial contracting can apply in the public setting—and how much the venture capitalist presence, separate and apart from high-powered incentives like vesting, contribute to a venture-backed company's success. At some level, of course, the crowd will never be able to exert the same sort of concentrated monitoring that a venture fund does.

However, crowdfunding could look to the governance structure of venture funds themselves for an alternative approach. Venture funds sometimes have a committee of investors that provide a check on the fund's managers.[280] This

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[280] *See* Alexander J. Davie, *Managing Conflicts of Interest in Private Equity and Venture Capital Funds,*

check, to be sure, is quite weak, and it is generally understood that high-powered incentives (the return the fund's managers will earn on the fund's profit, taxed at a beneficial capital gains rate),[281] and the reputation the managers want to cultivate in order to raise future funds, do much of the work of governance at the fund level.[282] Crowdfunding could profitably explore such innovative governance structures—if it were allowed to do so.

Yet crowdfunding, as currently conceived, is a meager half loaf that both fails to address the capital raising needs of entrepreneurs and fails to allow the crowd a meaningful way to invest in private firms. Given concerns about income inequality and wealth disparity, crowdfunding has the potential to be a force to democratize capital. Currently, it is not fulfilling that potential.

Both venture capital and ICOs address the risks of uncertainty, asymmetric information, and agency costs, often with similar mechanisms. That fact alone suggests that we should consider importing these protections to equity crowdfunding.

IV. THE LEGISLATIVE SOLUTION

Crowdfunding is broken. Its rules are too complicated, and it limits firms to only $1.07 million in capital raising over a twelve-month period.[283] The next Part will articulate the contours of a solution, informed by the features of ICOs and VC financial contracting that Parts III and IV described. To implement this solution, ideally Congress would create a tailored exemption from registration under the Securities Act that balances investor protection with the new opportunities for capital raising, fostering a robust market that creates a level playing field, benefiting investors and issuers alike. Unfortunately, congressional action is unlikely. Congress sometimes legislates in the securities law area, but it does so relatively rarely.[284] If Congress *were* to intervene, however, financial contracting suggests following certain insights from VCs and

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STRICTLY BUS. (May 24, 2017), https://www.strictlybusinesslawblog.com/2017/05/24/managing-conflicts-interest-private-equity-venture-capital-funds/ (discussing usefulness in dealing with conflicts of interest and noting that the "fund's limited partnership agreement establishes the existence and authority of the limited partner advisory committee").

[281] *See* Chris Isidore & Jill Disis, *Tax Break for Hedge Fund Managers Mostly Survives in GOP Bill*, CNN MONEY (Dec. 21, 2017, 2:53 PM), https://money.cnn.com/2017/12/21/news/trump-carried-interest-tax-plan/index.html (discussing favorable tax treatment).

[282] *See* Bob Zider, *How Venture Capital Works*, HARV. BUS. REV., Nov.–Dec. 1998, at 131, 135–36 (noting that the return to managers on fund's profit incentivizes investment success).

[283] *See supra* note 114 and accompanying text.

[284] *See generally* Usha R. Rodrigues, *Dictation and Delegation in Securities Regulation*, 92 IND. L.J. 435 (2017) (examining when Congress chooses to legislate in the area of securities law).

ICOs. For now, this Part presumes such an exemption to be politically feasible and explores what form it might take.

A. Threshold Raise and the Power of Escrow

As Parts II.C and IV.B.4 described, both ICOs and current crowdfunding rules employ a threshold raise concept, termed a "target amount" in crowdfunding parlance. The ICO experience teaches that this concept, which likely has its origins in pre-equity crowdfunding norms,[285] is a valuable investor protection for the crowd. Keep in mind, crowdfunding differs from the venture context, where, at most, a handful of venture funds will collectively finance a fundraising round, and the closing will occur in a single day. Given that crowdfunding, in contrast, unfolds over a period of weeks or even months, setting a threshold amount to raise makes good sense.

The threshold raise also conveniently introduces an escrow mechanism to crowdfunding. As discussed in Part II.C, the crowdfunding rules require that the crowdfunding intermediary be a registered broker-dealer or a funding portal that uses a qualified third party to hold the funds for the benefit of the investors.[286] Qualified parties are defined as a registered broker or dealer, or a bank or credit union "that has agreed in writing either to hold the funds in escrow …, or to maintain a bank or credit union account … for the exclusive benefit of investors and the issuer."[287] Once the target amount and other requisite conditions have been met, then the funding portal directs the funds to be released from escrow.

This simple concept of an escrow is a powerful one, as we will see. By allowing for funds to be securely amassed, but not dispersed, it can simultaneously reassure the entrepreneur that funds are available, while at the same time leaving the investors with some strings to pull. Notably, before the enactment of the Securities Act, certain states imposed escrow requirements on offerors. Florida's blue sky law, for example, required an "escrow agreement with a bank, trust company, or an attorney-at-law, setting forth the price per share, the total amount of stock to be issued and the total funds to be obtained from the sale, and the date the sale is to be concluded."[288] The funds were then to be deposited with an escrow agent, and if they were not deposited with the "escrowee within the time prescribed in the escrow agreement, which shall be for not more than six months, then the escrowee shall return all funds held to the

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285 Heminway, *supra* note 264, at 192.
286 17 C.F.R. § 227.303(e) (2017).
287 *Id.*
288 FLA. STAT. ANN. § 517.06(10) (West 1971) (repealed 1978).

respective subscribers."[289] In Arizona, an administrator was allowed to "hold the stock of promoters in escrow as a condition of registration," and the capital would not be released until a petitioner provided at least one year of satisfactory earnings.[290] Thus, although the Securities Act's move to put deep-pocketed investment banks on the hook for fraud in registered companies' offerings may have obviated the need for escrows in 1933, the escrow's power to delay funding has historical antecedents.

