The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists’ Dilution of the Crowd

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ABSTRACT

By virtue of Title III of the JOBS Act, signed into law on April 5, 2012, crowdfunding could become a powerful, even revolutionary, force to finance start-up companies. It democratizes entrepreneurs’ access to seed capital and converts the masses of Internet users into potential retail venture capitalists. Many have cautioned, though, that crowdfunding poses serious investment risks of start-up companies failing, committing fraud, and being mismanaged. Accordingly, the JOBS Act includes numerous disclosure obligations designed to mitigate such downside risks.

But what has been overlooked, and what this Article analyzes from a venture capitalist perspective, is that even if a crowdfunded start-up company is successful, crowdfunding investors can lose the value of their investment if they lack venture capital legal protections. When successful start-up companies raise additional funds from professional venture capitalists, the value of ground-floor investments can be severely diluted, as colorfully dramatized in The Social Network. In addition, when crowdfunded companies are acquired in private transactions, crowdfunders are at risk of being left out.

Therefore, under a “qualitative mandates” regulatory philosophy that moves beyond securities law’s status-quo disclosure requirements, this Article proposes substantive venture capitalist protections for crowdfunding investors. For example, down-round

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anti-dilution protection, tag-along rights, and preemptive rights should help safeguard the value of early-stage crowdfunding investments in successful start-up companies. Especially because many crowdfunding investors are likely to be inexperienced and unsophisticated in start-up-company investing, crowdfunding laws and regulations should go beyond disclosure requirements that warn investors of danger (to the extent investors even read or understand the disclosures) to help crowdfunders obtain market-based economic protections characteristic of venture capitalist investment contracts.

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Though the risk of start-up companies going bankrupt, defrauding investors, or mismanaging investor funds is significant and well-documented, an equally serious risk of investing in start-up companies, as vividly portrayed in The Social Network, is that investors can lose out on substantial profits when a start-up venture is successful, if they lack necessary investor protections. This is a crucial danger of the innovative capital-raising method known as “crowdfunding” investment, which, as used in this Article, is the practice of many (i.e., crowds of) people investing small amounts of money over the Internet in early-stage businesses in exchange for equity interests that are not registered with the Securities and Exchange Commission (Commission).

Securities laws prohibited crowdfunding investment offerings in the United States prior to President Obama signing the JOBS Act on April 5, 2012. Title III of the Act provides a securities-law exemption for crowdfunding investment and directs the Commission to issue implementing regulations no later than January 1, 2013,

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1. The Social Network (Columbia Pictures 2010); see also First Amended Cross-Complaint at 1, TheFacebook, Inc. v. Saverin, No. 105 CV 039867 (Cal. App. Dep't Super.

2. Of course, prior to the JOBS Act there were a few limited ways that for-profit businesses could legally raise capital over the Internet, but they did not mesh well with crowdfunding. See infra note 60.


4. Id. § 302(c). In implementing the rules, the Commission is guided by its three-pronged mission to protect investors, maintain fair, orderly, and efficient markets, and
after which time crowdfunding investment may begin in earnest. Thirteen entities are joining together to create a self-regulatory organization known as the Crowdfund Intermediary Regulatory Association.\(^5\) Furthermore, numerous companies are already planning to provide advisory services and an electronic platform for crowdfunding investments.\(^6\) Meanwhile, countless entrepreneurs are awaiting the opportunity to sell securities through this novel capital-raising method and, “[a]s of March 26, 2012, [three] thousand investors pledged to invest $7.5 million when crowdfunding becomes legal.”\(^7\)

As the Commission prepares the rules that will govern the contours of crowdfunding, this Article explores the theoretical and philosophical tensions in crowdfunding securities regulation and analyzes a material risk that crowdfunding scholarship and the crowdfunding provisions of the JOBS Act have neglected. The crowdfunding debate has focused too narrowly on the downside potential for crowdfunders to lose their investment to fraudulent, mismanaged, or failed companies.\(^8\) This Article expands the analytical lens to capture the upside, horizontal risks crowdfunders will face from other investors, such as venture capitalists, when a crowdfunded company is successful. Without the economic protections that sophisticated venture capitalists require when investing in early-stage-growth companies, crowdfunding investors, like Eduardo Saverin in The Social Network, are doomed to lose out on the gains facilitate capital formation. Crowdfunding requires balancing of each prong because of the risks of retail investing in start-up companies over the Internet and the need for capital-raising techniques to keep pace with technological developments. The JOBS Act affords the Commission broad rulemaking authority, such as requiring issuers to “comply with such other requirements as the Commission may, by rule, prescribe, for the protection of investors and in the public interest.” \(\S\) 302(b)(b)(5).


that ground-floor investors typically enjoy after investing in successful start-up enterprises.

Apart from crowdfunding investment, the Internet community practiced four other types of crowdfunding prior to the JOBS Act’s passage, and Part I of this Article briefly describes these four types in order to distinguish the unique features of crowdfunding investment. Part I also discusses the size and power of the crowdfunding market and the democratic allocation of capital that crowdfunding facilitates. Part II then explains the political forces that led to the enactment of the crowdfunding provisions of the JOBS Act. Bipartisan support, bolstered by business and grass-roots advocacy and stubbornly high unemployment rates, was instrumental in helping to legalize crowdfunding investment. Part II also provides a brief overview of the crowdfunding provisions of the JOBS Act, which are a positive, if imperfect, step toward updating securities laws to accommodate crowdfunding’s technologically advanced method of investing.

Part III assesses the underlying theoretical tensions that crowdfunding investment raises for securities laws. Specifically, it probes both the dominant disclosure-based philosophy of securities regulation and the less-favored merit review model. Part III then proposes a hybrid regulatory approach, one of market-based “qualitative mandates,” that is uniquely appropriate for crowdfunding investment.

Part IV moves beyond the discussion of both vertical agency concerns between crowdfunders and company management and downside risks of fraud, failure, and mismanagement. Instead, it considers the horizontal, upside risks that will likely threaten the value of crowdfunders’ investments in successful start-up companies when venture capitalists participate in subsequent rounds of financing, or when a crowdfunded company pursues a private exit event.

Finally, Part V describes and applies the qualitative-mandates proposal and offers suggestions for how legal rules could help crowdfunders obtain the types of economic protections that venture capitalists typically negotiate when investing in start-up companies. It focuses on three possibilities: template contracts, disclosure tables, and statutory or regulatory provisions.

I. CROWDFUNDING OVERVIEW

A. The Five Models of Crowdfunding

Before examining the type of crowdfunding that the JOBS Act legalizes, it is helpful to consider briefly the other types of
crowdfunding that have become popular recently. The power and proliferation of these other types of crowdfunding were instrumental, and likely indispensable, to the passage of the Act, which applies solely to crowdfunding investment made in exchange for securities (usually stock).

Internet crowdfunding divides into five categories, or models, differentiated by what crowdfunders receive in exchange for their money: (1) the donation model, (2) the reward model, (3) the pre-purchase model, (4) the peer-to-peer lending model, and (5) the equity model.9 Because of the focus of the JOBS Act, this Article is concerned with only the fifth category, the equity model, but a brief overview describes the other four models in order to draw attention to the equity model’s unique characteristics.10

The donation model simply means that crowdfunders donate money to a cause without receiving anything in return, other than possibly a tax benefit and satisfaction from whatever else motivates their donation (e.g., helping to right social wrongs, accruing treasure in heaven, or furthering their preferred political candidate’s campaign).11 In contrast, crowdfunders who give money to a website operating under the reward model do receive a tangible benefit in return for their contribution.12 This benefit cannot be a “security,” such as stock in a company, but the benefit can include almost anything else, for example, the opportunity to meet the directors of the movie whose production depended on the crowdfunders’ contributions or a memento such as a T-shirt.13 The pre-purchase model is similar to the reward model but narrows the scope of the reward to the item produced as a result of the crowdfunders’ contributions, such as a print of the painting made by the artist who raised funds from the crowd or a copy of the video game created by the game makers that received contributions from fans.14

The lending model, also known as peer-to-peer lending, includes websites where crowdfunders make loans, with or without interest, and thus expect to receive their contribution back in the

10. The JOBS Act does not prohibit companies from selling debt securities through crowdfunding, so the equity model potentially includes non-equity (i.e., debt) securities and hybrid securities that include both debt and equity components. The Act does not affect the peer-to-peer lending model of crowdfunding, though, because the Act requires recipients of crowdfunding proceeds to be entities (i.e., not natural persons), which removes the peer-to-peer lending model of crowdfunding from the scope of the Act.
12. Id. at 16–19.
13. Id.
14. Id.
future. Interest-bearing loans, like stock, are securities subject to regulation by the Commission; hence, the Commission has required some peer-to-peer lenders to register their securities with the Commission because no exemption from registration exists for crowdfunded debt securities.

Finally, the equity model differs from all other types of crowdfunding because crowdfunders invest money in order to receive ownership interests in a company. This unique characteristic of the equity model has had far-reaching implications because, while securities laws have allowed other types of crowdfunding to flourish, they have impeded the development of the crowdfunding investment model.

Thus, prior to the JOBS Act, the law produced a curious result. On the one hand, it permitted nonprofits and artists to raise an unlimited amount of money over the Internet from crowds of strangers with virtually no legal restrictions or oversight. But on the other hand, the law prohibited for-profit entrepreneurs from using the Internet to raise start-up capital for a business without going through costly registration or exemption procedures. This discrepant treatment was based simply on what crowdfunders received or expected to receive (namely, a security such as stock) in exchange for their money. This perceived unfairness to entrepreneurs and the

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15. Id. at 20–24. Individual lenders who loan money through Kiva.org, discussed below, do not receive interest payments, and one article argues that such lenders should “be given the option of taking a charitable deduction for that foregone interest.” Sarah B. Lawsky, Money for Nothing: Charitable Deductions for Microfinance Lenders, 61 SMU L. REV. 1525, 1527 (2008).


18. The peer-to-peer lending model with interest-bearing loans is regulated under securities laws. Id. at 34–42. Lending companies have registered the loans under securities laws in order to proceed with the practice. Eric C. Chaffee & Geoffrey C. Rapp, Regulating Online Peer-To-Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry, 69 WASH. & LEE L. REV. 485, 509–19 (2012); Verstein, supra note 16, at 475–77.

19. The full analysis of why crowdfunding investment ran afoul of securities laws prior to enactment of the JOBS Act has been described elsewhere. See, e.g., Chaffee & Rapp, supra note 18, at 509–19. In brief, Internet platforms that facilitate crowdfunding investment would likely need to register with the Commission as broker-dealers, and crowdfunded securities would either need to be registered with the Commission or fall within an exemption from registration. See, e.g., Bradford, supra note 8, at 49–81. Prior to the Act, no exemption was available for crowdfunded securities. See, e.g., id. at 29–80; Hazen, supra note 8, at 1744–50; Heminway & Hoffman, supra note 8, at 892–907; Pope, supra note 8, at 986–93.

20. See infra notes 59–60 and accompanying text.

unquestioned power of crowdfunding to raise money for a cause led to political pressure that culminated in the JOBS Act.22

B. Examples of Crowdfunding

Before moving to the discussion of the political forces that led to the JOBS Act, a few examples of crowdfunding in action will help explain why crowdfunding has captured the attention and imagination of such diverse groups as nonprofit organizations, artists, businesspeople, political leaders, the press, and academics. In short, crowdfunding is extremely powerful and scalable to a wide variety of projects. It also strikes a chord with the spirit of democracy and equality in the United States by harnessing masses of people toward a common goal.23

The impact of Internet crowdfunding was shown recently when video-game makers raised over $3 million in approximately one month24 from more than eighty-seven thousand game aficionados eager to fund the creation of a new point-and-click video game, Double Fine Adventure.25 After eight hours, the campaign reached its target funding amount of $400,000, and after twenty-four hours it surpassed $1 million.26 In exchange for monetary contributions, each crowdfunder was entitled to receive the cumulative rewards set forth in the following table.27

22. Id. at 81–99.

23. Crowdfunding’s antecedent is crowdsourcing, which harnesses the knowledge of the crowd (as opposed to raising money from the crowd) to solve complex problems. See, e.g., Pope, supra note 8, at 975–77 (describing examples of crowdsourcing, such as open source software and Netflix’s online competition to create an improved “movie recommendation algorithm”).


27. Double Fine Adventure, supra note 25.


<table>
<thead>
<tr>
<th>Contribution Amount</th>
<th>Number of Contributors</th>
<th>Total Contributions</th>
<th>Reward</th>
</tr>
</thead>
<tbody>
<tr>
<td>$15</td>
<td>47,946</td>
<td>$719,190</td>
<td>Access to <em>Double Fine Adventure</em> private discussion community, beta version of the game, and a copy of the final version.</td>
</tr>
<tr>
<td>$30</td>
<td>24,636</td>
<td>$739,080</td>
<td>High-definition documentary and soundtrack.</td>
</tr>
<tr>
<td>$60</td>
<td>1,090</td>
<td>$65,400</td>
<td>PDF version of <em>Double Fine Adventure</em> book.</td>
</tr>
<tr>
<td>$100</td>
<td>11,530</td>
<td>$1,153,000</td>
<td>Special-edition box containing game disc and DVD or Blu-Ray of the documentary, T-shirt, poster, and special thanks in the game’s credits.</td>
</tr>
<tr>
<td>$250</td>
<td>900</td>
<td>$225,000</td>
<td>Autographed poster.</td>
</tr>
<tr>
<td>$500</td>
<td>148</td>
<td>$74,000</td>
<td>Autographed hardcover game book.</td>
</tr>
<tr>
<td>$1,000</td>
<td>100</td>
<td>$100,000</td>
<td>Mini-portrait of contributor.</td>
</tr>
<tr>
<td>$5,000</td>
<td>10</td>
<td>$50,000</td>
<td>Larger original painting of art used in the game.</td>
</tr>
<tr>
<td>$10,000</td>
<td>4</td>
<td>$40,000</td>
<td>Lunch with game designers and tour of offices.</td>
</tr>
</tbody>
</table>

In true crowdfunding form, approximately 99 percent of the backers contributed less than $500 and accounted for approximately 92 percent of the total contributions.28 The example highlights the essence of crowdfunding: relying on many small contributions from a large crowd instead of on high-dollar contributions from a small group of supporters.

