INTRODUCTION

In recent years the question has arisen of whether the Internet can be used by entrepreneurs to facilitate the fund-raising process for innovators. There is no doubt that, as a technological matter, the Internet provides an alternative communications and promotion medium that can be used to reach potential investors. The challenge presented by the use of the Internet is not technological, but regulatory. Can the Internet be used in a way that is compatible with the requirements of the Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act (“Exchange Act”) of 1934? The answer provided by Congress in the Jumpstart Our Business Startups Act (“JOBS Act”), passed in April 2012, is that it can, but only subject to complex and extensive regulatory restrictions.1

Previously, I argued that the patent system not only creates incentives for innovation but also lowers transaction costs by making it easier for innovators to contract in relation to their innovation.2 Innovators need access to many different resources to turn their innovation into a commercial product. Whereas the earlier work applied a broad-brush, top-down approach, this Essay takes the opposite approach by looking at the legal and regulatory barriers that affect the innovator’s access to one vital resource: money. It is a common strategy for independent innovators to first patent their innovation, to transfer ownership of that patent to a corporation, and then to sell debt or equity securities issued by that corporation to investors. The stereotypical venture capital sequence is to sell first to angel investors and then, as progress is made toward commercialization, to venture capital funds and, eventually, to the public.

This process faces regulatory and technological challenges that could hinder innovation and generate uncertainty. Part I of this Essay provides a brief history of the important statutes governing securities regulation. Part II explores how the emergence of the Internet has affected the legal and regulatory landscape of securities law. Part III analyzes the congressional

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response to market innovation and the effect of regulation on investing through the Internet. This Essay concludes that recent legislation may create more uncertainty in the market for entrepreneurial investing, which will contribute to higher costs than necessary.

I. HISTORY OF THE SECURITIES ACTS

The Securities Act requires that anyone offering securities to the public must first prepare a registration statement, a complex disclosure document, with the Securities Exchange Commission (“SEC”) and make that statement available “under such regulations as the [SEC] may prescribe.” Putting information about an issue of securities up on a website is clearly such a solicitation, subject to this requirement. The Exchange Act requires that anyone acting as a broker must be registered under Section 15 of that Act. Any person who operates a website offering securities for sale on behalf of an issuer falls within the expansive definition of broker in the Exchange Act.

The Securities Act and Exchange Act, passed in the early 1930s as part of President Franklin D. Roosevelt’s New Deal, have traditionally been interpreted expansively. The expansive interpretations have been justified by a concern that if citizens are permitted to invest their money in a process that is not subject to the procedures dictated by the securities acts, citizens will invest unwisely, harming both themselves and the economy.

For instance, in a famous case that reached the Supreme Court in 1946, SEC v. W. J. Howey Co., the Court held that an offer to sell to ordinary investors small orange grove plots along with the option of a service contract to take care of the plot constituted a security which could only be legally sold in compliance with the requirements of the securities laws. The effect of the decision was to make it impractical for W. J. Howey Co., a small Florida company that owned orange groves and a resort hotel, to offer the plots for sale to the public. An offer became impractical because the securities acts required that a complex disclosure document called a registration statement be prepared and filed with the SEC. Doing so required the involvement of specialized accountants and lawyers and dealing with the SEC in Washington.

5 Section 3(a)(4) of the Act defines “broker” as “any person engaged in the business of effecting transactions in securities for the account of others.” Id. § 3(a)(4), 48 Stat. at 883 (codified as amended at 15 U.S.C. § 78c(a)(4)(A) (2012)). This definition includes employees of an issuer helping to sell its securities, in which case the issuer is the “other[].” Id.
6 328 U.S. 293 (1946).
7 Id. at 295, 299-301.
The SEC was never seriously criticized for using its resources to go far from Wall Street and the securities markets to prevent ordinary citizens from having the opportunity to commit some portion of their assets to the nourishment of orange trees and the production of oranges, thus supplying an important source of vitamin C to other citizens.

Securities regulation was imposed by Congress at a time when gambling was illegal at both the federal and state levels on the ground that it was bad for citizens and society. The argument that gambling is bad for citizens and society is easy to make—gambling is an unproductive activity that induces citizens to waste both their time and their financial resources. However, views on gambling have changed. Governments no longer attempt to prevent it by criminalizing it, but position themselves as virtual partners in order to profit from it. The consensus view now is that since citizens seem to enjoy it, and the industry is profitable, governments should take advantage of it to generate tax revenue.

If governments are now of the view that it is perfectly fine for citizens to choose to engage in gambling, does it make sense to try to prevent them from investing in orange groves and assuming the risk that their investment is an unprofitable one? Application of the securities acts needs to adapt to modern technologies and contemporary views.

II. EFFECT OF THE INTERNET ON SECURITIES REGULATION

The emergence of the Internet has had a large impact on securities regulation. Today, required disclosure documents are both filed and disseminated electronically through the EDGAR system. This disclosure requirement both reduces the cost of their production and filing and increases the ability of the public to access them. The Internet has also reduced the cost of commercial interactions and dramatically altered markets in which intermediary agents once played a dominant role—such as travel arrangements, retailing, taxi services, restaurant reservations, and securities transactions.