Promisingly, escrow figures prominently as a protective feature in one area where the SEC *has* allowed experimentation in raising funds from the general public—the special purpose acquisition company (SPAC).[291] The promoters of a SPAC take an entity public that is a mere shell corporation.[292] Because the corporation is just a fundraising vehicle, liabilities are nearly nonexistent, and disclosures are limited to biographies of the management team and a description of what the team is looking for in an acquisition target (industry, etc.). Once the funds are raised, the team launches a time-limited search for an acquisition target.[293] Once the managers find a target, SPAC investors typically have a pre-acquisition vote as to whether to get their money back, or to approve the acquisition and remain as shareholders of the now-public firm.[294] In this manner, like entrepreneurs seeking venture capital, or crowdfunding entrepreneurs seeking money from the general public, SPAC promoters turned to financial contracting to raise money from the general public for future events.

SPACs thus addressed the familiar problem of how to raise money for a yet-to-be determined future enterprise, with a key difference from the funding models we have explored thus far. Where both venture financing and ICOs contemplated raising funds in order to build a business or grow a business, SPACs ducked the problem of judging how the venture was progressing by raising money for a future acquisition of an existing business. The SPAC form relied on escrow to offer its investors protection.

SPACs characteristically agree to hold 90% or more of the offering proceeds

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289 *Id.*

290 Marianne M. Jennings, Bruce K. Childers & Ronald J. Kudla, *Federalism to an Advantage: The Demise of State Blue Sky Laws Under the Uniform Securities Act*, 19 AKRON L. REV. 395, 400 n.34 (1986).

291 *See generally* William K. Sjostrom, Jr., *The Truth About Reverse Mergers*, 2 ENTREPRENEURIAL BUS. L.J. 743, 756–59 (2008) (discussing SPACs).

292 *Id.* at 756.

293 *Id.* Sjostrom describes SPACs as a species of reverse mergers, and at a high level of generality. *See id.* at 744, 756. In contrast, this Article conducts an empirical analysis of individual characteristics of SPACs and documents how they change over time.

294 *See id.* at 758.

in escrow.[295] "[T]he trust is held at a custodian independent of the SPAC … and is monitored by a third-party trust company, making the value of the trust account extremely safe."[296] The key question, then, becomes what should trigger the release of the escrowed funds. As in the venture space, SPACs turned to voice and exit as investor protections, voice being the aforementioned vote, and exit being the right of investors to get their money back. The Sections below will explore the potential for these mechanisms as protections for the general public in the crowdfunding context.

B. Exit, Voice, and Staged Financing

Albert Hirschman identified exit and voice as two mechanisms that discipline organizations.[297] As we have seen, staged financing and voting control, coupled with a theoretical redemption right, are potent investor protection mechanisms venture capitalists deploy to protect against the common problems of uncertainty, information asymmetry, and agency costs. A robust escrow could enable crowdfunding to offer the general public a version of the same kinds of protections.

First, a word of explanation. This Section will describe *exit* as a redemption right, that is, a right for the investor to get either all or a portion of her money back from the firm. The liquidity that comes with the right to sell on the secondary market can function as a separate investor protection, as discussed below.

Recall the basic problems confronting the investor: uncertainty as to what will happen, asymmetric information as compared to the entrepreneur, and fear that the entrepreneur will shirk or steal.[298] Staged financing is part of what solves this problem in venture finance by dividing the funding commitment into stages.[299] An escrow would allow a similar function in the crowdfunding context. Say a firm is looking to raise $10 million to develop a remote, phone-operated video doorbell.[300] The crowdfunding offering documents could

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295 Rodrigues & Stegemoller, *supra* note 155, at 913. These funds must be invested in government obligations or treasury securities. *Id.*; Douglas S. Ellenoff, *Trusting SPACs During Difficult Times*, EQUITIES MAG., Dec. 2008, at 30, 30.

296 Christopher Raby, *Sourcing SPAC Returns*, DET. LEGAL NEWS (Sept. 7, 2018), http://www.legalnews.com/Detroit/1464013.

297 *See* Heather K. Gerken, *Exit, Voice, and Disloyalty*, 62 DUKE L.J. 1349, 1349 (2013) (discussing Hirschman's ideas in context of minorities in a democracy).

298 *See supra* Part II.A.

299 *See supra* Part II.B.1.

300 SkyBell, a video doorbell company, raised $600,000 on Indiegogo to fund its business. Murray Newlands, *This IoT Product Crowdfunded $600K and Is Now Worth Millions: Here's How*, FORBES (Feb. 24,

articulate specific milestones. For example, perhaps it would take $3 million to develop a prototype, $3 million more to launch in a few test markets, and $4 million more to roll out nationwide. The company could raise the full $10 million but keep $7 million in escrow. If and when the prototype is finished (on or ahead of schedule), investors can vote on whether to release the next $3 million for the test launch.

This vote brings us to the question of voice, or control. It is true that the ICO market reacted to the SEC's DAO report by stripping voting power from ICOs, but I do not think that alone is enough to reject the potential for voting as a powerful protective mechanism. As described above, the elimination of the vote to create so-called utility ICOs in the post-DAO report context is best understood as an attempt to evade the *Howey* test,[301] rather than as a natural evolution of the market.

A right to vote is common in typical securities (and in democratic government): Corporate shareholders typically vote on a slate of directors that oversee the corporation, and crowdfunding investors could certainly vote on management in a like manner. Shareholders also vote on fundamental changes in a corporation's life, including amendments to its organizing documents, mergers, and dissolution. But voting can wield an even stronger discipline when paired with staged financing, because it gives shareholders a right to extend or withhold financing at a future point in time. Used in conjunction with staged financing, and powered by the security of escrowed funds, it allows the crowd in essence an option on the future prospects of the venture.