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28. *Id.* The percentage calculations are derived from the numbers in the table, which was created from the information on Kickstarter’s website. It is not clear why the total amounts in the table do not match exactly the totals provided on Kickstarter’s website; thus, all figures and amounts should be understood as approximations.
This example illustrates the power of the crowd to exert direct influence over corporate decision making and consolidate multiple business tasks into one. Whereas without crowdfunding, a company would have to engage in market research to understand and know its customers, fund the development of a product through debt or equity financing, market the product to potential customers, and ultimately sell the product to its customers (often through a middleman), crowdfunding accomplishes each of these tasks. It allows the Internet community to simultaneously express market demand, finance product development, and deliver a revenue base of prepaid customers—all without a middleman, likely increasing the company’s profit margin. Crowdfunding thus embodies “Web 2.0,” which capitalizes on the wisdom of the crowd and involves users in the creative process. “Web 1.0,” on the other hand, follows a more traditional, authoritarian model in which companies publish information for passive users to consume.

Web 2.0 companies such as Kiva, Kickstarter, and IndieGoGo are the most well known of the crowdfunding sites, but countless others exist, including many based outside the United States. Kiva facilitates people making micro loans to third-world business owners, and Kickstarter and IndieGoGo primarily help artists, such as independent filmmakers, receive funds to pursue artistic projects. Kiva has facilitated over $330 million being raised from more than 780,000 individual lenders to fund loans to over 815,000 recipients around the world. Kickstarter has facilitated over $275 million in contributions to fund nearly 26,000 artistic and other projects. The peer-to-peer lending industry is already approximately $1.5 billion in size and is projected to “exceed $5 billion annually by 2013, with some even suggesting figures greater than $30 billion.” Politicians also

29. Daniel M. Satorius & Stu Pollard, Crowd Funding: What Independent Producers Should Know About the Legal Pitfalls, 28 ENT. & SPORTS LAW. 15, 16 (2010) (“Finally, if crowdfunding involves the sale of tickets, copies of the film, or merchandise, the lack of middlemen in these transactions means the producers keep a larger percentage of the subsequent revenues.”).
30. Chaffee & Rapp, supra note 18, at 501–02.
31. Id. at 502.
32. See Bradford, supra note 8, at 11–14 (referencing numerous crowdfunding sites); Burkett, supra note 8, at 74–76 (describing crowdfunding-investment websites outside the United States, such as “Hong-Kong based Grow VC . . . along with its Indian partner, Springboard Ventures”).
rely heavily on Internet crowdfunding contributions; for instance, President Obama’s campaign “used crowd funding to raise about $1 million a day, all online, with more than a million sub-$1,000 contributions. In all, the campaign raised nearly three-quarters of a billion dollars over the Internet.”

Additional examples abound, but Kickstarter’s largest crowdfunded project to date is particularly instructive. The campaign raised over $10 million in thirty-six days, as people flocked to the “Pebble” proposal to receive an “infinitely customizable” wristwatch that downloads information from a smart-phone. The campaign met its goal of raising $100,000 after only two hours and received $4.7 million after six days. The watch is expected to retail at approximately $150, and the company offered a pre-order discount to crowdfunders: the first two hundred “early-bird” participants contributed $99 dollars for a pre-ordered watch, and then others could receive a black watch for $115 or a color watch for $125. Prior to Pebble’s crowdfunding success, the company had struggled to raise funds from traditional venture capitalists, but Internet crowdfunding allowed the company to go directly to its customers and capitalize on an outpouring of market demand.

37. Satorius & Pollard, supra note 29.
38. For instance, the film Blue Like Jazz was funded by the crowd, with 4,495 crowdfunders participating to raise $345,992. Steve Taylor, SAVE Blue Like Jazz! (The Movie), Kickstarter (Sept. 24, 2010), http://www.kickstarter.com/projects/2128223578/save-blue-like-jazz-the-movie-0. Fifty people contributed more than $500 each (approximately $78,000 total, representing approximately 23 percent of all funds), meaning that approximately 99 percent of backers contributed less than $500 each, representing approximately 77 percent of all contributions. Id. In exchange, crowdfunders received rewards depending on the amount of their contribution: for a $10 contribution, crowdfunders received a “digital download package” and a phone call from the film’s director; for $125, the previous rewards, plus a t-shirt, poster, coffee mug and the crowdfunder’s name listed in the movie’s credits; for the highest contribution tier of $8,000, the author of the book on which the movie was based would fly to the crowdfunder’s city (within the United States) for a book reading at the crowdfunder’s home. Id.
41. See Pebble Tech., supra note 39.
42. Id. Also, among other reward and pre-purchase tiers, Internet application developers could receive an early Pebble prototype and a color Pebble, once complete, for $235. Id.
43. Netburn, supra note 40.
C. The Transformative Power of Crowdfunding

These examples show the revolutionary power of Internet crowdfunding. It gives any person in the world with access to the Internet the opportunity to propose an idea to the Internet community and receive immediate feedback on whether the idea is worthy of attention and funding. In an economic and financial sense, crowdfunding epitomizes the democratic ideals of the United States: when Justice Holmes penned the words in 1919 that spawned the marketplace-of-ideas theory (“the ultimate good desired is better reached by free trade in ideas . . . the best test of truth is the power of the thought to get itself accepted in the competition of the market . . .”),44 it would have been difficult to imagine how inclusive and instantaneous the marketplace would someday become through the Internet.

It is no exaggeration that crowdfunding could well mark a “revolution in how the general public allocates capital,”45 or at least represent a democratic leveling of how, and whose, ideas are financed. As one senator noted during the Senate’s debate on what became the crowdfunding provisions of the JOBS Act, “We want to support our entrepreneurs. We want to make this process more democratic. We want to get out of the secret boardrooms and the private conversations on Wall Street. So many more people could take advantage, appropriately, of exciting investments in the entrepreneurial spirit of America.”46 Similarly, another senator marveled at the “enormous potential [of crowdfunding investment] to bring more Americans than ever into the exciting process of powering up startups and expanding small businesses.”47 Undoubtedly, the democratic spirit and huge potential impact of crowdfunding investment influenced politicians to embrace the concept and pass the JOBS Act.

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44. Abrams v. United States, 250 U.S. 616, 630 (1919) (Holmes, J., dissenting); see generally JOHN STUART MILL, ON LIBERTY (Gertrude Himmelfarb ed., 1982) (1859) (espousing similar ideas to what later became known as the marketplace of ideas theory).
45. Bradford, supra note 8, at 5.
47. Without addressing potential adverse tax consequences: In 2011, Americans had invested $17 trillion in retirement funds. Imagine if 1 percent of those investments went into crowdfunding. The result would be $170 billion of investment in our startups and small businesses. That is extraordinarily powerful—more powerful than loans to small businesses . . . . So it has huge potential. 158 CONG. REC. S1,829 (daily ed. Mar. 20, 2012) (statement of Sen. Jeffrey Merkley).
II. POLITICAL INFLUENCES

A. Securities-Law Prohibitions on Crowdfunding

With crowdfunding’s appealing democratic themes, the JOBS Act received bipartisan political support, and President Obama promptly signed it into law. In contrast to the examples of successful non-equity crowdfunding described above, the following two examples of how securities laws blocked crowdfunding investment illustrate why, from a political perspective, the JOBS Act is necessary. The two examples below demonstrate that crowdfunding sites that facilitate stock transactions, and companies that sell stock through crowdfunding, receive disparate and unfavorable treatment under the law, compared to crowdfunding sites and entrepreneurs that provide other, non-equity, benefits to crowdfunding.\(^{48}\) Especially during a time of high unemployment, it can be difficult for politicians to explain why nonprofits, artists, and politicians themselves can use crowdfunding to raise money, but start-up companies seeking to innovate and create jobs are prohibited from using crowdfunding.\(^{49}\)

In 2010, ProFounder Financial, Inc. (ProFounder) operated a website to assist start-up and small businesses in raising capital over the Internet through crowdfunding investment.\(^{50}\) ProFounder’s website provided start-up companies with stock-offering materials, including investment contract templates, that the start-up companies could use to sell securities to investors.\(^{51}\) This business model

\(^{48}\) 158 CONG. REC. S1,887 (daily ed. Mar. 21, 2012) (statement of Sen. Jeffrey Merkley) (describing the peer-to-peer lending model of crowdfunding and asserting that “what crowdfunding [investment] does is to create an equal opportunity for folks to invest in early-stage businesses”).

\(^{49}\) 158 CONG. REC. H1,592 (daily ed. Mar. 27, 2012) (statement of Rep. James Himes) (“[W]hen you give to a charity, you know you’re not getting your money back. When you invest in a company, you hope you’re getting your money back. And we should be vigilant that that, in fact, occurs.”). Additionally, Senator Merkley stated:

> [W]hat we do not have is a process in which companies can list themselves on the Internet and say: Do you want to invest in my company? . . . It is parallel to these other efforts . . . . [But] if we do not provide rules that require accountability for the accuracy of that information, then what we are simply doing is saying here is a Web site where predators can put up a fictitious story about what they want to do, make it as exciting as possible, and run away with people’s money . . . .


\(^{51}\) In a nod to securities law requirements under Rule 504 of Regulation D, discussed below, ProFounder did require potential investors to represent that they had a “substantial, preexisting relationship” with the start-up company in which they invested, but “ProFounder did not attempt to verify independently that the substantial preexisting relationships in fact existed
subjected ProFounder to a complex web of state and federal laws and regulations, both with respect to its status as a broker-dealer of securities as well as in relation to the securities offered on its website.\textsuperscript{52} Having failed to obtain the necessary licenses to operate the ProFounder website, in August of 2011 ProFounder entered into a Consent Order to Desist and Refrain with the State of California, agreeing not to operate “any website that induces securities to be sold over the Internet” without first obtaining the necessary legal authorizations and licenses.\textsuperscript{53}

Similarly, in 2011 the Commission issued a cease-and-desist order against the organizers of an Internet campaign that gathered investment commitments to fund the purchase of Pabst Brewing Company (Pabst).\textsuperscript{54} In exchange for contributors’ financial pledges, contributors would receive not only beer but also ownership certificates, which placed the campaign squarely within the equity model of crowdfunding because ownership certificates are included within the definition of a security.\textsuperscript{55} Thus, for failing to register the securities with the Commission, the campaign was forced to close, despite more than five million people having pledged approximately $200 million to buy Pabst during the six months that the campaign was open.\textsuperscript{56} Had the campaign organizers promised participants only beer (a reward), and not ownership certificates (a security), the campaign would likely have fallen outside the equity model of crowdfunding and would probably not have encountered regulatory hurdles. Of course, without offering ownership certificates, the campaign might have attracted fewer pledges because the ownership certificates (as much as or more than the beer) might have motivated supporters to participate in the campaign.

In the case of the Pabst campaign that raised $200 million in pledges, the campaign organizers, with the benefit of hindsight, presumably could have afforded the “hundreds of thousands of dollars” it typically costs to register securities with the Commission prior to a public offering.\textsuperscript{57} But most crowdfunding offerings do not seek to raise

\textsuperscript{52} Id. at 3.

\textsuperscript{53} Id.


\textsuperscript{55} Id. at 3.


\textsuperscript{57} Id. at 42.
hundreds of millions of dollars, and “registration is not a viable option for early-stage small businesses seeking relatively small amounts of capital. It is too expensive and too time consuming for crowdfunded offerings.” Alternatively, crowdfunding-investment offerings could have attempted to qualify for an exemption from registration, but “[u]nfortunately, none of those exemptions is conducive to crowdfunding.” As a result, without the Commission crafting a regulatory exemption or Congress creating a statutory path for crowdfunding investment, the law prevented the growth of the equity model of crowdfunding while other crowdfunding models continued to expand.

B. Democratic Push for Crowdfunding

In view of securities-law prohibitions on crowdfunding investment, a cross section of political and business leaders and grass-roots Internet activists came together to advocate for the legalization of equity crowdfunding. An IndieGoGo crowdfunding campaign (under the donation model of crowdfunding) even provided an opportunity for people to contribute to mobilization and publicity efforts to legalize equity crowdfunding (the campaign raised $1,321).

58. In any case, as discussed below, the JOBS Act only allows a company to raise $1 million per year through crowdfunding investment. See infra note 80 and accompanying text; see also Bradford, supra note 8, at 11 (citing a study that found the median amount raised in crowdfunding offerings to be $28,583 and the largest amount raised to be $82 million).

59. Bradford, supra note 8, at 42 (footnote omitted); Heminway & Hoffman, supra note 8, at 911 (“[R]egistration is a nonstarter for most crowdfunding websites and crowdfunded ventures because of the expense and prolonged nature of the process.”).

60. Bradford, supra note 8, at 44 (discussing why several possible exemptions, such as offerings under Section 4(2), Rules 504, 505 and 506, Section 4(5), and Regulation A, fail to accommodate crowdfunding investment). Burkett reaches similar conclusions. See Burkett, supra note 8, at 80–92; Heminway & Hoffman, supra note 8, at 912–31; Pope, supra note 8, at 986–93.

61. Bradford, supra note 8, at 87 (“The SEC clearly has the authority to exempt crowdfunding [investment] from the registration requirements of the Securities Act and to exempt crowdfunding [investment] web sites from registration as brokers or investment advisers.”); Heminway & Hoffman, supra note 8, at 950 (”[E]xisting regulation offers ample opportunity for the SEC to act without a grant of additional congressional authority.”).