Investment bankers play a key role in connecting innovators with investors, helping innovators sell the securities issued by their corporations. For this service, they charge a fee based on the amount of money they help the innovator raise.

The Internet has facilitated and lowered the cost of this transaction through the concept of crowdsourcing. The most well-known and successful crowdsourcing site is Kickstarter. Kickstarter permits “filmmakers,
musicians, artists, and designers” to propose a project.\(^{10}\) The project “creator” solicits funds to enable him or her to carry out the project in exchange for a promise. For instance, a person seeking to write and produce a play might promise a ticket to attend the play, or a person seeking to design a really nifty wallet or bike light might promise one of the wallets or bike lights. Similar to an investment banker who finds investors for innovators, Kickstarter charges a fee based on the amount of money raised.

From its inception, Kickstarter took the prohibitions of the securities laws into account. Projects are not permitted to offer debt or equity, which are a security under the law.

The SEC could have taken the position that the items offered in association with Kickstarter projects are securities because they do not offer an asset, but a contract. Under the expansive definition of a “security” in the Howey case,\(^ {11}\) the SEC could have argued that these contracts are really debt contracts, payable not in dollars but with an asset. The contracts offered on Kickstarter present the same type of risks as security offerings. The person who hands over his or her money to the solicitor can lose it all. Do those subject to such solicitations need the same protection from their own foolishness that the government requires for those solicited to buy securities?

Many of the projects funded on Kickstarter raise substantial amounts of money. Take for instance a project fully funded last April for the production of a superior line of hoodies.\(^ {12}\) This project has raised over $1 million.\(^ {13}\) And the sponsors disclose that this is their second of four projects on Kickstarter, and they have sponsored thirty-eight other projects.\(^ {14}\) The regulators should not ignore Kickstarter on the ground that it is de minimus.

Kickstarter makes it clear that project sponsors are obligated to make a good faith effort to complete their funded projects.\(^ {15}\) If they are unable to do so, they are obligated to refund the money. It is difficult to believe that given the many Kickstarter-funded projects, there are not at least a few where the sponsor has not proceeded in good faith, or has not completed the project and has been unable or unwilling to refund. At this time, there are no reports of dissatisfied Kickstarter contributors nor is there a court case seek-

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\(^{11}\) Howey, 328 U.S. at 297.


\(^{13}\) Id.


ing to enforce the obligation of sponsors to perform. The SEC has docu-
mented only one Kickstarter project that has failed to perform.16

Many of the projects offered on Kickstarter look like they might be
better structured as securities offerings. Individuals are being asked to fund
a risky project that could be profitable. Why should they not be offered the
opportunity to share in that profit if the project is successful? The projects
offered on Kickstarter are attractive. Often including self-made videos, they
picture young, healthy, attractive people working to create a useful product
or an entertaining, amusing, or informative work. They are asking others to
make the project possible by providing needed funding. Is that not exactly
what we want everyone, and particularly our young people, to do? People
welcome the sense of involvement in these projects and are willing to take
risks for uncertain return, much as customers of farmer’s markets are will-
ing to pay more in exchange for the opportunity to be involved in an au-
thentic experience.17

III. CONGRESS AND CROWDFUNDING REGULATION

Offering securities to fund a venture over the Internet is colloquially
called “crowdfunding,” a term which some speakers are careful to distin-
guish from the term “crowdsourcing.” Congress has now used the term in
specific crowdfunding provisions in the JOBS Act. Title III of that statute
creates a special exemption from the requirements of the securities acts for
crowdfunding.18

The exemption is subject to important requirements, including com-
plex disclosure and filing provisions that are likely to require the services of
an expert in securities law. A few of the important qualifications are:

* The offering must be for less than $1 million during any twelve-
month period.

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16 Crowdfunding, 78 Fed Reg. 66,428, 66,430 n.20 (proposed Nov. 5, 2013) (to be codified at 17
C.F.R pts. 200, 227, 232, 239, 240 & 249). The project is Eyez, which promised glasses that would
record live video and which raised $300,000. Matt Krantz, Crowd-Funding Dark Side: Sometimes
money/markets/story/2012-08-14/crowd-funding-raising-money/57058678/1. As of April 9, 2014, the
Eyez project could still be accessed on Kickstarter and showed simple eyeglasses without any apparent
electronic additions. See ZionEyez Team, Eyez14 by ZionEyez HD Video Recording Glasses for Face-
recording-glasses-for?ref=search (last visited Apr. 9, 2014). Compare the pictures of Google Glass,
which offers similar functionality. See Glass, GOOGLE, www.google.com/glass/start/ (last visited Apr. 9,
2014).
17 And as perhaps the investors in the orange plots in the Howey case got satisfaction from having
an ownership interest in an actual orange grove.
* The website must be operated by a licensed securities broker or a registered funding portal.
* No buyer can purchase an amount in excess of 10 percent of his or her income or net worth.
* The SEC must issue regulations implementing the exemption.\textsuperscript{19}