The question next becomes what to do with the escrowed funds if individual shareholders, or the majority of crowdfunding shareholders, vote against continuing with the project. This brings us to exit—and a cautionary tale. Recall the redemption rights venture capitalists sometimes bargain for, but rarely use.[302] SPACs, in contrast, offer strong exit rights, which are often used.[303] Early SPACs coupled this exit right with robust voting rights—shareholders had a vote on an acquisition, coupled with a right to receive their pro rata share of the

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2017, 7:41 PM), https://www.forbes.com/sites/mnewlands/2017/02/24/this-iot-product-crowdfunded-600k-and-is-now-worth-millions-heres-how/#5bc17312460f; Ryan Robinson, *5 Crowdfunded Side Projects that Became Million-Dollar Companies*, FORBES (Sept. 18, 2017, 12:25 PM), https://www.forbes.com/sites/ryanrobinson/2017/09/18/crowdfunded-side-projects-that-became-million-dollar-companies/#574ad86d3f1d.

301 *See* Randolph A. Robinson II, *The New Digital Wild West: Regulating the Explosion of Initial Coin Offerings*, 85 TENN. L. REV. 897, 950 (2018) ("One result of the SEC's report has been a deluge of articles drawing a distinction between so-called equity tokens, like those the SEC contends The DAO issued, and so-called 'utility' tokens.").

302 *See supra* Part II.B.4.

303 *See supra* note 294 and accompanying text.

escrowed funds if they opposed the merger.[304] This exit functioned as a secondary veto, because if enough shareholders exercised their redemption rights, the merger would not go forward.[305]

Keep in mind, however, these protective voting mechanisms introduce costs of their own. For a time after the 2008 crisis, there was evidence that SPAC investors were voting down deals not on the merits, but instead because the cash promised if the fund were to liquidate was more valuable, in a world of widespread illiquidity, than tying up assets in an acquisition.[306] So, while these shareholder approval provisions helped convince the SEC to allow the first experiments in SPAC offerings to proceed, they created an unintended holdout right.[307] Ultimately, giving SPAC shareholders a vote introduced more trouble than it was worth.[308] More recently, the SEC has allowed SPACs to go forward with fewer votes—relying on exit and liquidity to protect investors.[309]

This story will resonate for readers familiar with appraisal rights and appraisal litigation. Corporate law typically gives shareholders appraisal rights in mergers, allowing them to dissent and petition the court for the fair value of their shares.[310] The rise of "appraisal arbitrage," where hedge funds bought shares of companies after a merger's announcement solely to dissent and sue, led to an uptick in lawsuits.[311] Delaware has moved to curtail these rights, but they do sound a cautionary note.[312]

The power of investors to exit, and get all, or a portion of, their money back from the firm, is a formidable protective device. In fact, Professors John Morley and Quinn Curtis suggested that voting in mutual funds may be a less reliable constraint on agency costs because exit—true exit, that is, the redemption of assets rather than the sale of a claim on the assets—is so cheap.[313] To apply this insight to our crowdfunding example, if a crowdfunding investor sours on the

304 *See supra* note 294 and accompanying text.

305 Rodrigues & Stegemoller, *supra* note 155, at 910. Early SPACs put this "conversion threshold" at 20%. *Id.*

306 *See* Christie Smythe, *Conflicting Interests Put SPAC Mergers in Limbo*, LAW360 (Sept. 15, 2009, 1:54 PM), https://www.law360.com/articles/118397/conflicting-interests-put-spac-mergers-in-limbo ("As an aftereffect of the recession, many SPAC investors would rather get money back than see a deal get done….").

307 Rodrigues & Stegemoller, *supra* note 155, at 910.

308 *Id.* at 912.

309 *Id.* at 856.

310 *See, e.g.*, DEL. CODE ANN. tit. 8, § 262(a) (2019).

311 Jetley & Ji, *supra* note 170, at 428.

312 Lawrence A. Hamermesh & Michael L. Wachter, *Finding the Right Balance in Appraisal Litigation: Deal Price, Deal Process, and Synergies*, 73 BUS. LAW. 961, 962 (2018).

313 John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 89 (2010).

video doorbell after the prototype stage, she could receive back $0.70 of every dollar she had invested. If so many investors redeemed their shares that less than $3 million was left for the next stage of the venture, then everyone would receive their money back.

In evaluating the benefits of voice versus exit, it is wise to be mindful of the lessons of SPACs and appraisal in Delaware: Any time an organization introduces a vote, it risks opportunistic voting behavior. Articulating the proper balance between voice and exit rights, which guard against firm opportunism but create a concomitant risk of investor opportunism, is ultimately beyond the scope of this Article.[314] As was the case with SPACs, the market itself is probably the best guide.

C. Vesting

The venture contract requires founders' shares to vest over time as a matter of course. This provision mitigates the risk of agency cost by tying the founder's success to the ultimate success of the business. Because most of the founder's compensation is equity based, if she shirks, she risks losing not only her job, but also her stake in the business. The ICO market replicated the vesting mechanism, although with mere passage of time as the vesting condition.

These two experiences suggest that imposing a vesting schedule serves an important role in protecting investors. Requiring that the founders' shares vest over time does not appear widespread in crowdfunding.[315] It would be relatively easy for Congress to impose the standard four-year cliff-vesting schedule on its executive officers as a condition of availing itself of a new crowdfunding exemption. As importantly, it is a clear contractual provision, the existence of which would be easy for the SEC or funding portals to verify. Coupled with an escrow-driven milestone timeline, vesting has the potential to echo in the crowdfunding context a mechanism that has been a powerful motivational tool in the venture capital space.