In late 2011, a flurry of legislative activity occurred, with the House of Representatives passing its version of a crowdfunding investment law, the Entrepreneur Access to Capital Act,\(^{64}\) and the Senate introducing, first, the Democratizing Access to Capital Act of 2011,\(^{65}\) and then another version, the Crowdfund Act, which became Title III of the JOBS Act.\(^{66}\)

Numerous commentators assailed the House version for its lack of investor protections, and it even earned the label of the “Boiler Room Legalization Act”—a reference to the bad old days when people gathered in what were called boiler rooms and made cold calls to try to elicit unwary investors into dubious schemes.”\(^{67}\) One senator remarked that “the House bill essentially legalizes the business model of unscrupulous boiler rooms,”\(^{68}\) and another described it as “a pathway to predatory scams . . . [because it required] no information to be provided by a company; and if the company provides information, it requires no responsibility or accountability for the accuracy of that information.”\(^{69}\) As a result of the widespread criticism of the House version in the media, from the Commission, and by special interest groups,\(^{70}\) the Senate introduced numerous investor protections into

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\(^{69}\) 158 CONG. REC. S1,972–76 (daily ed. Mar. 22, 2012) (statement of Sen. Jeffrey Merkley); see also 158 CONG. REC. S1,825 (daily ed. Mar. 20, 2012) (statement of Sen. Tom Harkin) (“In the name of helping small business, the [House] bill takes a meat ax to the very investor protection laws that have allowed our capital markets to flourish.”).

the final version of the law.71

The resulting crowdfunding provisions of the JOBS Act are a classic example of the compromises that characterize a democratic system. One Republican congressman lamented that the final law includes “ill-conceived and burdensome changes”72 to the House version and “is riddled with burdens on issuers, investors, and intermediaries and . . . enhances [the Commission’s] rulemaking authority.”73 Meanwhile, one Democratic congressman complained that the revisions the Senate introduced do “not go far enough to ensure that investors will be protected from unscrupulous actors,”74 and a senator warned that the Senate’s revisions, “though welcome, are far from sufficient. We are about to embark upon the most sweeping deregulatory effort and assault on investor protection in decades.”75 In the end, the Senate’s version received bipartisan support, passing the House by a 380 to 41 vote margin76 and the Senate by a 73 to 26 vote margin.77

C. Crowdfunding under the JOBS Act

This section provides only a brief sketch of some of the most salient characteristics of the JOBS Act’s crowdfunding provisions.78 The Act tasks the Commission with implementing regulations that will define the full extent of the numerous proscriptions and prohibitions on crowdfunding investment. Also, the Act affords the Commission the discretion to create additional requirements that the Commission finds necessary “for the protection of investors and in the public interest.”79

The Act allows start-up companies to raise up to $1 million through crowdfunding in any twelve-month period.80 In addition, the
cap on the amount any person may invest increases in accordance
with the investor’s annual income or net worth (e.g., from a low of
$2,000 for investors with an annual income or net worth up to
$40,000, to a high of 10 percent of an investor’s annual income or net
worth above $100,000). The cap on each investor applies to the
investor’s aggregate crowdfunding investments in any twelve-month
period, not to each investment.

Another fundamental component of the Act is that all
crowdfunding investments must occur through a website that has
registered with the Commission (either as a “funding portal” or a
broker). The Act places substantial obligations on these websites,
such as disclosing information related to the risks of investing in
start-up companies, ensuring that each investor affirms an
understanding of the risks of crowdfunding investments, and
obtaining a background check on key company personnel.

Furthermore, on an annual basis, a crowdfunded company
must provide its financial statements and a report of the results of the
company’s operations. Companies must also make disclosures
related to key company personnel, the company’s business, and its
intended use of investment proceeds. In addition, the Act requires
disclosures in potentially complex areas of corporate law and finance,
such as a description of the company’s capital structure, the terms of
the company’s securities (including how the terms may be modified,
the differences among the classes of securities, and how other classes
of securities may materially affect the rights of the crowdfunded
securities), the valuation of the crowdfunded securities, and the risks
of owning a minority equity interest in the company.

Some of the disclosures summarized above (e.g., the effect of
one class of securities on another, corporate events, minority positions)
touch on issues of concern to venture capitalist investors. But the
disclosure requirements are insufficient—indeed, disclosure
requirements alone are the wrong mechanism—to protect the value of
crowdfunders’ investments if the crowdfunded company succeeds. The
remainder of this Article explores this problem and proposes potential
solutions.

81. Id.
82. Id.
83. Id. § 302(b)(a)(1).
84. Id. § 302(b)(a)(2)–(12).
85. Id. § 302(b)(b)(4).
86. Id. § 302(b)(b)(1).
87. Id. § 302(b)(b)(1)(H).
III. THEORETICAL TENSIONS

Crowdfunding investment challenges many of the tenets of paper-based securities laws because it relies on the Internet to facilitate mass electronic investment in start-up companies, which would have been impossible in the 1930s when Congress enacted the legislation that continues to govern federal securities regulation.\textsuperscript{88} Unfortunately, the crowdfunding provisions of the JOBS Act reflect a deductive approach to regulating crowdfunding investment because they squeeze a modern-day investing technique into a dated regulatory scheme.\textsuperscript{89} In contrast, an inductive approach would focus on the importance of matching an innovative regulatory strategy to the innovative practice of crowdfunding investment.\textsuperscript{90}

Prior to passage of the Act, several articles urged the Commission to create an exemption from registration for crowdfunding investment offerings, and one was especially clear in its preference for a deductive regulatory approach, citing “legal transition costs . . . [that] are inevitable in any legal rule change . . . . The [Commission] can reduce these types of costs by constructing any new crowdfunding exemption in a way that minimizes variation from the existing registration exemption scheme . . . .”\textsuperscript{91} In this deductive approach, the “existing exemptive framework” is the starting point of the analysis, and the end goal is to minimize disruption of the status quo.\textsuperscript{92}

Though friction from change, transaction costs, and legal-transition costs are real and should be factored into a cost-benefit analysis of any legal rule change, the flaw in applying a

\textsuperscript{88} The principles and framework codified by the Securities Act of 1933 and the Exchange Act of 1934 remain the foundation of federal securities laws. 158 CONG. REC. H1,592 (daily ed. Mar. 27, 2012) (statement of Rep. Patrick McHenry) (discussing crowdfunding investment and referencing a letter from Oversight Chairman Darrell Issa to the Commission “that really challenged the Commission’s complacency and asked them about these 80-year-old regulations that were modern at the time where the new invention was the telephone and asked them if they had ways to update them”).

\textsuperscript{89} While a deductive approach is “top down,” giving priority to existing legal regimes and principles and seeking to accommodate new phenomena within established legal frameworks, an inductive approach is “bottom up,” giving priority to new phenomena and seeking to revise existing legal frameworks to meet innovative demands. See, e.g., Bryan L. Walser, \textit{Shared Technical Decisionmaking and the Disaggregation of Sovereignty: International Regulatory Policy, Expert Communities, and the Multinational Pharmaceutical Industry}, 72 Tul. L. Rev. 1597, 1602 (1998) (describing the deductive approach as “proceeding from first principles towards a specific policy option” and the inductive approach as “proceeding from the analysis of a series of case histories towards some operational conclusion”).

\textsuperscript{90} \textit{Id.}

\textsuperscript{91} Heminway & Hoffman, supra note 8, at 940–41.

\textsuperscript{92} \textit{Id.} at 941.
A deductive regulatory approach to new technologies is that it treats the innovative practice as secondary to its primary concern of maintaining the existing regulatory framework. The result, perhaps unintentional, is adherence to outdated regulatory systems even when they are a poor match for the innovative practice they seek to regulate.93

Instead, Congress and the Commission should design crowdfunding laws and regulations inductively in order to tailor them as much as possible to the specific risks of crowdfunding investment. Historically, the Commission’s regulations have been “modest in [their] adaptations to new environments, changing only in small steps, as opposed to allowing for new visions and accepting of sweeping innovations.”94 Unfortunately, this sort of “detailed, incremental regulation fails when the underlying economics or competitive context, or the technology itself, moves other than in slow incremental steps. In that instance, a broader, bolder approach is not only desirable, but necessary.”95 This Article argues that crowdfunding investment is one such instance, and therefore an innovative, bold regulatory approach is appropriate.

Compared to the technology and investing practices of the 1930s, the Internet’s fusion of electronic investment and social networking through crowdfunding is a leap—not a slow, incremental step—forward that allows the direct participation of many people to vote with their money on the most popular ideas for start-up companies. Crowdfunding exemplifies the democratic marketplace of ideas because the Internet provides equal and direct access to start-up ventures, and the Internet community collectively selects the ones deemed worthy of funding.96 From an economic perspective,
crowdfunding thus resembles original Athenian direct democracy even more than modern representative democracy. As such, it is fitting that the paternalistic themes embodied in Plato’s conception of a ruling class of philosopher kings (and queens) also animate the crowdfunding-investment debate. As described below, historical precedent demonstrates the need for investor protections when small businesses sell unregistered stock to unsophisticated investors over the Internet, as the JOBS Act permits start-up companies to do.

A. Paternalistic Impulses: The Rule 504 Lesson

Other than a failed seven-year experiment in the 1990s under Rule 504 of Regulation D, never before have everyday citizens had such direct access to investing in start-up companies, and never before have start-up companies had such direct access to public markets. When Rule 504 permitted small companies to offer unregistered securities to the general public without substantive disclosures, unscrupulous promoters capitalized to “facilitate a number of

truth and error, see, for example, Christopher T. Wonnell, Truth and the Marketplace of Ideas, 19 U.C. Davis L. Rev. 669, 672–76 (1986) (summarizing criticisms of the marketplace of ideas theory and restating the two predictions of the theory: “a society that permits free speech will find itself nearer to the truth . . . [and] exhibit more progress toward truth over time than an otherwise similar society that proscribes free speech”).

97. Keith Werhan, The Classical Athenian Ancestry of American Freedom of Speech, 2008 Sup. Ct. Rev. 293, 294–95 (distinguishing the high level of citizens’ direct involvement in Athenian government from the representative nature of American democracy); see also Anthony Kenny, An Illustrated Brief History of Western Philosophy 21–22 (2006) (“[Athenian democracy] was not like a modern democracy, in which the citizens elect representatives to form a government. Rather, each citizen had the right personally to take part in government . . . . The judiciary and the legislature in Athens were drawn by lot . . . , laws were passed by a panel of 1,000 chosen for one day only, and major trials were conducted before a jury of 501.”).


99. Inclusion of “philosopher queens” is self-evident today, no less notably than at the Commission, where Mary Schapiro was, until November 2012, the Chairman. It also may have been Plato’s intent. See id. at 451d–456e (“If, then, we are to use the women for the same things as the men, we must also teach them the same things. . . . [T]he contrast with present custom would make much in our proposals look ridiculous if our words are to be realized in fact. . . . Women of this kind [that is, guardians], then, must be selected to cohabit with men of this kind and to serve with them as guardians since they are capable of it and akin by nature.”); see generally Feminist Interpretations of Plato (Nancy Tuana ed. 1994) (noting scholarly debates between those that view Plato as being ahead of his time for advocating gender equality and those that believe the totality of Plato’s work does not endorse equality).

100. 158 Cong. Rec. S1,828 (daily ed. Mar. 20, 2012) (statement of Sen. Mary Landrieu) (“[W]e have to write these rules fairly or it is the poor people, it is the middle class, it is the people who didn’t go to the Ivy League schools . . . who are going to be led down the Primrose path. . . . [L]et’s give them, the investor, protections they deserve.”).

101. Burkett, supra note 8, at 96.
fraudulent secondary transactions.” For instance, one famous approach, the “pump-and-dump” scheme, sought to generate widespread interest in small companies with “thin capitalization, low share prices, and little to no analyst coverage” in order to inflate the stock price. Once the stock price rose, the promoters would sell their shares prior to other investors’ discovery of the artificial inflation of the stock price.

As the Commission has recognized, the lessons learned from the Rule 504 experiment are helpful in crafting a regulatory approach to crowdfunding investment because of the similarities between crowdfunding companies and the companies whose stock was used to defraud investors under Rule 504:

The Commission’s rules previously included an exemption, Rule 504, which allowed a public offering to investors (including non-accredited investors) for securities offerings of up to $1 million, with no prescribed disclosures. In 1999, that exemption was significantly revised due in part to investor protection concerns about fraud in the market. In assessing any possible exemption for crowdfunding, it would be important to consider this experience and build in investor protections to address the issues created under the prior exemption.

In this regard, one prominent crowdfunding-investment article extols the disclosure-based regulatory approach, arguing that “[e]xposing unsophisticated investors to risky investments without adequate disclosure unduly sacrifices investor-protection goals to the perceived need to lower the disclosure barriers for small businesses.” The article concludes that, “Hopefully, the new crowdfunding exemption as implemented by the [Commission] will provide sufficiently meaningful disclosure so that investors receive the protection they both need and deserve.”

The article references the Rule 504 experience to support the argument that required disclosures are necessary to protect crowdfunders, noting that under the JOBS Act, crowdfunding is

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103. Hazen, supra note 8, at 1748 (footnotes omitted).
104. Revision of Rule 504 of Regulation D, supra note 102.
105. Hazen, supra note 8, at 1748 (footnotes omitted).
106. Crowdfunding: Connecting Investors and Job Creators: Hearing Before the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs of the House Committee on Oversight and Government Reform, 112th Cong. 11 (2011) (statement of Meredith B. Cross, Director, Division of Corporation Finance, Securities and Exchange Commission); see also Bradford, supra note 8, at 105 (“The SEC’s experience when it eased the requirements of the Rule 504 small offering exemption in the 1990s also illustrates the potential fraud associated with unregulated small offerings.”).
107. Hazen, supra note 8, at 1767.
108. Id. at 1769. “Only time will tell whether the express disclosure requirements in . . . [the Act] will be sufficient to provide meaningful investor protection. If not, the SEC can correct the situation” through its implementing regulations. Id. at 1765 (footnote omitted).
Undoubtedly, a crowdfunding exemption that ignored the lessons gleaned from Rule 504’s failures prior to the 1999 revisions would have been counterproductive, but it is also important not to over-emphasize the power of disclosure alone to protect crowdfunding investors.