Although the statute required the SEC to issue the implementing regulations within 270 days after the enactment of the statute, the SEC failed to meet that deadline.\textsuperscript{20} The SEC proposed regulations for comment on October 23, 2013, 559 days after the enactment of the statute.\textsuperscript{21} The proposing release makes it clear why the SEC did not meet the deadline. The release itself is 585 pages long, with the text of the proposed regulations representing ninety-seven of those pages. For the SEC, crowdfunding is very complicated. As the SEC makes clear in its release, the crowdfunding exemption is still not in effect.\textsuperscript{22} Crowdfunding in the United States is a criminal activity, and will be until the SEC issues the implementing regulations.

Much of the complexity of the crowdfunding regulation is attributable to Congress, which limited the exemption with many conditions. It did not provide that an issuer could simply put information about the securities on a website, subject only to a requirement that the information be truthful. Congress limited the exemption by tiered disclosure requirements and limitations on both the amount of securities a single issuer could sell and the amount of securities that could be sold under the crowdfunding exemption to a single investor.\textsuperscript{23}

Congress also provided that website operators could satisfy their obligation to register as brokers under Section 15 of the Exchange Act, by qualifying as a “funding portal.”\textsuperscript{24} However, it then imposed extensive requirements on funding portals. The newly proposed regulation on funding portals requires that they become members of the Financial Industry Regulatory Authority, something that few operators of websites will find it feasible to do.

\textsuperscript{21} See SEC Proposed Rules, supra note 20.
\textsuperscript{23} Jumpstart Our Business Startups Act § 302(a)-(b), 126 Stat. at 315-18 (codified at 15 U.S.C. §§ 77d(a)(6), 77d-1(a)-(b)).
\textsuperscript{24} Id. § 304(a)-(b), 126 Stat. at 321-22 (to be codified at 15 U.S.C. § 78c(a), (h)).
Lying behind the congressional and SEC ambivalence about crowdfunding is the political reality that the securities industry does not want to be subject to competition from a funding vehicle that is not subject to the same regulatory burdens. A nonspecialist user of the Internet, however, can reasonably believe that crowdfunding is desirable and legal, explicitly approved by Congress. For instance, the Wikipedia entry on crowdfunding (which uses the term to encompass both the Kickstarter-type website and a site offering securities) cheerfully reports that “[a]s of 2012, there were over 450 crowdfunding platforms.” The entry reports that there is an issue about securities regulation but would leave a lay reader confused about whether crowdfunding is legal or not.

So far, the SEC has neither acted to legalize crowdfunding nor acted to remove illegal websites from the Internet. It appears that there are large numbers of citizens who believe that crowdfunding is desirable and would be surprised to learn that it is criminal.

In fact, based on the reactions to be found on the Internet, there appear to be a large number of people who object to the SEC requirements. How have basic legal requirements that were once widely supported and stringently enforced lost the support of so many citizens? Perhaps it is in part a consequence of the fact that the requirements of the securities acts are mandatory rather than optional. Because the requirements are mandatory there is no group of citizens that has chosen to make use of the SEC requirements because they consider them desirable, and hence form a natural constituency to advocate for the importance of the SEC’s regulation.

What does this clash between the culture of securities regulation and the Internet culture portend for the future of innovation? Will “cyberspace” simply roll over the legal limitations of the securities laws much as it has rendered the protections of copyright ineffective? Many users of the Internet found it difficult to believe that it was illegal to copy a copyrighted song when it was so easy to do with a click of their mouse. In the same way, it is hard for many of the users of the Internet to believe that it is illegal for them to charge $200 to their credit card in order to provide capital to an attractive entrepreneur to support a project that appears interesting and attractive. It strikes them as particularly odd that it is perfectly legal for them to do this if their return is in the form of a promised (but not yet existing) bike light,

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but illegal if it is in the form of an equity share of or debt claim on the business.

CONCLUSION

The sharp clash between the culture of securities regulation and Internet culture portends continuing instability in the law. Despite the early enthusiasm for the JOBS Act exhibited on the Web, Congress has not legalized the straightforward and simple process of capital-raising illustrated by the crowdsourcing websites. It seems likely that this struggle will continue for a long time. The SEC is a powerful agency with a budget in excess of a billion dollars a year and a deep commitment to the need to protect citizens from their own folly.

The securities laws and other laws that govern the investing process should provide stability so that innovators, intermediaries, and investors all know the rules. Stability is difficult to provide when key provisions of the law of securities regulation are contested. The conflict between the ease and simplicity of crowdfunding and an SEC steeped in a paternalistic regulatory culture may continue for years. This instability will not be good for independent innovation because it will complicate the access of innovators to capital, raising their costs. The SEC needs to provide certainty in the marketplace so that innovators and entrepreneurs alike may raise capital efficiently and legally.