D. Liquidity/Resale

Resale, the ability of a dissatisfied owner to sell their shares, can serve as a disciplining force on corporations. In theory, the market for corporate control

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[314] This discussion suggests that negative covenants, a potent tool in the venture setting, might similarly pose too high a risk of investor opportunism.

[315] Jeff Thomas, *Equity Crowdfunding Portals Should Join and Enhance the Crowd by Providing Venture Formation Resources*, 42 NOVA L. REV. 375, 397–98 (2018) (stating crowdfunding issuers "are less likely to use" vesting provisions because there are no venture capitalists to demand them).

constrains corporate management because, as a failing corporation loses value, it becomes ripe for takeover by more able managers.[316] While this mechanism is powerful over time, it unfortunately punishes the investor, who must sell a devalued asset to express her displeasure. Thus, in a traditional public corporation, the resale right is cold comfort because it usually means selling at a loss. Given this harsh fact, the redemption right discussed above is a more powerful protective mechanism for the crowd.

The question remains whether a right of resale would be a useful secondary protection for crowdfunding investors. Looking to our analogs, the power to resell traditionally was not one that venture capitalists relied upon. Increasingly, however, particularly as firms like Uber developed high valuations before going public, secondary sales are becoming more common (although still constrained by statutory restrictions of at least six months).[317] SPAC developers, in contrast, purposefully planned for the stock to trade on the secondary markets as soon as the SPAC went public.[318] ICOs likewise offered free resale, without the built-in protection that the escrowed funds provided SPACs.[319] The ability of free resale clearly contributed to the speculative frenzy that took over the ICO market at its height.[320]

As is the case with other private securities, current crowdfunding rules restrict resale to non-accredited investors for a year.[321] On balance, this seems a sensible restriction, despite the risk it poses to investors. Allowing free resale might create a vibrant secondary market, thus offering some protection to investors. But it would also expose more investors to the heightened risks that equity crowdfunding presents. The one-year resale restriction should encourage potential crowdfunding investors to do their due diligence and assess the issuer before investing. This beneficial incentive to "look before you leap," hopefully will diminish the kind of frenzy that surrounded ICOs.

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316 The concentration of power in the hands of founders that has proved so popular in Silicon Valley weakens the disciplinary effect of the market for corporate control.

317 *See* Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573, 1576 (2013) (observing rise in "nonexchange trading markets" to facilitate these transactions).

318 Rodrigues & Stegemoller, *supra* note 155, at 877. SPACs deliberately modeled their features on blank check companies that proceeded them, which were heavily regulated by the SEC, but included this key distinction that SPAC shares were freely tradable. *Id.* at 875, 877.

319 *See supra* Part III.B.5.

320 *Cf. supra* Part I.C.

321 *See supra* note 136 and accompanying text.

E. Raising Crowdfunding Limits

As described in Part II.C, current equity crowdfunding can fairly be characterized as a market for lemons. Joseph Green and John Coyle made the following observations:

> [Because of] the additional costs and disclosures required of crowdfunding issuers, most startups that have access to traditional forms of startup fundraising will be loath to undertake a crowdfunding offering. As a result, many of the startups that choose to pursue crowdfunding as a means of raising capital do so because they have no other options, and they may still struggle to raise traditional venture financing down the road.[322]

But the SEC *has* allowed experimentation in one area of crowdfunding—and the results of this experimentation suggest that equity crowdfunding may in fact be a market for lemons, attractive mostly to those too unsophisticated to understand their investments. Early crowdfunding studies suggest the popularity of Simple Agreements for Future Equity (SAFEs) as offerings.[323] SAFEs are a relatively recent innovation in venture financing, developed by Y Combinator as a means for extremely early-stage companies to secure funding cheaply and quickly.[324] SAFEs are neither equity nor debt—they basically give their holder the option to buy equity in a firm at an advantageous price should it continue to grow to a point where it can obtain venture financing in the future, be acquired, or go public.[325] Importantly, these triggering events are common in venture finance, but may be quite rare in "non-tech offerings like the craft brewery or local bakery."[326] The hapless SAFE holder in such instances would be left with a worthless security, because no trigger event would ever occur that would allow her to convert her SAFE into a share of the business.[327] To add insult to injury, some SAFEs allow the company to redeem them for the purchase price at the company's option—presumably to be exercised just when conversion would be most valuable.[328]

Green and Coyle observe that SAFEs are "highly company-favorable,"[329]

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322 Joseph M. Green & John F. Coyle, *Crowdfunding and the Not-So-Safe Safe*, 102 VA. L. REV. ONLINE 168, 175 (2016).

323 Studies suggest 26% of crowdfunding offerings involve SAFEs. FSLR NO. 2766, *supra* note 125, at 12.

324 Green & Coyle, *supra* note 322, at 172.

325 *Id.*

326 FSLR NO. 2766, *supra* note 125, at 12–13.

327 Green & Coyle, *supra* note 322, at 177–78.

328 *Id.* at 178–79.

329 *Id.* at 173.

and really only make sense in the binary world of early-stage tech startups, which will either experience explosive growth, or flame out quickly.[330] Green and Coyle recommend that the SEC rethink its "laissez-faire approach" and require that crowdfunders issue investors debt, preferred equity, or common equity.[331] The SEC later issued an investor bulletin titled *Be Cautious of SAFEs in Crowdfunding*.[332]

More fundamentally, the presence of SAFE offerings in equity crowdfunding suggests that today's crowdfunding regime is unworkable. The combination of the stiflingly low $1.07 million cap[333] on raising funds and the burdensome disclosure regime[334] means that seeking traditional debt or equity does not make financial sense for firms. SAFEs may be attractive precisely because they allow non-tech firms to raise money without giving much of anything to investors in return.