Disclosure can be helpful in pursuing legal claims for material misstatements or omissions, but its effectiveness in helping investors, especially unsophisticated ones, judge the quality of securities offerings is questionable, as discussed in Part III.B. Further, the historical lesson from Rule 504 is not simply that without disclosures unsophisticated investors are vulnerable to fraudulent investment schemes. Rather, the broader lesson is that unsophisticated investors need protection (not necessarily in the form of disclosures) when investing in unregistered securities.

In fact, when the Commission amended Rule 504, it did not add a disclosure requirement to the exemption. Rather, the amendment required issuers to have a preexisting relationship with purchasers (i.e., friends and family), thereby eliminating public solicitation (over the Internet or otherwise) and relying on investors’ preexisting relationships to decrease the risk of fraud. Importantly, Rule 504 still does not require any disclosures to unsophisticated investors. Instead, a different mechanism of protecting unsophisticated investors was applied as the Commission eliminated public solicitations under Rule 504 through the requirement of a preexisting relationship. Therefore, the Rule 504 example does not teach that required disclosures are the necessary tool to protect unsophisticated investors; more precisely, it shows that unregistered securities offerings to unsophisticated investors should include investor protections, in one form or another.

109. Id. at 1769 (footnote omitted).
111. Public solicitation over the Internet is inherent in crowdfunding investment and thus cannot be removed like it was from Rule 504.
112. The amendment to Rule 504, 17 C.F.R. § 230.504(b)(1), prohibited general solicitations except in the narrow case where a company offers stock under a state law exemption, such as an intra-state offering, and complies with state law disclosure requirements. See 17 C.F.R. § 230.504(b)(1) (2011).
Particularly where disclosure is complex, formalistic, and difficult to understand, disclosure is unlikely to compel retail investors to seek their own protections. This is likely to be especially true in the case of widely dispersed crowdfunders who lack an efficient mechanism to negotiate contractual terms. Therefore, continuing to apply a purely disclosure-based philosophy to crowdfunding investment is flawed because it places excessive trust in the power of disclosure to protect crowdfunding investors.

B. Securities Regulation: Disclosure vs. Merit Review

The US federal securities regulatory regime, like that of most if not all other advanced economies, adheres to the disclosure-based philosophy of securities regulation. Due to the risks that crowdfunding investment presents for retail investors, however, the competing philosophy of merit review offers insights that highlight the theoretical flaws of the crowdfunding provisions of the JOBS Act. Even while appreciating the insights from the merit-review philosophy, though, this Article does not suggest replacing the disclosure-based system with a merit-review approach, as explained at the end of this Part.

The merit-review and disclosure philosophies differ as follows:

Under the disclosure-based model, securities regulation is effected, not by prohibition or direct intervention, but by requiring adequate disclosure with respect to the transaction and imposing sanctions for false or misleading statements. By contrast, the merits-based model goes beyond the mere requirement of information disclosure to include merit-review by the state of the efficacy and equity of the securities being offered.

The disclosure model, then, typically results in issuers preparing extensive reports (e.g., prospectuses, private placement memoranda, etc.) that describe both the general risks of investing as well as the specific risks of the issuer’s company and business. Justice Brandeis famously captured its rationale of exposing falsehood through transparency with his enduring description: “Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.” An important characteristic of the disclosure model is to provide either (1) a basis for defrauded investors to recover from issuers that make

115. Id.
116. Louis D. Brandeis, Other People’s Money and How the Bankers Use It 92 (1914).
misleading statements in, or omit material information from, their disclosure documents, or (2) a shield for issuers to avoid liability for investors’ risky, yet informed decisions.117

The disclosure model, though, has its shortcomings,118 such as “information overload[, which] raises doubts about the effectiveness of the disclosure philosophy at the core of the federal securities laws,”119 and has been under increased scrutiny after the capital markets’ collapse in 2008.120 The alternative model of merit review has simultaneously received renewed attention. In summarizing the historical antecedents of US securities laws, one commentator noted:

By adopting disclosure as the underlying philosophy of the federal securities laws, the framers of that legislation put too much faith in the prudence of investors and the self-policing mechanisms of the capital markets. As such, they passed up the opportunity to exercise more meaningful control over the quality of issued securities by a regime of merit regulation.121

Merit review focuses on “substantive standards”122 and “represents a form of state ‘paternalism’ in that it replaces investors’ value judgments with those of the regulator with respect to the securities and the issuing corporation.”123 State “blue sky”124 securities

117. E.g., Donald C. Langevoort, Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers, 84 CALIF. L. REV. 627, 627 (1996) (“When risky investments go wrong, brokers and customers may blame each other for the misfortune. Courts and others resolving these disputes must then decide whether the broker withheld information about the risk, or whether the customer knew about the risk and simply made a bad decision.”).


120. E.g., Henry T. C. Hu, Too Complex To Depict? Innovation, “Pure Information,” and the SEC Disclosure Paradigm, 90 TEX. L. REV. 1601, 1607 (2012) (asserting that the Commission’s “disclosure philosophy and its longstanding implementation methodology . . . are at the brink of metamorphosis” in part due to the complexity of contemporary financial products that contributed to the market collapse in 2008, and suggesting increased use of technology to provide market participants with disintermediated, pure information instead of disclosures filtered through intermediaries, including issuers themselves).

121. Morrissey, supra note 118, at 649. The disclosure philosophy is more faithful to the United States’ emphasis on personal responsibility than the more paternalistic merit review philosophy. See, e.g., Adam Benforado, Don’t Blame Us: How Our Attributional Proclivities Influence the Relationship between Americans, Business and Government, 5 ENTREPRENEURIAL BUS. L.J. 509 (2010) (describing, in the context of advertising, the United States’ personal responsibility ethic that tends to deemphasize corporate responsibility for shaping consumer desires, notwithstanding the billions of dollars that companies spend to influence consumer preferences).


regulations have historically focused on merit review, and in the 1930s the debate about which model was most appropriate for federal regulation was still alive: the “original draft of [the Securities Act of 1933], following the states’ example, was premised on a merit standard,” though the final draft adopted the disclosure-based philosophy.125

Merit review generally requires the issuer to submit information to regulators for substantive review and approval in advance of offering securities to investors.126 As such, merit review involves a regulator’s qualitative assessment of the offering.127 Merit review aims to detect and prevent fraudulent or ill-advised offerings before they occur in order to avoid expensive litigation after investors suffer losses.128 In contrast, under the disclosure model, the Commission challenges issuers engaging in a public offering to provide more comprehensive disclosures and seeks clarification of the issuer’s statements, but it refrains from judging the substantive quality of the offering.129

One way to highlight the difference between merit review and disclosure is to consider a hypothetical example of how securities regulators under a merit review system would have treated “the opaque and exotic derivative instruments” that were sold prior to the

124. Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917) (showing an early use of the term “blue sky” in relation to state securities laws: “The name that is given to the law indicates the evil at which it is aimed; that is, to use the language of a cited case, ‘speculative schemes which have no more basis than so many feet of ‘blue sky’”).
127. Id.
128. Arguing, to no avail, that the Act should not preempt state securities laws: States [need] to get “under the hood” of an offering to make sure that it is what it says it is. . . . One of the fundamental tenets of [disclosure-based] securities law is that an investor is protected when the seller of securities is required to disclose sufficient information so that an investor can make an informed decision. [However, p]ost-sale antifraud remedies provide little comfort to an investor who has lost a significant sum of money that is unrecoverable. [Therefore, a]ny effort to remove or weaken the up-front registration and disclosure process should not happen without adequate alternative safeguards.
129. E.g., Manning G. Warren III, Legitimacy in the Securities Industry: The Role of Merit Regulation, 53 BROOK. L. REV. 129, 129–31 (1987) (citing an example where the Commission was “frustrated by its limitations” under the disclosure-based regime in reviewing “only for compliance with disclosure standards’ the prospectus filed by a company whose CEO had a history of securities law violations).
collapse of financial markets in 2008. Under merit review, a federal agency would have had “the power to prohibit the sale of securities not based on ‘sound principles’ . . . [and theoretically] would then have found that the [collateralized debt obligations (CDOs) popularized in the bubble leading up to the 2008 collapse] were tantamount to a Ponzi scheme since they would only have value in a real estate market whose escalation never ended.” Because such an eternally optimistic assumption is not a “sound principle,” the federal agency would have been empowered to stop the sale of the CDOs or mandate substantive changes in the financial instruments.

In contrast, the disclosure philosophy does not ask whether a security is based on sound principles, deferring instead to the market to judge the quality of issuances, so long as the issuer has provided sufficient disclosures (or disclaimers). Hence, the theoretical justification for the more paternalistic merit review is evident from the failings of the disclosure-based approach in the area of complex financial products that retail investors do not fully understand:

Disclosure documents like prospectuses are close to impenetrable for many investors. When faced with complex structured products, investors are more likely to use emotional responses . . . [; thus,] risk disclosure does not necessarily lead to risk awareness on the part of average investors [which] casts doubt on the effectiveness of disclosure-based regulation . . . [particularly because] even in the [United States], retail investors have limited knowledge of finance and are not capable of fully understanding disclosures.

In sum, “merits-based regulation may be appropriate for emerging markets where there are a large number of unsophisticated retail investors, and which lack professional analysts.” Crowdfunding investment, therefore, could be considered a prime example of when the more paternalistic securities-regulation philosophy of merit review is appropriate. Crowdfunding investment

130. Morrissey, supra note 118, at 683.
131. Id.
132. Id.
133. Id. (“Although almost all [CDOs] were sold as unregistered, exempt securities, it is hard to see how our current regime of requiring mere disclosure would have forestalled their issuance or protected investors who eagerly snapped them up.” (footnote omitted)).
134. Huang, supra note 114, at 272–75 (footnote omitted); see also Bradford, supra note 8, at 109–12 (discussing the low levels of financial literacy in the United States); Willis, supra note 118, at 753–77 (noting that “the majority of Americans are unaware of their lack of financial literacy” and discussing the role of emotion in decision making as one justification for consumer regulatory protections); see generally Barry P. McDonald, Campaign Finance Regulation and the Marketplace of Emotions, 36 PEPP. L. REV. 395 (2009) (observing that neuroscience research reveals the influence of emotion on rational decision making, and thus suggesting that courts consider regulating emotionally charged political rhetoric more vigorously, that is, paternalistically).
135. Huang, supra note 114, at 278–79.
is characterized by most, if not all, of the elements described above: emotion (due to the excitement of innovative ideas with the potential to produce astronomical profits), unsophisticated investors, an emerging market, complexity, and few professional analysts.\(^{136}\)

Despite how well crowdfunding investment fits the theoretical justifications of merit review, this Article does not argue for replacement of the disclosure-based regulatory regime with a merit-review system. Even advocates of merit review believe “[s]kepticism is warranted” in using a merit-review system for federal securities regulation.\(^{137}\) Merit-review filings can create costly delays and introduce additional transaction costs to securities offerings,\(^{138}\) and it would be unrealistic and counterproductive for the Commission, whose “limited resources are well-known,”\(^{139}\) to assume the responsibility of merit review. In addition, a merit-review system is prone to creating market inefficiencies by supplanting the judgment of the market with that of regulators.\(^{140}\) Further, the crowdfunding provisions of the Act already preempt state merit-review filings.\(^{141}\)

Nonetheless, the theoretical insights of merit review are instructive for protecting crowdfunders in ways that go beyond exclusive reliance on disclosure. As explained in Part V, this Article proposes a third way, one of “qualitative mandates,” that borrows the best of the merit-based approach (i.e., “meaningful control over the

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136. Though professional analysts might give attention to crowdfunding securities offerings, information about many start-up companies is speculative and unproven because the companies are entering new markets or introducing new products or technologies; therefore, the quality of the information available to professional analysts, and the value of the analysts’ reviews, are questionable. For example:

Small companies . . . present investors with the greatest risk of getting stuck with a lemon. The stocks of small companies provide much potential return—who would not want to get in on the ground floor with a Microsoft or Dell—but little is typically known about these companies. Large, publicly traded companies with many years of reporting experience have several investment analysts following them.

Stephen J. Choi, Gatekeepers and the Internet: Rethinking the Regulation of Small Business Capital Formation, 2 J. SMALL & EMERGING BUS. L. 27, 31 (1998); Letter from Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm’n, to Darrell E. Issa, Chairman, Comm. on Oversight & Gov’t Reform, U.S. House of Representatives 24 (Apr. 6, 2011), available at http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf (“Startups are different from the typical company in which financial institutions and institutional investors invest because startups are characterized by uncertainty and information asymmetry . . . and often have high levels of intangible assets, making it difficult for institutional investors . . . to value them accurately.”).

137. Morrissey, supra note 118, at 685.

138. Jennings, supra note 122, at 240.

139. Morrissey, supra note 118, at 685.

140. Huang, supra note 114, at 268–70; Jennings, supra note 122, at 242.

141. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 305, 126 Stat. 306 (2012) (preempting state securities laws, except for anti-fraud enforcement and notice filings in the state where the company’s principal place of business is located or the state where 50 percent or more of the purchasers of the crowdfunded securities are residents).
quality of issued securities”) and applies it within the framework of the disclosure-based system.

IV. VENTURE CAPITALIST ELITES AND THE MASSES

Crowdfunding brings the masses of everyday retail investors into what historically has been the nearly exclusive domain of venture capitalists and other wealthy investors. This is a paradigm change for securities regulation because in general, securities “regulatory requirements favor those with connections to high-net-worth individuals, wealthy friends and family members; those lacking connections have a much tougher time raising funds.... [It is] ‘a rather undemocratic process.” Before the JOBS Act, broad restrictions on general solicitations prior to a public offering usually resulted in unsophisticated investors having the opportunity to invest in start-up companies only after the companies were successful enough to engage in a public offering.

