

Send in the Crowds

The SEC should enable crowdfunding to help kick-start enterprises, and allow regulators and the markets to sort out procedures.

Charles Ponzi conned investors out of millions of dollars through false promises of outsized returns on their investments in his international postage stamp scheme. He allegedly owed \$7 million when he was prosecuted in 1920 — a sizable fortune at the time.

Ponzi's colossal scam was not the first of its kind, but it earned him titling rights to "Robbing from Peter to pay Paul" and forever linked his name to fraud. Notable recent examples of similar behavior include the reported scams of \$18 billion for Bernie Madoff, \$7 billion for Allen Stanford, and \$3.7 billion for Tom Petters. All three men have been charged and are serving long sentences in federal prison.

Ponzi was convicted numerous times under existing laws for defrauding victims in financial scams, but the stock market crash in 1929 and the Great Depression led Congress to adopt very strong investor-protection legislation in 1933.

The Securities Act was designed to ensure investors would receive fair treatment by requiring full and fair disclosure of the merits and risks of an investment, and by prohibiting fraud in their sale.

The Securities Act also requires registration of public offerings with the Securities Exchange Commission (and with state regulators), and provides for substantive review of prospectuses. The registration requirement does not apply to private or limited offerings where investors have financial wherewithal and investment experience — factors believed to provide these investors with bargaining power to reduce the incidence of fraud.

For the past 80 years, numerous critics have railed against the restrictive regulations employed under state and federal law to protect investors. The complaint is that by mandating safeguards such as registration of public offerings, the regulations stifle capital formation and slow development of new and growing businesses. Legislators often have picked up on this criticism, particularly in weak or stagnant economies.

More than a year has passed since the enactment of the JOBS (Jumpstart Our Business Startups) Act and its provisions, which facilitate certain crowdfunding offerings. The act sets a \$1 million plateau and limits the amount that can be invested by any one person. However, the offerings are to be conducted by registered "funding portals" — essentially websites where companies can post offerings and the general public is able to invest.

As they await possible regulations from the

SEC, entrepreneurs and others interested in crowdfunding have not sat idle. Operators have proliferated more than 8,000 websites constructed to host crowdfunding offerings once the SEC issues its final rules. Entrepreneurs, meanwhile, have initiated a few interesting financing models — some with active crowdfunding-like activities that take advantage of current securities law registration exemptions.

During this regulatory waiting period, there has been significant confusion about crowdfunding in the media and in casual conversation among interested persons. One source of confusion is the proliferation of activities where resources (including cash) are broadly "crowd-sourced" from a community of persons interested in an artistic, religious, or other social project in exchange for a right to participate in an event or other privileges, such as first rights to purchase or receive a product.

Since many of these sourcing transactions are lawfully conducted on the Internet, observers may not understand the distinction under the law of raising capital in exchange for participation in the future financial prospects of a business. Sites like *Kickstarter*, *Crowdfunder*, and others may be raising money for projects, but they are not facilitating the sale of securities to do so.

The human and financial capital invested in this effort has produced little in the way of job creation and less in "jump-started" businesses. The

Operators have proliferated more than 8,000 websites constructed to host crowdfunding offerings once the SEC issues its final rules.

reality of today's capital markets is that it is very difficult and inefficient to raise the small amounts of capital that many startup and fledgling businesses need to get traction. However, statistics show that it is exactly these types of businesses that generate the bulk of new jobs and wealth.

The concerns of state and federal regulators over the prospect of increased fraud in connection with unregistered public offerings on the Internet are legitimate. Notwithstanding this concern, the SEC should issue reasonable regulations to put Congress's intent into effect, while state and federal regulators and the Financial Industry Regulatory Authority should be vigilant in policing activities to prevent and prosecute fraud.

While there may be an increased number of scams initially, the markets and regulatory oversight will create a normative offering process with minimal incidences of fraud.

Once we reach that norm, we should see a simpler, less expensive means of funding small, developing businesses. We can then evaluate the successes and failures of Congress's grand "experiment" and react appropriately with necessary revisions. *db*



PETER SUGAR is a partner at the law firm of *Jaffe Raitt Heuer & Weiss* in Southfield who specializes in securities regulation, corporate finance, and mergers and acquisitions. He is also an adjunct professor at Wayne State University Law School in Detroit.