Also problematic is the limited amount that any investor can invest in crowdfunding ventures, per year, if those small amounts do not incentivize much diligence on the part of particular investors.[335] Implementing financial contracting safeguards like the ones suggested above may give legislators the comfort to raise crowdfunding limits considerably. This simple move, already championed by Representative McHenry,[336] has the potential to lower the cost of capital for crowdfunding dramatically, so long as neither the SEC nor Congress imposes new requirements on issuers who seek to raise more money. The same disclosure requirements that seem too burdensome to raise $1 million may well be worth it for $3 million or $5 million.

V. IMPLEMENTING THESE MECHANISMS WITHIN THE CURRENT REGULATORY FRAMEWORK

The previous Part evaluated how financial contracting could help protect crowdfunding investors if Congress chose to intervene in securities laws. But Congress only rarely makes securities laws—generally, it does so in two

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330 *Id.* at 172–73.

331 *Id.* at 180–82.

332 Office of Inv'r Educ. & Advocacy, *Investor Bulletin: Be Cautious of SAFEs in Crowdfunding*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes (last updated Sept. 18, 2019).

333 17 C.F.R. § 227.100 (2018).

334 *See id.* § 227.201.

335 *See supra* note 115 and accompanying text. The counterargument is that an investment of 5–10% of an investor's net worth is enough to make any investor investigate the issuer seriously. *See supra* note 115 and accompanying text.

336 *See supra* notes 10–12 and accompanying text.

settings. The first is in response to a crisis, when it delegates much of the actual regulation to the SEC.[337] The second is in response to lobbying from special interest groups, who generally tend to be sophisticated, moneyed, and successful in having their policy preferences enshrined in law, as opposed to being delegated to agency rulemaking.[338] This binary is not absolute—crowdfunding, which lacked these sophisticated backers and delegated many details to the SEC, made its way into the JOBS Act by being swept into a larger deregulatory agenda championed by Silicon Valley.[339] Reform may be feasible if crowdfunding boosters can similarly fold it into larger "JOBS 3.0" style legislation, and bill it as a path to democratizing capital.

Still, given historical trends and the current political landscape, this Part moves from hypotheticals to reality, and presumes there will be little impetus to "fix crowdfunding" on Capitol Hill. Reality, in this case, means finding a non-crowdfunding exemption from the IPO registration requirement.

Noteworthy is the fact that there are two potential regulators at play: the SEC at the federal level, and the individual state securities regulators. Because crowdsourcing usually involves interstate commerce, the regulation could be enacted at the federal level.[340] But states also have jurisdiction to regulate, unless Congress has preempted state regulation by asserting an intention that its regulation will supersede, rather than complement, state regulation.[341] Thus, the intrastate exemption remains a viable possibility, as discussed below.

With each of the methods discussed below, the SEC could engage in formal rulemaking, where the SEC meets with industry groups and other stakeholders, conducts research, proposes rules, and opens them up for public notice and comment.[342] It then takes the comments back, studies and analyzes further, and eventually promulgates final rules.[343] This is always a lengthy process and explains why crowdfunding only became a reality three and a half years after the JOBS Act of 2012 directed the SEC to develop crowdfunding rules.[344] With

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337 Rodrigues, *supra* note 284, at 449.

338 *Id.*

339 *Id.* at 496.

340 *See* United States v. Lopez, 514 U.S. 549, 552–53 (1995) (explaining that the U.S. Constitution gives the federal government the power to regulate interstate commerce).

341 *See* Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 540–41 (2001) (explaining that the Supremacy Clause allows Congress to preempt state action).

342 *See* 5 U.S.C. § 553(b)–(c) (2012) (detailing the formal rulemaking process).

343 *Id.* § 553(c).

344 The JOBS Act was enacted in 2012 and the SEC rules were promulgated in 2015. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315–16 (2012) (codified as amended at 15 U.S.C. § 77d-1 (2012)); 17 C.F.R. § 230.257 (2018).

those preliminaries out of the way, I explore below three ways the SEC might be able to allow enhanced equity crowdfunding to go forward within existing exemptions.

A. Reg A+

Reg A+, sometimes called a "mini-IPO," enables general solicitation and sale to the general public.[345] What's more, it allows promoters to raise substantial sums in a twelve-month period.[346] The Reg A+ exemption differentiates offerings up to $20 million, which require relatively fewer disclosures, from offerings from $20 to $50 million, which have additional disclosure and reporting requirements.[347] These larger offerings permit general solicitation and impose no restrictions on resale.[348]

The problem is that raising the funds in this manner requires a threshold spend of hundreds of thousands of dollars. This is because Reg A+ requires that offerors both make an electronic filing and provide to investors an offering statement that includes risk factors, dilution, plan of distribution and selling securities holders, description of business and property, and other matters.[349] These filings take time and cost money, often in the $200,000–225,000 range.[350] After the initial sale, offerors are required to file periodic disclosures on these subjects.[351] Crowdfunding firms must look to another source for the money to pay for the disclosure process. Certainly, they can turn to bank loans or angel or VC investors, but if those funding methods were feasible, the issuer would likely have employed them to raise funding in the first place.

The financial contracting mechanisms described above could provide a solution. The JOBS Act provides that the "[t]he issuer may solicit interest in the

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[345] Shadab, *supra* note 109, at 367.

[346] Tier 1 allows offerings of securities up to $20 million in a twelve-month period. 17 C.F.R. § 230.251. Although Tier 1 offerings do not preempt state Blue Sky laws, they have fewer reporting requirements than Tier 2 offerings. *Id.* § 230.257; *see* Rutheford B. Campbell, Jr., *The Role of Blue Sky Laws After NSMIA and the JOBS Act*, 66 DUKE L.J. 605, 617 n.63 (2016) ("The Commission's regulatory preemption in its Regulation A+ rules is modest, however, only preempting state authority over Tier 2 offerings and leaving Tier 1 offerings … subject to state registration authority.").