Investing in start-up companies in their infancy and development stages is a high-risk, high-reward game in which sophisticated venture capitalists have made legendary profits while also refining multiple strategies to protect their investments. Crowdfunding investment could create competition for venture capitalists, and especially angel investors, in what was previously a near monopoly for the wealthy, but it is unlikely to threaten venture capitalists because successful start-up companies will often need more

142. Morrissey, supra note 118, at 649 (emphasis added).
143. Pope, supra note 8, at 984 (observing that prior to the Act, securities rules related to investing in start-up companies created “a relatively closed [process.] . . . providing investment opportunities to venture capital firms and high net worth individuals and financing opportunities to select entrepreneurs”).
145. Title II of the JOBS Act removes the restriction on general solicitations from Rule 506 offerings while still requiring that all purchasers be accredited investors. Jumpstart Our Business Startups Act § 201. Prior to the Act’s amendment to Rule 506, securities offerings to accredited investors over the Internet under Rule 506 were permitted only if issuers were careful to avoid unaccredited investors and a general solicitation. See, e.g., Jonas A. Marson, Comment, Surfing the Web for Capital: The Regulation of Internet Securities Offerings, 16 SANTA CLARA COMPUTER & HIGH TECH. L.J. 281, 284–88 (2000); Lisa A. Mondschein, Note, The Solicitation and Marketing of Securities Offerings Through the Internet, 65 BROOK. L. REV. 185, 208 (1999) (describing the two requirements as a questionnaire to verify accredited investors status and a password-protected website).
investment than the Act’s $1 million annual cap. In addition, without adequate protections, crowdfunding investors will be easy prey for sophisticated venture capitalists. The latter point has been neglected in crowdfunding investment scholarship and the crowdfunding provisions of the Act.

A. Vertical and Horizontal Risks

The blind spot of overlooking the potential conflicts between crowdfunding investors and venture capitalists may be a product of the “implicit dichotomy of the corporation [that] exists in legal scholarship. On one side of the dichotomy rests the publicly held corporation suffering from a significant conflict of interest between its managers and dispersed shareholders; on the other side, the closely held corporation plagued by intershareholder conflict.” But analyzing venture capital investing “reveals that start-up companies are indeed plagued by both vertical agency problems between investors and managers and horizontal agency problems among [venture capital] investors themselves.” Unfortunately, both the crowdfunding provisions of the JOBS Act and crowdfunding scholarship have neglected horizontal agency problems in crowdfunding investment, despite horizontal concerns being a primary risk for crowdfunding investors.

The focus on vertical agency problems in the Act is evident in the overriding concern with disclosures from the company’s management. Even the clunky, full title of the crowdfunding provisions of the Act (the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012) is emblematic of the emphasis on the vertical agency concerns of fraud and disclosure in crowdfunding investment. In addition, Professor Bradford’s comprehensive crowdfunding-investment article, for example, takes a vertical agency perspective in discussing the risks to crowdfunders of investing in start-up companies, noting that “the entrepreneur holds all the cards. Investors have little information about what is to come and little control over what the entrepreneur does. This presents entrepreneurs with opportunities for self-dealing, excessive compensation, misuse of corporate opportunities, and dilution of  

149. Id. at 37, 40–41.
The article’s focus on vertical risks is also apparent when it recognizes that venture capitalists have developed strategies to “constrain self-dealing, opportunistic behavior by the entrepreneur” but remains silent on the horizontal threats that venture capitalists (and soon, crowdfunders) face from other investors when a start-up company is successful. Venture capitalists do use numerous techniques to constrain entrepreneurs in order to manage vertical risks, but as discussed below, venture capitalists also design these techniques to protect against the horizontal risks that other investors pose.

B. Downside and Upside Risks

The arrival of subsequent investors, such as venture capitalists, can temper the upside potential of crowdfunders’ ground-floor investment in a successful start-up company. Therefore, neglecting horizontal risks can lead to an overly optimistic view of the upside potential of crowdfunding investment. An absence of appropriate venture capital protections can result in significantly lower financial returns on an early-stage crowdfunding investment in a successful start-up company.

For instance, in comparing the equity and non-equity models of crowdfunding, Professor Bradford’s article concludes that contributions under the other models “are subject to the same risk of loss as crowdfunded securities, but do not offer the upside potential of a securities investment. Allowing crowdfunding entrepreneurs to sell securities would, therefore, be a net gain to investors, increasing the possibility of gains without any increase in the risk.”

Unfortunately, where there is upside potential, there is also increased risk for crowdfunders because promising investment opportunities in start-up companies attract competing investors, who are often sophisticated venture capitalists. Another crowdfunding article, though, expresses a similarly rosy outlook that, “If the [crowdfunded] company continues to grow, early investors should reap some financial rewards for their investments . . . .” It is possible that early crowdfunding investors will reap financial rewards, but as explained

152. Id.
153. E.g., id. at 9 (noting that “[c]rowdfunding exposes relatively unsophisticated investors to the greater risks associated with small business offerings—illiquidity, fraud, business failure, and entrepreneurial self-dealing” but stopping short of discussing upside, horizontal risks directly).
154. Id. at 105.
155. Pope, supra note 8, at 985.
below, the value of crowdfunders’ investments in start-up companies
can be negligible without investor protections against horizontal
risks. As unfortunate as it would be for a crowdfunding investor to
lose money to a fraudulent, failed, or mismanaged start-up company,
it would be at least as painful, if not more so, for a crowdfunder to
invest in a start-up venture that becomes a multi-million (or -billion)
dollar enterprise and not receive a fair share of the profits while other
investors enjoy the gains.

*The Social Network* portrays this risk poignantly in its
description of Eduardo Saverin’s quest to recover his ownership interest
in Facebook through no-holds-barred litigation. Though Mr. Saverin’s
struggles could be viewed through the vertical agency lens that gives
priority to his dispute with company management (i.e., Mark
Zuckerberg), his struggles were directly related to the horizontal
agency problem that arose in the movie when Facebook sold equity
interests to other investors—first to venture capitalist Peter Thiel and
then, in a separate round of financing, to Case Equity. Because Mr.
Saverin apparently lacked the investor protections that venture
capitalists typically negotiate, his original 30 percent ownership
interest was diluted down to less than 1 percent when Case Equity
invested in the second round of Facebook’s venture capital financing,
even though the other existing investors’ ownership interests were, at
most, minimally diluted.

Similar to Mr. Saverin’s failure to negotiate necessary investor
protections, individual crowdfunding investors have little ability to
negotiate the types of protections against horizontal risks that venture
capitalists require. As Professor Bradford’s article argues, albeit in
connection with a discussion of vertical agency risks,

156. Former Chairman Schapiro’s comments are typical, and though they are accurate,
they are incomplete because they do not address horizontal agency risks. Schapiro, *supra* note
136 (discussing crowdfunding investment and noting that venture capitalists “have developed
certain mechanisms that allow them to successfully manage the risks involved in investing in
[start-up companies]. Often [venture capitalists] are active investors that vigorously monitor
their investments and participate in the day-to-day operations of their investments, and they
frequently are value-added investors because . . . they furnish business expertise . . . ”).

157. In the movie, after the first round of investment led by Peter Thiel, a second round
of investment occurred when Case Equity made “an investment offer that was hard to turn
down.” Facebook’s counsel stated to Mr. Saverin that “we had some new investors that have
come in” and proceeded to show Mr. Saverin the contracts that would dilute Mr. Saverin’s
ownership share down to 0.03 percent while not diluting the ownership share of the other

158. Mr. Saverin eventually settled his lawsuit against Facebook and became a
billionaire through his Facebook shares, see *Eduardo Saverin*, FORBES, at http://www.forbes.com/
profile/eduardo-saverin (last visited Nov. 11, 2012), but it would have been better for him, and it
will be better for crowdfunders, to avoid litigation through protections against horizontal risks
that arise in follow-on rounds of financing.
Most crowdfunding investors will not have the sophistication to understand the need for or benefits of control rights or protective covenants. Even if they were sophisticated enough to seek such protection, it is unclear how they would negotiate for it, or whether it would be worth their effort. The small amount invested by each crowdfunding investor and the remote, impersonal nature of crowdfunding preclude any meaningful negotiations.\footnote{Bradford, \textit{supra} note 8, at 107 (internal citations omitted).}

Especially due to the high per-person investment caps under the Act,\footnote{Written prior to the JOBS Act, Bradford’s article argued for a significantly lower per-person investment cap than the actual caps under the Act. Bradford, \textit{supra} note 8, at 149.} obtaining economic protections against horizontal risks is worth the effort because, without them, the upside to crowdfunders can end up being little more than pennies on the dollar even if the crowdfunded company is wildly successful.\footnote{Describing an expectation that the Commission provide investor protections against horizontal risks: \textit{Another essential issue is . . . dilution. . . . Those are folks who get in on the front end and think: I got in on this idea early. I am going to benefit from having made this effort, and find out later a bigger investor came in and the stock was diluted in a fashion in which they are basically written out of their share of the ownership. So the Senate bill directs the SEC to provide investor protections in this area.} 158 CONG. REC. S1,887 (daily ed. Mar. 21, 2012) (statement of Sen. Jeffrey Merkley).}

As crowdfunders step into the shoes of venture-capital investors, the areas of most potential vulnerability for crowdfunders under the horizontal-agency paradigm will track the primary risks of venture-capital investing: “Although interinvestor conflicts might arise in a variety of contexts, the two that appear to play the largest role in [venture capital] contracts are those relating to a company’s ultimate exit strategy and a company’s future financing.”\footnote{Bartlett, \textit{supra} note 148, at 71 (footnote omitted).} Accordingly, protections relating to the economic risks posed by start-up companies’ follow-on rounds of financing and potential exit events are addressed below.

\section{Financing Rounds, Exits, and Protecting Crowdfunders}

Through staged financing, venture capitalists exert “enormous control over portfolio companies by forcing them to raise capital repeatedly” through multiple rounds of financing in which venture capitalists invest “only enough money to allow [the company] to progress to the next milestone in its business plan.”\footnote{D. Gordon Smith, \textit{Team Production in Venture Capital Investing}, 24 J. CORP. L. 949, 952 (1999).} If a start-up company that receives crowdfunding investment succeeds, it will often need additional investments that could easily exceed the $1 million annual cap under the JOBS Act. In fact, one of the specific purposes of crowdfunding investment is to “give entrepreneurs an opportunity
to travel further down the development path by taking incremental steps before approaching venture capitalists.”

This is consistent both with venture capitalists’ frequent preference to invest in growing companies that have successfully moved beyond the perilous early-start-up stage and with typical venture capital investment amounts that average between $2 million and $10 million.

When growing crowdfunded companies seek additional financing from other investors, such as venture capitalists, the arrival of the new investors can severely impact the existing stockholders (i.e., crowdfunders). Two of the most pronounced and interrelated effects include (1) dilution of crowdfunders’ ownership percentages when the company issues new shares to new investors, similar to how The Social Network portrayed the substantial dilutive impact of Case Equity’s new investment on Eduardo Saverin’s ownership interest; and (2) exclusion of crowdfunders when other stockholders resell (or the company sells) shares to new investors.

a. Price-Based Anti-Dilution Protection

Crowdfunders, like venture capitalists, are at risk of dilution in two ways. The first, as discussed in this subsection, is based on the relative price of the new securities issued in subsequent financing rounds. The second, discussed in the next subsection, relates to maintaining a conversion ratio that adjusts to issuances of additional securities. Venture capitalists include the contractual protections discussed in these two subsections to guard against both types of dilutive risks, and crowdfunders should enjoy similar protections.

Dilution results when a company issues new shares to new investors because, with an increase in the total number of outstanding shares, existing shareholders own a lower percentage of the company’s total shares. This may not be problematic from an economic

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164. Pope, supra note 8, at 985.
165. Bradford, supra note 8, at 102 (footnote omitted).
166. Further research could investigate the effect that a round of crowdfunding financing has on subsequent financings, including whether crowdfunders make it more or less likely for venture capitalists to invest, and what effect crowdfunders have on the terms of a venture capitalist’s investment.
167. Because the cofounder of one crowdfunding investment website might be correct—“I absolutely think that a company funded on our platform could be the next Facebook”—it is imperative that crowdfunders be protected from the risks posed by staged financing and exit events. Carl Franzen, One Company Ready to “Crowdfund” After JOBS Act: Rock the Post, TALKING POINTS MEMO (Apr. 6, 2012, 6:00 AM), http://idealab.talkingpointsmemo.com/2012/04/one-company-ready-to-crowdfund-after-jobs-act-rock-the-post.php (internal quotation marks omitted) (quoting the cofounder and chief operating officer of Rock the Post).
perspective if the company issues the new shares at a higher price per share than what the existing investors paid (an “up-round”) because the value of the existing investors’ positions does not decrease (i.e., they own a smaller percentage, but of a larger pie).\footnote{169}

But dilution is problematic from an economic perspective if the new shares are sold for a lower price per share than what the existing stockholders paid (a “down-round”).\footnote{170} In a down-round, existing stockholders will own a lower percentage of a less valuable company, unless they have down-round anti-dilution protection to mitigate the dilutive effect.\footnote{171} Venture capitalists protect themselves against the economic risks of down-rounds through price-based anti-dilution provisions in their preferred-stock-investment contracts.\footnote{172}

In a down-round, the issuance of new stock “can easily reach into the hundreds of millions of shares...leaving common stockholders and unprotected investors with truly worthless stock.”\footnote{173} Down-round anti-dilution protection, though, “diminishes the dilutive effect...by increasing, upon the issuance of the lower-priced [preferred] stock, the ratio at which each share of the...higher-priced preferred stock converts into common stock.”\footnote{174} Thus, in accordance with the terms of the anti-dilution provision, existing preferred stockholders obtain the right to convert their preferred stock into more shares of common stock than they otherwise would.\footnote{175} Depending on

\footnote{169. As Bartlett explains:
Ordinarily, a preferred stockholder will expect its ownership...to be diluted when the company issues stock to new investors at a higher price than the preferred stockholder paid for its own shares. Although its percentage ownership...will be diminished, the value of the stockholder’s ownership interest will generally be the same or greater...as the company will have a greater aggregate valuation.


170. A down-round does not necessarily imply that a company is failing. Company valuations vary for numerous reasons, and the risk of a down-round is particularly prevalent when the first round overvalues the company, which is foreseeable when inexperienced crowd funders invest in unproven companies. See, e.g., Startup Funding—Startup Valuation at the Friends and Family Round, ANGELBLOG, http://www.angelblog.net/Startup_Funding_Valuation_at_the_Friends_and_Family_Round.html (last visited Dec. 12, 2012) (observing that “[o]ver-valuation is one of the most common structural problems” entrepreneurs and inexperienced early-stage investors make when financing start-up ventures, due in part to “being wildly optimistic” and in part to the lack of “any objective way to do a fair startup valuation”).


172. Id.

173. Id. at 30.


175. See id. at 81.
the specific anti-dilution formula used, the result is less dilution for
the preferred stockholder, though some dilution may still occur.\textsuperscript{176}

In practice, another effect of down-round anti-dilution
protection is “generally [to] require the new investor to negotiate with
the existing investors regarding the waiver of all or part of their
antidilution protection.”\textsuperscript{177} In crowdfunding investment, this would be
a fair result for crowdfunders because new investors could still invest
in follow-on rounds of financing, but, like venture capitalists,
crowdfunders would have price-based anti-dilution protection.
Therefore, issuance of new shares would not excessively dilute the
value of crowdfunders' investments without their knowledge and
consent. Without price-based anti-dilution protection, crowdfunders
would be in a similar position to managers of start-up companies but
with a fundamental distinction.\textsuperscript{178} Down-round anti-dilution is an
acceptable risk for managers because managers have a voice in the
negotiation with follow-on investors, as they decide whether and on
what terms to issue new shares to new investors.

But this risk is unacceptable for crowdfunders (or venture
capitalists) because without down-round anti-dilution protection, the
value of existing investments can be reduced to next to nothing in
subsequent rounds of financing, without existing investors having any
control over (or even knowledge of) their dispossession. Absent
price-based anti-dilution protection, crowdfunders will likely find
themselves in Mr. Saverin’s position before his successful litigation:
pushed out of a once promising ground-floor investment in a
successful start-up company. Therefore, crowdfunders, like venture
capitalists, need down-round anti-dilution protection against the
horizontal risks that subsequent investors represent.

\textbf{b. Shares-Based Anti-Dilution Protection}

Another dilutive risk is that the company will issue additional
shares of common stock, either through a stock split or a stock
dividend, potentially resulting in shares-based dilution of convertible
preferred stock. Therefore, crowdfunders, like venture capitalists,
need standard contractual protection against shares-based dilution.

\begin{footnotesize}
\begin{enumerate}
protection, which eliminates the effect of dilution, is less common than a weighted average
formula, which lessens the effect of dilution).
\item[177.] Bartlett, \textit{supra} note 169, at 30.
\item[178.] See id. at 31 (“[A] principle effect of antidilution protection is to increase the dilution
of a down-round financing on common stockholders, such as a company’s management and
employees.”).
\end{enumerate}
\end{footnotesize}
Absent this protection, crowdfunders' ownership interests will be diluted when the company issues additional shares of common stock because crowdfunders' preferred stock will convert into a lower percentage ownership of the company's common stock. Unlike the price-based dilution described in the preceding subsection, shares-based dilution can occur at any time and is not tied to an up-round or down-round.

For example, crowdfunders could hold one hundred shares of preferred stock convertible on a one-for-one basis into one hundred shares of common stock. If there are one hundred shares of common stock outstanding, and the common shares are split by a five-for-one ratio, then the one hundred shares of common stock outstanding will become five hundred. Without a corresponding adjustment to crowdfunders' preferred stock conversion ratio, though, the preferred stock will still convert into only one hundred shares of common stock. Thus, before the stock split, crowdfunders could have converted into common stock and owned a 50 percent interest in the company (one hundred of two hundred total shares). But after the split, crowdfunders would own only a 16.7 percent interest on an as-converted basis (one hundred of six hundred total shares).

Protection against this structural risk is so essential that all crowdfunding investments in preferred stock should include shares-based dilution protection. Inexperienced crowdfunding investors, however, understandably might be unaware of this nuance in standard venture capital transactions. Therefore, as described in Part V, crowdfunding statutes and regulations should help crowdfunders avoid the possibility of the serious error of omitting shares-based anti-dilution protection.

c. Tag-Along Rights

Tag-along, or co-sale, rights are another technique venture capitalists use for protection in subsequent financings. Tag-along rights help venture capitalists, and they should also help crowdfunders, avoid being excluded from a profitable exit event.
Apart from an initial public offering (IPO), a successful exit event for early-stage investors often comes through a private sale or merger.\(^1\) Venture capitalists, especially those holding a minority ownership interest in the company, protect themselves from the risks of private sales by insisting on tag-along rights to ensure they are not left out of a profitable private transaction when another stockholder, especially a majority owner, sells its shares.\(^2\)

Two straightforward scenarios show the importance of tag-along rights, especially for minority investors, as individual crowdfunders are likely to be. In the first, stockholders with a majority ownership position (possibly including company founders and managers) might sell a controlling interest in the company to a third party, perhaps an investor or a strategic acquirer, in a private transaction that includes a control premium in the sale price.\(^3\) In another scenario, an investor might seek to exit its illiquid investment\(^4\) through a private sale to another investor who hopes for a future exit event at a higher valuation—prior to Facebook’s IPO, for

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Comment, Venture Capital Contracting under the Korean Commercial Code: Adopting U.S. Techniques in South Korean Transactions, 13 PAC. RIM L. & POL’Y J. 439, 468 (2004) ("[Tag-along rights] can be an important investment exit strategy for venture investors owning a minority stake in the investment when a substantial portion of the common stock held by the entrepreneurs is being sold privately to an outside party.").


\(^2\) Lawrence Cohen, Private Equity Portfolio Companies: Their Needs Today, in REPRESENTING PRIVATE EQUITY AND VENTURE CAPITAL BACKED PORTFOLIO COMPANIES 49, 55 (2010) (describing tag-along rights as requiring “a buyer of the private equity fund’s shares to offer the same price and terms for the management’s [or other investors’] shares before the private equity fund can sell its interest”).

\(^3\) Maria Isabel Saez Lacave & Nuria Bermejo Gutierrez, Specific Investments, Opportunism and Corporate Contracts: A Theory of Tag-Along and Drag-Along Clauses, 11 EUR. BUS. ORG. L. REV. 423, 431 (2010) (noting that tag-along rights have the effect of forcing “the shareholder with selling power to negotiate for” itself and minority investors because “the idea is to force the conversion of a majority sale into a 100 per cent sale”).

\(^4\) Venture capitalists have short time horizons on their investments and, depending on how many years remain in a fund’s lifecycle, some venture capitalists will be motivated to seek a profitable exit event before others: Because of the ten-year term of most funds, an early investor who has held an investment for several years may face a structural incentive to exit at a time when a company’s later investors are not subject to these pressures. A company’s earlier investors may therefore be less willing to forego a low-value exit yielding a return on investment, even if the investors believe the company could obtain a higher valuation in the long term.

Bartlett, supra note 148, at 74.
instance, there were hundreds of private transactions in Facebook’s stock.  

Without tag-along rights, crowdfunders could lack the opportunity to participate in these types of profitable private sales. The risk is especially acute when a majority owner sells its interest and receives a control premium. Without protection, crowdfunders would be left to continue waiting for an IPO, which may never come, in order to realize the value of their illiquid shares, even while other investors sell their interests and take profits, including a control premium in many cases.

With tag-along rights, however, qualified private transactions could not occur unless crowdfunders also had the opportunity to participate in the transactions by selling their shares at the same price and on the same terms. Therefore, with tag-along rights, crowdfunders would be left out of a profitable transaction only if they chose to wait for a potentially more profitable transaction in the future. Crowdfunding laws should provide crowdfunders this option because, without it, crowdfunders will likely be frozen out of profitable private transactions while more sophisticated investors or majority investors cash out.

d. Preemptive Rights

Another way venture capitalists manage the risks that the arrival of new investors pose is through preemptive rights. These rights “allow the shareholders to participate in any issuance of shares pro rata to their percentage holding” so existing shareholders can avoid dilution of their ownership positions when the company issues

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188. See M. Todd Henderson, Deconstructing Duff and Phelps, 74 U. CHI. L. REV. 1739, 1751 (2007) (observing that in private sales, absent contractual tag-along rights, there is no requirement that “offers to buy stock . . . be made to every shareholder on a pro rata basis”).

189. See id. (arguing that, absent contractual tag-along rights, there is “no duty for the majority to share . . . [the control] premium with the minority”).

190. Prior to an IPO, all of the company’s preferred shares customarily convert to common stock. Venture capitalists negotiate veto rights over automatic conversion of their shares (and thus, over the IPO itself) by requiring that the per-share IPO price equal or exceed the per-share price the venture capitalist paid. See Bartlett, supra note 148, at 74–77 (discussing price- and voting-based veto rights). Whether or not crowdfunders hold a veto right over an unprofitable IPO, crowdfunders are much less likely to be left out of an IPO than a private sale, which is why this Article emphasizes tag-along rights for private sales.
shares to new investors.\(^{191}\) As a simple example, a shareholder who owns 1 percent of a company’s stock would have the right to purchase 1 percent of any qualifying\(^ {192}\) new issuance of the company’s shares, thus maintaining a 1 percent ownership interest in the company.

Just as venture capitalists often require preemptive rights to avoid being pushed out when new investors arrive, it is reasonable for crowdfunders to enjoy this basic protection, too. Preemptive rights were once mandatory in the United States and continue to be mandatory in other jurisdictions.\(^ {193}\) If crowdfunders want (and have the funds)\(^ {194}\) to continue investing in a company that has follow-on rounds of financing, they should not be barred from the opportunity to maintain their percentage ownership solely\(^ {195}\) because they lacked the sophistication or the bargaining power to negotiate what venture capitalists customarily demand.\(^ {196}\)

V. QUALITATIVE PROTECTIONS FOR CROWDFUNDERs

To address the risks of venture-capital investing, neither a pure disclosure-based regime nor a merit-review system will realistically protect crowdfunders. Instead, a qualitative-mandates approach is appropriate because it emphasizes the importance of crowdfunders obtaining substantive investor protections (such as contractual, statutory, or regulatory protective provisions) within the existing disclosure-based regime. As such, a qualitative-mandates

\(^{191}\) Ganor, supra note 169, at 706.

\(^{192}\) For example, issuing stock to employees typically does not trigger preemptive rights.

\(^{193}\) Ganor, supra note 168, at 739.

\(^{194}\) See id. ("Liquidity constraints, as well as collective action problems, can prevent shareholders from exercising preemptive rights.").

\(^{195}\) One carve out to crowdfunders’ right to exercise preemptive rights would be their eligibility under securities laws to participate in a follow-on round of financing. Crowdfunders who are accredited investors could invest under Rule 506 (and up to thirty-five unaccredited investors could, too). Unaccredited crowdfunders could likely invest under Rule 504 because, as existing stockholders of the company, they would have a preexisting relationship with the company.

\(^{196}\) Preemptive rights provisions could potentially include oversubscription rights and pay-to-play penalties. Oversubscription rights are triggered when some shareholders choose not to exercise their preemptive rights, giving the shareholders who do exercise the rights the option to also purchase the shares the nonparticipating shareholders could have bought. William J. Schnoor, Jr., Key Issues in Follow-On Financing Rounds, in VENTURE CAPITAL 2011: NUTS & BOLTS 295, 297 (2011). Whereas oversubscription rights benefit investors, “[p]ay-to-play provisions . . . provide ‘teeth’ to the pre-emptive rights . . . [by imposing] penalties on investors that do not purchase their pro rata portion . . . .” Id. at 298. The penalties can range from the severe (automatic conversion of preferred stock into common stock) to the more benign (loss of anti-dilution protection or preemptive rights for future financings). Id. at 298–99; see Bartlett, supra note 148, at 57.
approach is more closely, or at least as closely, aligned with the Commission’s mission to protect investors than disclosure requirements designed to warn investors of danger, and it avoids the defects of merit review (e.g., administrative burdens, filing delays and market inefficiencies) precisely because it does not involve review or regulatory approval.

A qualitative-mandates philosophy incorporates and applies the notion of “libertarian paternalism,”2197 which recognizes that, due to “the likely effects of default rules, framing effects, and starting points on choices and preferences, paternalism, at least in a weak sense, is impossible to avoid.”2198 Thus, “the term ‘paternalistic’ should not be considered pejorative, just descriptive.”2199 By this definition, the crowdfunding provisions of the JOBS Act and the Commission’s implementing regulations are unavoidably paternalistic2200 because they create default rules, framing effects, and a starting point for how crowdfunding investment will operate.2201

Similarly, a qualitative-mandates approach is consistent with the view that the Commission can help provide “what would be the collective contract of many disaggregated investors if there were an efficient mechanism for each to contract separately and well. In this manner, the [Commission] can be viewed as the collective bargaining agent for investors, although one could argue that it need not be that way.”2202 In the case of crowdfunding investment, this Article argues that it should be that way,2203 in large part due precisely to

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198. Id. at 1166.
199. Id.
200. Id. at 1182 (“[E]ffects [of default rules, framing effects and starting points] are often unavoidable. . . . But in an important respect the anti-paternalist position is incoherent, simply because there is no way to avoid effects on behavior and choices.”); see also Christine Jolls et al., A Behavioral Approach to Law and Economics, 50 STAN. L. REV. 1471, 1535 (1998) (“[I]n the real world, she who provides information ends up giving advice.”).
201. Sunstein & Thaler, supra note 197, at 1184 (“The inevitability of paternalism is most clear when the planner has to choose starting points or default rules.”).
203. Certainly, a qualitative-mandates approach demands restraint of overly paternalistic impulses that intrude on issuers’ and investors’ rights (and the market’s ability) to set the terms of private contracts, even more so in other contexts where bargaining-power disparity and collective-action problems are not as prominent as they are in crowdfunding investment. It also requires balancing of flexible principles-based versus strict rules-based regulation so that bright-line rules cannot be substantively skirted but technically obeyed, and principles can be predictably applied. See Coffee, Jr. & Sale, supra note 123, at 752–53 (“Although the debate about rules-based and principles-based standards often occurs as if the two never overlap, in reality they usually coexist. . . . Most systems are really combinations of the two, with the major difference being the location of the system’s center of gravity in one or the other system.” (footnote omitted)).
disaggregated crowdfunding investors’ probable inability to negotiate necessary venture capitalist protections in start-up company investments.