[347] 17 C.F.R. §§ 230.251, 230.257; *Regulation A*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/smallbusiness/exemptofferings/rega (last updated Sept. 18, 2019).

[348] *Overview of Exemptions*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/smallbusiness/exemptofferings/exemptofferingschart (last updated Feb. 12, 2019).

[349] U.S. Sec. & Exch. Comm'n, *Form 1-A Regulation Offering Statement Under the Securities Act of 1933*, https://www.sec.gov/files/form1-a.pdf (last visited Nov. 15, 2019).

[350] *See* KNYAZEVA, *supra* note 112, at 13–14 (showing that the median cost of a Reg A+ filing is approximately $205,000).

[351] 17 C.F.R. § 230.257.

offering prior to filing any offering statement, on such terms and conditions as the Commission may prescribe in the public interest or for the protection of investors."[352] Congress then directed the SEC to require Reg A+ issuers to file audited financial statements annually, and to impose whatever other conditions the SEC deemed "necessary in the public interest and for the protection of investors."[353]

The SEC could allow issuers to solicit interest in the offering by describing a project, and then allow a limited offering that escrows almost the full amount. The issuer could then use an amount proposed in those offering documents—perhaps $200,000 or $400,000—to complete the necessary Reg A+ paperwork and pay for future filings. If successful, after the crowdfunding shareholders had read the offering documents and had a chance to vote, then the offering would be completed if a majority (or supermajority) of shareholders approved. If not, the investors would receive back their investment (a redemption right), less the cost of the disclosure documents—perhaps 95 cents on the dollar. The issuer would be free to impose a vesting schedule on its officers—and, indeed, would be well advised to do so, and to advertise that fact in its offering documents.

One drawback to the Reg A+ approach is that the offering could raise only $50 million in the first year.[354] This may not be enough money for the project, although it is nearly fifty times the current crowdfunding limit.[355] And organizers could always return to the capital markets twelve months later.[356] Indeed, as discussed earlier, this type of staged financing is a protective mechanism that venture capitalists typically employ.[357]

B. Intrastate Offering

Because the basis for federal regulation is interstate commerce, intrastate offerings are free from federal regulation.[358] Not waiting for federal crowdfunding legislation, in 2011, Georgia enacted the Invest Georgia Exemption (IGE)[359] to take advantage of just this exemption to offer an early

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352 Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 401(b)(2)(E), 126 Stat. 306, 324 (2012) (codified as amended at 15 U.S.C. § 77c(b)(2)(E) (2012)).

353 *Id.* § 401(b)(2)(F)–(G), 126 Stat. at 324 (codified as amended at 15 U.S.C. § 77c(b)(2)(F)–(G) (2012)).

354 17 C.F.R. § 230.251.

355 *See supra* note 114 and accompanying text.

356 *See* 17 C.F.R. § 230.251 (restricting the limit of aggregate offers within a twelve-month period).

357 *See supra* Part II.B.1.

358 *See* United States v. Lopez, 514 U.S. 549, 552–53 (1995) (explaining that the U.S. Constitution gives the federal government the power to regulate interstate commerce).

359 GA. COMP. R. & REGS. 590-4-2.08 (2011).

species of crowdfunding.[360] The statute allows certain for-profit entities to raise up to $5 million a year from Georgia resident investors.[361] Investments are limited to $10,000 unless the investor qualifies as an accredited investor.[362] Georgia requires those entities who wish to take advantage of the program to file a two-page form,[363] similar to the Form D used by the SEC, but requiring much less information.[364] The form must be filed by the issuer with the Commissioner before engaging in any general solicitation efforts or the sale of the security.[365] More than seventy-five companies have filed notice with the Commissioner under the IGE.[366]

Intrastate offerings are thus a possibility, although a tricky one. Section 3(a)(11) of the Securities Act exempts an issuance of securities offered and sold only to state residents, where the issuer is incorporated in that same state and doing business in it.[367] Generally, "doing business" has been interpreted to mean that a substantial, but not exclusive, portion of business is within that state.[368] Purchasers can resell the securities without restriction to another bona fide

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360 OFFICE OF THE GA. SEC'Y OF STATE, SEC. DIV., UNDERSTANDING THE INVEST GEORGIA EXEMPTION (2014).

361 *Kemp Expands Georgia's Crowdfunding Rule*, GA. SECRETARY ST., http://sos.ga.gov/index.php/general/kemp_expands_georgias_crowdfunding_rule (last visited Sept. 22, 2019).

362 *Invest Georgia Exemption*, GA. SECRETARY ST., https://sos.ga.gov/index.php/securities/invest_georgia_exemption (last visited Oct. 6, 2019).

363 Office of the Sec'y of State, Comm'r of Sec., *Form GA-1 Invest Georgia Exemption*, GA. SECRETARY ST., http://sos.ga.gov/admin/uploads/Invest_Georgia_Exemption_-_Form_GA-1_(v7.2017)_5.pdf (last visited Oct. 27, 2019) [hereinafter Form GA-1].

364 Christopher Douglas Mitchell, *Chartering a New Revolution in Equity Crowdfunding: The Rise of State Crowdfunding Regimes in Response to the Inadequacy of Title III of the JOBS Act*, 3 J. MARSHALL GLOBAL MKTS. L.J. 135, 174 (2015).