Crowdfunding investment’s unique characteristics cry out for an innovative regulatory paradigm that is not held hostage to the reigning disclosure-based philosophy. Meaningful disclosure is not enough to protect retail investors. After all, Eduardo Saverin received adequate disclosure in *The Social Network*, but it did not protect him. Mr. Saverin, as a Harvard business major and cofounder of Facebook, was no less (and was possibly more) sophisticated than many crowdfunding investors will likely be. Yet, he undoubtedly could have used negotiating assistance when venture capitalists invested millions of dollars to bankroll Facebook’s astounding growth from the humble roots that Mr. Saverin’s initial $19,000 investment had nurtured.

Applying a qualitative-mandates philosophy to crowdfunding investment results in the pursuit of optimal ways to help crowds of unsophisticated investors obtain necessary venture capitalist protections in start-up company investments. These protections approximate the protections that crowdfunders would likely demand if they were knowledgeable about investing in start-up companies and did not suffer from the collective-action problems that could prevent them from bargaining for appropriate protections on their own. A qualitative-mandates approach seeks to use framing effects, starting points, and default rules to guide crowdfunders toward investor protections patterned off of market-based venture capital deal terms. Similar to how the efficient market hypothesis posits that retail investors piggyback on professional investment analysts’

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204. Facebook counsel to Mr. Saverin: [There are] four documents. The first two are common stock purchase agreements, allowing you to buy stock in the newly reincorporated Facebook as opposed to the old shares, which are completely worthless. The third is the exchange agreement allowing you to exchange the old shares for new shares, and then finally a voter holding agreement.

*The Social Network*, supra note 1.

205. Some venture capitalist protections relate to the unique contributions venture capitalists make to portfolio companies. See Smith, supra note 163, at 953–54 (citing surveys finding that entrepreneurs most value venture capitalists’ management expertise, advice, and access to additional financing). In exchange, venture capitalists typically receive “significant rights of control over the new venture.” Id. at 952. Crowdfunders will normally not provide management expertise, so board seats or other direct control rights will usually not be justified for crowdfunders, and even if they received such rights, it is not clear how a group of widely dispersed people would exercise them effectively. However, crowdfunders do offer contributions that venture capitalists do not, such as a wide potential customer base (with higher margins after cutting out middlemen), viral marketing, Internet social networking, and “feedback and endorsements that build awareness and forward momentum.” Satorius & Pollard, supra note 29.
scrutiny of public companies, this Article's qualitative-mandates proposal suggests that crowdfunders should piggyback on professional venture capitalists' market-based protections included in typical start-up company investments. The proposal also implements the recommendation that "securities regulation needs to focus to a greater extent on the user of information.... It might be that we get more out of disclosure with less of it." Several possible mechanisms for protecting crowdfunders from venture-capitalist risks are proposed below: contractual provisions, disclosure tables targeted to venture-capital deal terms, and statutory rules and regulations.

A. Contractual Provisions

Virtually no sophisticated venture capitalist invests in start-up companies without certain fundamental protections present in preferred-stock contractual arrangements, such as anti-dilution provisions and tag-along rights. Crowdfunders, though, are unlikely to negotiate similar protections because of their weak bargaining positions (due in large part to collective-action problems) and lack of sophistication in start-up company investing. Therefore, in the interest of protecting investors and facilitating efficient contracting practices, legal rules could provide a starting point for crowdfunding investment contracts by encouraging the use of market-based investment templates that include standard venture-capitalist protections.

This approach would ensure that venture-capital deal terms and protections are present by default in crowdfunding-investment contract templates and would lower the cost for start-up companies to produce (or have lawyers draft) investment contracts. Also, it would

207. Id. at 485.
208. E.g., Bartlett, supra note 148, at 58–59 (observing that in a sample of 155 venture-backed companies between January 1, 2001, and December 31, 2004, 97 percent “issued preferred stock to their VC investors”); see also In re Appraisal of Metromedia Int’l Grp., Inc., 971 A.2d 893, 900 (Del. Ch. 2009) (“Unlike common stock, the value of preferred stock is determined solely from the contractual rights conferred upon it in the certificate of designation.”).
209. At least one senator is on record as favoring the use of template agreements by funding portals. 158 Cong. Rec. S2,231 (daily ed. Mar. 29, 2012) (statement of Sen. Michael Bennet) (“[F]unding portals should be allowed to engage in due diligence services. This would include providing templates and forms, which will enable issuers to comply with the underlying statute. In crafting this law, it was our intent to allow funding portals to provide such services.”).
210. Robert B. Ahidieh, The Strategy of Boilerplate, 104 Mich. L. Rev. 1033, 1038, 1051 (2006) (noting that “the heart of bargaining is not conflict but coordination” and “contract bargaining is fairly understood as a type of coordination game”). Crowdfunding companies and investors each have an interest in minimizing wrangling over contractual language, which will tend to lead each party to standard agreements that reduce novelty. See e.g., id. at 1034 (“Yet
allow crowdfunders to more easily compare the terms of investment contracts in different offerings—if an issuer modified a default template agreement, then the issuer could be required to post a redline version of the agreement on the funding portal so that all investors could view the changes. In addition, investors would need to learn only once where to look for key provisions, and funding portals could teach about the default template agreements in their required investor-education tests.211

Unlike venture capitalists that invest in start-up companies, it is unrealistic for each crowdfunding party to hire sophisticated counsel to negotiate a unique agreement. Crowdfunders are disaggregated, often unsophisticated investors who will likely struggle to coordinate effective negotiation strategies and generally lack the knowledge of what investor protections to demand. Therefore, legal rules should help compensate for crowdfunders’ deficiencies and level the playing field by framing the terms of default investment contracts in a way that protects crowdfunders.212

Template agreements can have a powerful effect on negotiations, as research on boilerplate contract terms,213 the endowment effect, starting points, and framing effects214 bears witness. Using the tools suggested by this research is especially appropriate where “default rules, framing effects, and starting points are enlisted in the interest of vulnerable third parties,”215 such as crowds of unsophisticated retail investors investing in start-up companies over the Internet. Of course, crowdfunding investors and companies would retain free choice to opt for alternative arrangements that vary from the baseline agreements.216 Thus,

standard terms would appear to be no less widespread in contracts among the sophisticated.”); Stephen J. Choi & G. Mitu Gulati, Contract as Statute, 104 Mich. L. Rev. 1129, 1130 (2006) (“Boilerplate contracts, however, are found in many markets where the relationship between the parties is not characterized by power imbalances. Instead, we find sophisticated parties on both sides . . . with their slight variations on the same set of boilerplate terms.”).


212. See Wallman, supra note 94, at 351–52.

213. Ahdieh, supra note 210, at 1051, 1054 (asserting that boilerplate terms offer “a ‘focal point’ to facilitate resolution of negotiations and shape “expectations of the likely behavior of other[s]”).

214. See generally Jolls et al., supra note 200, at 1497–99 (asserting behavioral economics has influenced the assignment of legal entitlements); Sunstein & Thaler, supra note 197, at 1171–81 (detailing the effects of paternalism in rules and default plans).

215. Sunstein & Thaler, supra note 197, at 1162; see also Jolls et al., supra note 200, at 1513 (“[T]he likelihood, from the perspective of behavioral law and economics, that observed laws reflect . . . fairness considerations as well as efficiency and conventional forms of rent seeking.”).

216. See Sunstein & Thaler, supra note 197, at 1159 (“[L]ibertarian paternalists should attempt to steer people’s choices in welfare-promoting directions without eliminating freedom of choice.”).
market dynamics would ultimately guide the parties to final contractual provisions within the framework of using templates that reflect standard venture-capital deal terms as a starting point.

Though companies and crowdfunders could theoretically bargain over contractual terms, in most cases companies will likely offer take-it-or-leave-it click-through agreements, following the norm of electronic commerce. Therefore, if crowdfunding laws and regulations require companies to post redline agreements that show changes from market-based templates, then even though crowdfunders will have limited ability to negotiate investment terms, they will be more likely to become aware of unfavorable provisions and can more easily compare the terms of different offerings. Ideally, this would result in a more competitive and transparent market among issuers of crowdfunded securities. And as issuers compete for investors, crowdfunders will likely obtain more favorable investor protections.

Available evidence on crowdfunding suggests the market will develop standard-form contracts whether or not legal rules influence the content of template agreements—ProFounder provided investment-contract templates before it shut down and crowdfunding sites that facilitate peer-to-peer lending use template loan agreements today. In view of this existing market dynamic, legal rules should guide crowdfunding companies and investors toward appropriate investor protections, patterned off of applicable


219. ProFounder Order, supra note 50, at 3.

economic terms venture capitalists routinely require, as the baseline default arrangement that frames crowdfunding contracting practices.221

B. Venture Capital–Deal-Terms Disclosure Table

Another way legal rules can help crowdfunders obtain necessary venture-capitalist protections is through an easy-to-read disclosure table222 that frames investment decisions around the horizontal and upside risks inherent in crowdfunding. The JOBS Act requires the Commission to promulgate crowdfunding disclosure rules,223 and instead of rules that lead to dense disclosure documents characteristic of other securities-law exemptions,224 the Commission should set the default rules in a way that facilitates venture-capitalist investor protections for crowdfunders.225

A disclosure table like the one described below would frame the terms of crowdfunding investment by graphically highlighting the investor protections the company is offering. The table would reflect the essential terms venture capitalists negotiate when investing in start-up companies, especially terms relating to the economic value of

221. The Commission could encourage the use of template agreements in a variety of ways. In a hands-on approach, the Commission could convene a working group of industry experts to create standard agreements (the Venture Capital Financing Model Legal Documents would be an easy place to start, and the Commission could also collaborate with the newly formed crowdfunding self-regulatory body). Model Legal Documents, NAT’L VENTURE CAP. ASS’N, http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136 (last visited Nov. 12, 2012). Or the Commission could defer to each funding portal to create its own template agreements, though one concern would be proliferation of different templates, making it more difficult for crowdfunders to learn the agreements and compare the terms of offerings on different portals.

222. Commentators and the Commission have focused on disclosure tables and other formatting questions for years. E.g., Paredes, supra note 113, at 476 (encouraging the Commission to use “more charts, graphs and tables” and noting the Commission’s increasing “sensitivity to formatting considerations”).


224. Though Heminway & Hoffman, supra note 8, at 938, do not provide specific implementing proposals, they agree in principle that dense disclosures should be avoided in crowdfunding investment: “Transparency—meaning not necessarily more disclosure, but more targeted, simple, easy-to-access disclosure—should support more effective transmission of information to the potentially inexperienced or less experienced Internet investors that are among those attracted to crowdfunding.” See also Verstein, supra note 16, at 524 (discussing the inadequacy of the Commission’s disclosure-based regulatory approach for the person-to-person lending model of crowdfunding, and lamenting securities law requirements of “thick prospectuses and lengthy, unnecessary disclosures” of complex risks).

225. The Act requires three types of disclosures: general disclosures for which funding portals are primarily responsible, company-specific business disclosures, and technical risk disclosures. The disclosure table discussed in this Article relates to the third type. For a broader discussion of crowdfunding disclosure requirements, see Promise Unfulfilled, supra note 78.
the investment, such as anti-dilution protections and tag-along rights. This streamlined approach to disclosure would force to the surface the fundamental issues related to investing in start-up companies, but which would likely not be top-of-mind for the average retail investor. A disclosure table would be cost-effective for companies to produce and useful to investors, especially unsophisticated ones, and would help crowdfunders decipher the meaning of more complex contractual language.

The disclosure table could be presented as follows, with the “Description” column modified to match the terms of each deal.226

<table>
<thead>
<tr>
<th>Term</th>
<th>Yes or No</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>Yes/No</td>
<td>Common stock does not have any of the protections in this table.</td>
</tr>
<tr>
<td>Preferred Stock</td>
<td>Yes/No</td>
<td>Preferred stock includes the protections in your investment contract, as summarized in this table.</td>
</tr>
<tr>
<td>Warrants</td>
<td>Yes/No</td>
<td>In addition to your preferred stock, you may exercise warrants to purchase common stock equal to 1 percent of the number of preferred shares you are purchasing. You would typically exercise warrants only in a qualified public offering.</td>
</tr>
<tr>
<td>Shares-Based Dilution</td>
<td>Yes/No</td>
<td>If our common stock splits or we issue common stock as a dividend, your preferred shares will adjust accordingly so that they convert into the same percentage of common shares.</td>
</tr>
</tbody>
</table>

226. For an overview of venture capital deal terms, see generally Ellen B. Corenswet & Sarah Reed, Introduction to Venture Capital Deal Terms, in VENTURE CAPITAL 2012: NUTS AND BOLTS 61 (2012).

227. Warrants are an example of an upside benefit (an equity “kicker”) that companies might use to attract investment. Including warrants in the disclosure table will help make companies and investors aware of them so the parties can include them if desired. See Bo Sartain, Commentary: The Impact of Warrants on Venture Capital Preferred Stock Financings, 40 TEX. J. BUS. L. 453, 456 (2005) (describing warrants as “the right, but not the obligation, to purchase” additional shares and noting that warrants are normally exercised “immediately prior to a liquidity event” and only if the exercise price is less than the sale price in the liquidity event). Thus, “the warrant is not . . . intended to minimize . . . down-side exposure, but is a reward . . . [of] more up-side return if the . . . company is successful”). Id.
<table>
<thead>
<tr>
<th>Term</th>
<th>Yes or No</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price-Based Dilution⁴²²⁸</td>
<td>Yes/No</td>
<td>If we sell stock to someone else (except if we issue common stock to our strategic partners, like employees) for a lower price per share than what you are paying, the number of shares that you own will increase following the weighted average formula in your investment contract.</td>
</tr>
<tr>
<td>Tag-Along Rights</td>
<td>Yes/No</td>
<td>If we (or other stockholders) sell stock in a qualified offering (e.g., not including common stock we issue to our strategic partners, like employees), you can choose to sell your shares in the same offering and at the same price.</td>
</tr>
<tr>
<td>Drag-Along Rights⁴²²⁹</td>
<td>Yes/No</td>
<td>If you own at least 50 percent of the outstanding shares of the company and you decide to sell your shares, you can force other stockholders to sell their shares, too.</td>
</tr>
<tr>
<td>Preemptive Rights</td>
<td>Yes/No</td>
<td>If we sell stock to someone else (except for issuing common stock to our strategic partners, like employees), you can buy shares in the same offering in order to keep your percentage ownership of the company the same, or in some cases even increase your percentage ownership.</td>
</tr>
<tr>
<td>Pay-to-Play⁴²³⁰</td>
<td>Yes/No</td>
<td>If you do not exercise your preemptive rights, you will lose your preemptive rights for any subsequent rounds of financing.</td>
</tr>
<tr>
<td>Cumulative Dividends</td>
<td>Yes/No</td>
<td>Your preferred stock will accrue a dividend of 5 percent per year and will be paid to you if the company pays dividends or is sold in a qualified sale.</td>
</tr>
</tbody>
</table>

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²²⁸. This is an example of where template agreements would complement the disclosure table. If there were template agreements to reference, the description column should also state: “The key term in the anti-dilution formula is ‘Outstanding Common Stock.’” Then, issuers should include whichever of the following three statements applied: “We have not changed the definition from the template agreement”; “We have broadened the definition from the template agreement, which decreases the effectiveness of the formula for you”; or, “We have narrowed the definition from the template agreement, which increases the effectiveness of the formula for you.” See Understanding Price-Based Antidilution Protection, supra note 169, at 40–42.

²²⁹. Rather than crowdfunders having drag-along rights, issuers or other (especially majority) investors might want to enforce drag-along rights against crowdfunders to lessen hold-out problems and drag crowdfunders into certain corporate transactions.

²³⁰. See supra note 196 for a brief discussion of other potential consequences of a pay-to-play provision.
<table>
<thead>
<tr>
<th>Term</th>
<th>Yes or No</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registration Rights</td>
<td>Yes/No</td>
<td>You can force us to sell your shares in a public offering if at least 50 percent of the stockholders vote in favor and either we have already had a qualified public offering or it has been more than five years since you purchased your shares.</td>
</tr>
<tr>
<td>Redemption Rights</td>
<td>Yes/No</td>
<td>If it has been more than five years since you purchased your shares, you can force us to buy your shares back from you at the same price you paid, plus interest at 5 percent per year.</td>
</tr>
<tr>
<td>Liquidation Preference</td>
<td>Yes/No</td>
<td>If we sell the company in a qualified sale, you will receive two times the amount of your investment before the common stockholders receive any proceeds from the sale. Then, you will receive additional proceeds from the sale on a pro rata basis with the common stockholders.</td>
</tr>
</tbody>
</table>

Though the table does not include the nuances of each venture-capital deal term, it is more understandable than a narrative description and is more cost-effective for small companies to prepare. Furthermore, prominent disclosure of venture capital protections could help foster a competitive market in which investors could easily compare the terms of different offerings, making it more likely that crowdfunding companies would compete with each other for investors based on venture capital deal terms, likely resulting in crowdfunders obtaining better protections. The terms in the disclosure table would also likely become a point of Internet dialogue among crowdfunding investors and companies, thereby framing the

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231. Instead of interest, cumulative dividends could be payable upon exercise of the redemption right.

232. Compare Heminway & Hoffman, supra note 8, at 938–39 (arguing for standardized disclosures as "a potential source of economic efficiencies that may help constrain costs . . . while also protecting investors"), with Bradford, supra note 8, at 143–44 (arguing against standardized disclosures because it could "discourage experimentation and freeze its [i.e., crowdfunding's] development").

233. The disclosure table could evolve to include a column labeled "incremental price per share," designed for investors to select, and pay for, the protections they want on an a la carte basis. See, e.g., Radin, supra, note 217, at 653–55 (referencing an a la carte market for variable extended warranties on cars, computers, and washing machines and proposing an online system of “[i]ncreased customization of transactions” where “a consumer could check a box to pay an extra amount for selected provisions, such as warranties and the right to a jury); Sunstein & Thaler, supra note 197, at 1175–76 (describing two states that set opposite default rules for car insurance and allowed drivers to select and pay for a la carte provisions, and concluding that “[i]n both cases, the default rule tended to stick”).
development of the Internet’s “wisdom of the crowd” around the venture-capital deal terms that are most important to crowdfunders.\textsuperscript{234}

Accessible, easy-to-read disclosures are more appropriate for crowdfunding investment than dense, prospectus-like disclosures, which unsophisticated investors often do not read or understand, were developed in a different context, and are expensive to draft. Unlike the era when detailed narrative disclosures became commonplace, today, information over the Internet is plentiful, communication is inexpensive, investments are made with the click of a button, a visual presentation is customary for web users, and a graphic interface is easy to implement.\textsuperscript{235} Crowdfunding investment is unique, and therefore the Commission should tailor disclosure requirements to crowdfunding’s specific characteristics and risks.\textsuperscript{236}

C. Congressional and Regulatory Action

Apart from contractual protections and targeted disclosure, Congress could amend the Act, or the Commission could define the scope of Rule 10b\textsuperscript{237} as applied to crowdfunding investment. This would not only provide crowdfunders with venture-capital protections against horizontal, upside risks but also bring predictability to potential crowdfunding liabilities. Such statutory or regulatory measures could come in any number of forms.

\textsuperscript{234} For discussions of the wisdom of the crowd in crowdfunding, see generally Bradford, supra note 8, at 134–36; John S. Wroldsen, The Crowdfund Act’s Strange Bedfellows: Democracy and Start-Up Company Investing (unpublished manuscript) (on file with author).

\textsuperscript{235} See, e.g., Heminway & Hoffman, supra note 8, at 933–37 (“[T]he Internet may over-inform and, as a result, obfuscate or bury important information . . . .”); Pope, supra note 8, at 983 (“Although twenty-first century investors have access to much more information available to the public through the internet, the Commission seems stuck in the early twentieth century, regulating based on an outdated assumption that investors have limited access to restricted information.”).

\textsuperscript{236} Other examples of easy-to-read disclosure tables include public company disclosures of executive compensation, see Executive Compensation Disclosure, 57 Fed. Reg. 48,126 (Oct. 16, 1992); 17 C.F.R. § 229.402 (2011), and credit-card interest rates and late fees, 12 C.F.R. § 226.5 (2011). Also, one commentator has proposed a standard disclosure table for home loans. Willis, supra note 118, at 712, 820 (criticizing “federal law governing home lending [because it] requires that borrowers be given an avalanche of disclosures, but has few substantive requirements for home loans,” and suggesting a disclosure table to simplify and standardize home loans in a way that makes “pricing easily observable” to facilitate “effective price shopping”).

\textsuperscript{237} Section 10(b) of the Exchange Act of 1934 authorizes the Commission to prescribe rules and regulations against “any manipulative or deceptive device” that is used “in connection with the purchase or sale of any security . . . as necessary or appropriate in the public interest or for the protection of investors.” Securities Exchange Act of 1934, 15 U.S.C. § 78j–2 (2006). Under this authority, the Commission has developed various rules, ranging from the generic Rule 10b-5, which addresses fraud in securities transactions generally, to more specific rules, such as Rule 10b-18, which provides a safe-harbor for issuer repurchases of stock.
For instance, Congress could prohibit dilution of the value of crowdfunders’ shares in subsequent financings, subject to specified exceptions, such as the opportunity to either purchase shares in the new financing (akin to preemptive rights) or sell shares to the new investors on substantially similar terms and conditions. Congress also could essentially codify tag-along rights, as other countries have done in other contexts,238 by requiring companies to give crowdfunders the opportunity to participate in qualified private sales or resale of the company’s securities. Another possibility would be for Congress to require a minimum, market-based return to crowdfunders, before other stockholders receive proceeds of a distribution, upon specified corporate events, such as a merger, sale, or liquidation of the company (akin to venture-capitalist liquidation preferences).239

The Commission, for its part, could amend Rule 10b to accomplish similar goals. For example, the Commission could clarify under what circumstances the dilution of crowdfunders’ ownership interests in subsequent financings, or exclusion of crowdfunders from corporate events (such as private sales or resale of the company’s securities), would be subject to Rule 10b liability. Such a rule, along with appropriate carve-outs and safe-harbors,240 would protect investors and bring predictability to how issuers and funding portals could be liable, or could avoid liability, in transactions involving or affecting crowdfunded securities.


239. “Venture capital preferred stock almost always is granted a ‘liquidation preference,’ that is, the right to receive proceeds from a merger, sale or liquidation of the company before any amounts may be paid to the holders of the common stock (which is typically held by founders and employees).” Warren, supra note 176, at 514–17 (“[A] dividend that has been declared on the preferred stock, but not yet paid, usually must be paid as part of a liquidation priority preference payment . . . [that] [o]ver time . . . can create a significant shift in value to the preferred stockholders.”). The points of negotiation revolve around the amount of the liquidation preference (e.g., equal to, or two times, the amount invested) and whether the preferred stockholders will, in addition to receiving the preferred distribution of proceeds, also share pro rata in the distribution of the remaining proceeds (i.e., participating or non-participating). Id.

240. For instance, tag-along rights might only be triggered if the sale or resale involved more than a certain percentage of the company’s securities. Also, standard carve-outs, such as issuance of shares to employees, should be included. A safe-harbor for avoiding liability under the rule could include disclosure requirements related to the impending corporate event and a specified waiting period for crowdfunders to elect whether to participate.
The statutory or rules-based approach could be more effective than the template contractual provisions and disclosure-table recommendations described above because framing effects, default rules, and starting points are vulnerable to circumvention: “When firms oppose nudges[, such as template agreements and disclosure tables], substantive regulation aimed directly at placing consumers in welfare-enhancing positions will certainly be more transparent, and is likely to be more effective and less costly as well.”241 Some issuers of crowdfunded securities will undoubtedly resist granting crowdfunding investors preferred protections. Thus, if crowdfunding investors lack sufficient market power to translate default template agreements or specially tailored disclosure tables into actual protections, then substantive regulation offers a potentially stronger and less malleable instrument for investor protection.

Regardless of the mechanism(s) used to help crowdfunders, the investor protections must not overreach and excessively impinge on a crowdfunded company’s operations or ability to raise subsequent rounds of financing from other investors, such as venture capitalists. The nature of crowdfunding, with its open invitation to hundreds or even thousands of ground-floor investors, is antithetical to a start-up company’s limited operational capacities. Therefore, wherever possible, investor protection measures should minimize burdens on small companies. For instance, and as additional research will explore further,242 funding portals could route companies’ ongoing investor communications to crowdfunders even after the closing of the initial financing (including communications that give crowdfunders a defined window of opportunity to exercise preferential rights, such as anti-dilution, tag-along, and preemptive rights). Also, designation of a crowdfunding-investor representative could help alleviate collective-action problems related to crowdfunders exercising preferential rights efficiently.


242. Another area the Author is developing explores early exit events for crowdfunders (such as pre-negotiated cash-out payments through stock buy-backs funded by subsequent venture capital investors). So long as crowdfunders receive reasonable and fair protections, an early exit event could benefit the crowdfunded company, the crowdfunding investors and the subsequent investors. The crowdfunding investors would receive an acceptable rate of return and an early liquidity event on their ground-floor investment, and the company and venture capitalists would be free of the potential burden of too many early-stage investors.
VI. CONCLUSION

The JOBS Act’s initiative to open start-up company investing to the masses through crowdfunding is an important democratic step toward modernizing securities laws to comport with contemporary Internet investment practices. But the shortcomings of the crowdfunding provisions of the Act, particularly the absence of venture capitalist protections, leave crowdfunding investors vulnerable even when they invest in successful start-up companies. Therefore, crowdfunding statutes and regulations should seek to protect crowdfunding investors from the horizontal risks of sophisticated venture capitalists without unduly burdening the developing market of crowdfunding investment.

Securities laws that establish the ground-rules for crowdfunding investment must not merely discourage fraud but should also help crowdfunders preserve and harvest the fruits of their investments in successful companies.\footnote{An interesting corollary is found in Ronald J. Gilson & Curtis J. Milhaupt, \textit{Economically Benevolent Dictators: Lessons for Developing Democracies}, 59 AM. J. COMP. L. 227, 232–33 (2011), where the authors analyze several “economically benevolent” autocracies and, like one “autocratic champion of transitions—the private equity investor,” find that an “economically benevolent autocracy is able to assure economic actors that pledges . . . to allow economic actors to keep the fruits of their investments will be honored.” For crowdfunding laws to be economically benevolent toward crowdfunding investors, they must honor the promise of crowdfunding and help crowdfunders keep the fruits of ground-floor investments in successful start-up companies.} Granting the masses access to start-up company investment opportunities previously reserved for sophisticated venture capitalists exposes retail investors to a potentially greater danger than fraud or failure: success. As Eduardo Saverin learned in \textit{The Social Network}, venture capitalists and their lawyers have developed intricate strategies for protecting the value of their investments. They know that failing to secure the value of their ground-floor investment in a start-up company that rises to great heights represents a greater potential loss of profits than the cost of a doomed investment in a fraudulent or failed venture.

Thus, crowdfunding statutes and regulations should facilitate the ability of crowdfunders to receive upside protection from the horizontal threats of venture capitalists, whether through contractual provisions, streamlined and targeted disclosure tables, or statutory or regulatory measures. Without upside protections characteristic of venture-capitalist agreements, crowdfunders, like Mr. Saverin, will be vulnerable to venture capitalists swooping in to reap the fruits of crowdfunders’ ground-floor investments in successful start-up companies.