365 *Form GA-1*, *supra* note 363. Along with the $5 million limit and the $10,000 per investor cap for non-accredited investors, businesses must meet the following requirements: (1) the company must be a for-profit entity that has its principal place of business, and is doing business, in Georgia, (2) all investments received must be deposited in a bank or depository institution authorized to do business in Georgia, (3) the issuer must inform all purchasers that the securities are not registered and are subject to resale limitations under Rule 147(e), and (4) offers to sell securities can only be made to residents, or individuals the issuing company reasonably believes to be residents, of Georgia. GA. COMP. R. & REGS. 590-4-2.08 (2017).

366 *See Invest Georgia Exemption*, *supra* note 362; *see also Kemp: New Federal Crowdfunding Rules Take Effect Today*, GA. SECRETARY ST., http://sos.ga.gov/index.php/securities/kemp_new_federal_crowdfunding_rules_take_effect_today (last visited Oct. 27, 2019) (explaining that one Georgia business, GROUNDFLOOR, raised $1.7 million under the exemption during the year-long pilot). Another company, Gramarye Media, launched a Georgia-based entertainment studio through an ICO. *Gramarye Media Launches Georgia Entertainment Studio Funded by a Cryptocurrency Initial Coin Offering*, MKTS. INSIDER (Apr. 28, 2018, 8:00 AM), https://markets.businessinsider.com/news/stocks/gramarye-media-launches-georgia-entertainment-studio-funded-by-a-cryptocurrency-initial-coin-offering-1022668879. The company is offering 5 million of the 175 million tokens available to both accredited and unaccredited Georgia investors under the IGE. *Id.*

367 15 U.S.C. § 77c(a)(11) (2012).

368 The SEC created a "safe-harbor" rule that provides a list of ways that an issuer can satisfy the "doing business" requirement, including having 80% of its assets in the state. *See* 17 C.F.R. § 230.147(c)(2) (2017).

resident of the state and can resell to nonresidents after a nine-month holding period.[369] Best of all, there is no monetary limit on the amount of funds that can be raised.[370]

This exemption is actually quite promising: There is no monetary ceiling, and in a populous state like New York or California, both the initial offering and resale market would be considerable. There is one problem: General solicitation is not permitted, and crowdfunding issuers would have to come up with a reliable way to offer their shares only to residents of a single state.[371]

Technology may make it possible to work with this rule. States could create a website that is only accessible after proof of residence—perhaps by submitting a driver's license or other proof of state residency. California residents could then have access to California offerings, New Yorkers to New York offerings, and so on. State securities regulators could impose their own requirements and monitoring. Chief among them, they would have to ensure that resales were limited to state residents, at least for the first nine months.

The fly in the ointment may be the "doing business" in the state requirement, which the statute does not define.[372] In *Chapman v. Dunn*, the Sixth Circuit held that an issuer must conduct a "predominant" amount of its business within its state of residence.[373] While it is not necessary that a business is conducted exclusively in the state,[374] to meet the "doing business" requirement, a business cannot conduct all or most of its income-producing operations in another state.[375]

Rule 147, which the SEC promulgated as a safe harbor, sets out several requirements for a business to satisfy the "doing business" requirement. One is incorporating and locating a principal office in state, which would be simple enough.[376] Rule 147 also requires that the offeror satisfy one of the following tests:

> (1) The issuer derived at least 80% of its consolidated gross revenues from the operation of a business or of real property located in or from the rendering of services within such state or territory;

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[369] *Id.* § 230.147(e).

[370] *See* 15 U.S.C. § 77c(a)(11) (imposing no monetary limit on the intrastate exemption).

[371] *See* 17 C.F.R. § 230.147(d).

[372] *See* 15 U.S.C. §77c(a)(11).

[373] 414 F.2d 153, 159 (6th Cir. 1969).

[374] *See* 69 AM. JUR. 2D *Securities Regulation—Federal* § 90, Westlaw (database updated Aug. 2019).

[375] *See* Busch v. Carpenter, 827 F.2d 653, 658 (10th Cir. 1987) ("Conducting substantially all income-producing operations elsewhere defeats the [§ 3(a)(11)] exemption." (citing Chapman v. Dunn, 414 F.2d 153, 158–59 (6th Cir. 1969))).

[376] 17 C.F.R. § 230.147(c) (2017).

> (2) The issuer had at the end of its most recent semi-annual fiscal period prior to an initial offer of securities in any offering or subsequent offering pursuant to this section, at least 80% of its assets and those of its subsidiaries on a consolidated basis located within such state or territory;
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> (3) The issuer intends to use and uses at least 80% of the net proceeds to the issuer from sales made … in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory; or
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> (4) A majority of the issuer's employees are based in such state or territory.[377]

State crowdfunding issuers would have to be careful to meet one of these requirements to qualify for the safe harbor Rule 147 affords. Most attractively, Rule 147A allows for advertising to the general public—that is, outside the state—as long as the final investors are in-state.[378]

The most interesting aspect of this route is that it could bypass the SEC altogether. It could also allow state securities regulators to experiment with different requirements for crowdfunding in classic "laboratories of the states" fashion.[379] It remains an open question whether states have an interest in facilitating these offerings for their residents, but there is reason to think some states may be eager for such room to experiment in how best to foster small businesses. Wyoming, for example, appears to be aiming to become the most crypto-friendly state in an effort to draw new industry to the state, mirroring its efforts in the 1970s when it was the first state to allow LLCs.[380] The Wyoming legislature passed five pieces of legislation aimed at attracting blockchain and cryptocurrency businesses,[381] which has resulted in a handful of companies

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377 *Id.* § 230.147(c)(2).

378 *Id.* § 230.147A(b), (d).

379 *See* New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments ….").

380 Ben Bain, *Crypto's Wild, Wild West*, BLOOMBERG BUSINESSWEEK, May 21, 2018, at 36, 36.

381 Two are especially noteworthy: HB 70 provides that the development, sale, or facilitating of the exchange of a utility token is not subject to specified securities and money transmission laws; and SF 111 makes it so cryptocurrency is not taxed as "property" in Wyoming. H.R. 0070, 64th Leg., Budget Sess. (Wyo. 2018); WYO. STAT. ANN. § 39-11-105 (2019). Additionally, HB 19 provides an exemption for virtual currency used within Wyoming from money transmitter laws and regulations, undoing legislation that was passed in 2015 barring the use of cryptocurrency in Wyoming money transmitters, WYO. STAT. ANN. § 40-22-104 (2019); HB 101 provides for the maintenance of corporate records of Wyoming entities via blockchain, WYO. STAT. ANN. § 17-16-1601 (2019); and HB 126 permits the formation of "Series LLCs," WYO. STAT. ANN. § 17-29-211 (2019). *Cf.* CT Corp. Staff, *Series LLCs: Wise Option or Risky Strategy*, WOLTERS KLUWER (Aug. 11, 2015), https://ct.wolterskluwer.com/resource-center/articles/series-llcs-wise-option-or-risky-strategy ("In the simplest

registering in the state,[382] with dozens more expected.[383]

State competition for business remains high—one need only look to various states that vied to give Amazon a second headquarters.[384] A state could follow Georgia or Wyoming's lead and loosen crowdfunding rules to attract businesses to the state, while gaining political capital with constituents by favoring local small businesses.

C. Section 28

Finally, Section 28 of the Securities Act provides the SEC with the following broad powers:

> [The SEC may,] by rule or regulation … conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.[385]

The SEC has not used this power often.[386] In 1999, it increased the monetary amount of stock that can be issued under Rule 701 by invoking its exemptive authority under Section 28 of the Securities Act.[387] In 2016, it promulgated Rule 147A under its Section 28 powers.[388] You will recall that we discussed Rule 147 as a way for states to facilitate intrastate offerings.[389] Rule 147A has the same requirements as 147, with two key differences: (1) Rule 147A allows offers of

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terms, a Series LLC (limited liability Company) is an umbrella that shelters a number of independently operating LLCs under the master LLC."). The Wyoming Blockchain Coalition, a grassroots effort aimed at bringing blockchain business to Wyoming, led the recent cryptocurrency push. Bain, *supra* note 380, at 36. The Coalition has claimed to have been contacted by dozens of businesses seeking to move to Wyoming and has helped a new blockchain finance corporation file in the state. *Id.* at 36–37.

[382] Bain, *supra* note 380, at 37.

[383] Morgan N. Temte, Comment, *Blockchain Challenges Traditional Contract Law: Just How Smart Are Contracts?*, 19 WYO. L. REV. 87, 88 & n.7 (2019).

[384] *See* Nick Wingfield, *Local Expertise, in 238 Places*, N.Y. TIMES, Jan. 29, 2018, at B1 (noting that 238 cities and states bid to be Amazon's next headquarters).

[385] 15 U.S.C. § 77z-3 (2012).

[386] *See* THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 4:117, Westlaw (database updated May 2019) ("At the time of this writing, the SEC has not, however, used [Section 28] authority [elsewhere] ….").

[387] *See id.*

[388] Allen Sparkman & Adrienne Randle Bond, *Management Responsibilities of Governing Persons of Corporations and Limited Liability Companies, Including Fiduciary Duties and Law of Agency, and Compliance with Federal and State Securities Laws in Fund-Raising*, 37 CORP. COUNS. REV. 175, 206 (2018).

[389] *See supra* Part V.B.

securities to be accessible to out-of-state residents so long as sales are made only to in-state residents; and (2) Rule 147A allows issuers to be incorporated out-of-state so long as their "principal place of business" is in-state and they demonstrate at least one in-state "doing business" requirement.[390]

It is unlikely that the SEC would create a regulatory framework for high-dollar crowdfunding under Section 28. Historical examples of its use have been relatively small-bore, as just discussed. But the agency's mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.[391] It could theoretically serve this mission by replicating via rulemaking the investor protections of vesting of founder equity, staged financing, and a redemption right powered by escrow.[392]

CONCLUSION

Capital raising today is stratified into the "haves" and "have-nots." The traditional public/private divide required a choice between a difficult IPO process that brought with it access to the public markets and easy resale, or a relatively painless private offering process that imposed more limitations on resale and was open only to the wealthy. Recent regulation has blurred one side of the divide, giving private offerings more and more public attributes—like general solicitation and fewer restrictions on resale. On the other side of the divide, Reg A+ and equity crowdfunding have nominally loosened constraints but have not garnered broad support from either the investing public or the entrepreneurial community.

The VC model provides a time-tested blueprint for how sophisticated private actors protect themselves from the risks of uncertainty, asymmetric information, and agency costs. The ICO phenomenon offered a unique opportunity to examine financial contracting with the crowd "in the wild," free from the interpolation of the state. As such, ICOs provide the chance to think about how we might open up the public markets to private companies in new ways, while preserving the concern for investor protection that undergirds our securities laws.

Now crowdfunding exists nominally, but signs suggest that it may be, or at least risks becoming, a market for lemons. This Article concludes that Congress,

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390 17 C.F.R. §§ 230.147, 230.147A (2017).

391 *The Role of the SEC*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/basics/role-sec (last visited Oct. 27, 2019). The requirement that the SEC consider a rule's effect on capital formation, efficiency, and competition was not added until 1996. *See* H.R. REP. NO. 104-622, at 24 (1996).

392 *See supra* Parts IV.B and IV.C.

the SEC, and the states can couple the traditional VC model with the innovations ICOs offer to think creatively about contractual mechanisms that can create a viable future for equity crowdfunding.