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Protecting the Crowd Through Escrow: Three Ways that the SEC Can Protect Crowdfunding Investors

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*Uriel S. Carni**

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INTRODUCTION

The early twenty-first century has spawned the development and growth of crowdfunding, a process in which entrepreneurs raise capital from the general public over the Internet.¹ Certain crowdfunding campaigns, however, constitute securities offerings, triggering burdensome disclosure requirements under the Securities Act of 1933 (the “Securities Act”).² Namely, crowdfunding campaigns that offer investors equity interests must have a registration statement filed with the Securities and Exchange Commission (the “SEC”).³ Filing a registration statement, however, is typically impractical for startup companies and small businesses due to the disproportionately high cost, the potential for criminal and civil liability, and the potential to miss critical market windows due to the lengthy filing process.⁴

In an effort to raise the economy from the Great Recession, Congress passed the Jumpstart Our Business Startups Act (the “JOBS Act”) in 2012, creating an exemption for certain crowdfunding campaigns to offer and sell securities without filing a registration statement with the SEC.⁵ Critics have denounced the crowdfunding exemption in the JOBS Act, primarily focusing on the potential for securities fraud on the Internet, as well as the inability of investors to properly evaluate a company online.⁶ The JOBS Act tasks the SEC with alleviating these concerns through regulatory rules, which must implement adequate measures to protect investors. In November 2013,

1. *See infra* Part I.A.
 2. *See infra* Part I.C.–D.
 3. *See id.*
 4. *See infra* Part I.D.2.
 5. *See infra* Part II.A.
 6. *See infra* Part II.B.

the SEC proposed rules to regulate crowdfunding under the JOBS Act.⁷ The SEC's proposal then underwent a period of initial public notice and comment, which concluded on February 3, 2013. At the time of this paper's publication, the proposal awaits further SEC review in light of the public comments posted.⁸

This Comment suggests that the SEC's proposed rules require crowdfunding entrepreneurs to utilize escrow accounts to adequately protect crowdfunding investors.⁹ The SEC's current proposal does introduce some use of escrow to this effect, but this Comment argues for a much more extensive use.¹⁰ Specifically, this Comment argues that the SEC should require crowdfunding campaign managers to (1) place capital contributions into escrow and release them directly to the parties responsible for the development or expansion of the business, rather than the issuer; (2) maintain capital contributions that exceed a crowdfunding campaign's target offering in escrow, to be paid to investors if and when the business fails; and (3) wait one year and offer to buy out investors before expending capital contributions that exceed a target offering.¹¹

I. CROWDFUNDING & THE SECURITIES LAWS

Part I.A. of this Comment explores the mechanics of crowdfunding, its unique capacity for raising capital, and its other benefits to startup companies and small businesses. Part I.B. outlines the four models of crowdfunding. Part I.C. sets forth the classification of crowdfunding campaigns under the securities laws, describing the way in which crowdfunding campaigns may constitute "securities" offerings. Part I.D. describes the constraint that the securities laws place on such offerings. Part I.D.1. illustrates this constraint by looking to a campaign that sought to crowdfund a beer company before the SEC shut it down for failing to file a registration statement. Part I.D.2. describes the reasons that SEC registration is nonetheless impractical for small businesses and startup companies, which might otherwise benefit from selling securities through crowdfunding campaigns.

7. *See infra* Part II.A.

8. *See id.*

9. *See infra* Part III.

10. *See id.*

11. *See infra* Part III.B.

A. WHAT IS CROWDFUNDING?

Crowdfunding is a form of microfinance in which a large “crowd” of small investors pools together funds in order to provide the necessary capital for the development of a startup company or the expansion of a small business.¹² Crowdfunding campaigns are primarily conducted over the Internet, through dedicated crowdfunding-platform websites called “portals.”¹³ Through crowdfunding portals, the general public gains the capacity to fully fund a commercial project or social cause.¹⁴ Crowdfunding thus provides an unprecedented source of capital to startup companies and small businesses, which otherwise face difficulty obtaining capital investments from traditional lenders due to their heightened risk or uniqueness.¹⁵ Crowdfunding disperses the risks associated with investing in startup companies and small businesses amongst a large crowd of small investors, providing entrepreneurs with large sums of capital without requiring any individual investor to bear a large capital risk.¹⁶

Recent statistics demonstrate both the fundraising capacity and rapid growth of crowdfunding in recent years.¹⁷ In 2010, companies and individuals raised \$890 million through crowdfunding portals.¹⁸ In 2011, the number jumped 64% to \$1.47 billion.¹⁹ In 2012, the number spiked another 81% to \$2.66 billion.²⁰ In 2013, crowdfunding portals are projected to facilitate \$5.1 billion in fundraising, a 91.7% increase over the prior year.²¹

In one of 2012’s standout crowdfunding campaigns, Pebble Technology raised over \$10 million through Kickstarter, a North

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

13. *Id.* at 40.

14. Tanya Prive, *What Is Crowdfunding and How Does It Benefit the Economy*, FORBES (Nov. 27, 2012), <http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy/>.

15. Sumners, *supra* note 12, at 38.

16. *Id.*

17. See generally Kylie Maclellan, *Global Crowdfunding Volumes Rise 81 Percent in 2012*, REUTERS (Apr. 8, 2013), <http://www.reuters.com/article/2013/04/08/us-crowdfunding-data-idUSBRE9370QY20130408>.

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

American crowdfunding portal, to finance the development of the “Pebble” smartwatch.²² Pebble Technology’s founder, Eric Migicovsky, had already worked on a successful smartwatch that is compatible with the Blackberry, and then wanted to develop the Pebble for use with the iPhone and Android.²³ Despite his prior success, Migicovsky failed to secure funding from venture capitalists or angel investors, so he turned to Kickstarter to raise funds from the crowd.²⁴ Migicovsky began the Pebble’s Kickstarter campaign with a \$100,000 target,²⁵ which he planned to reach by selling pre-orders of the Pebble for \$115, at a \$35 discount off the retail price of \$150.²⁶ Migicovsky’s Kickstarter campaign also offered the Pebble in colors other than black for \$125, as well as a two-for-\$220 deal.²⁷

The Pebble’s Kickstarter campaign reached its \$100,000 target within its first *two hours*.²⁸ Only twelve hours into the campaign, Migicovsky had raised over \$500,000,²⁹ and by the end of day three, Migicovsky had raised \$2,656,389 from 18,867 people.³⁰ By the time the Kickstarter campaign finally concluded after ninety days, Migicovsky had pre-sold 85,000 Pebble smartwatches, raising \$10,266,845 from a crowd of 68,929 people.³¹ As of November 6, 2013,

22. *Id.*

23. Deborah Netburn, *Pebble Smartwatch Raises \$4.7 million On Kickstarter FundingSite*, L.A. TIMES (Apr. 18, 2012), <http://articles.latimes.com/2012/apr/18/business/la-fi-tn-pebble-smart-watch-kickstarter-20120418>.

24. *Id.*

25. Maclellan, *supra* note 17, at 1.

26. Netburn, *supra* note 23, at 1–2.

27. *Id.*

28. *Id.*

29. Gillian Shaw, *Vancouver-Born Entrepreneur’s Pebble Smartphone Breaks Kickstarter Record*, THE VANCOUVER SUN (Apr. 16, 2012), <http://blogs.vancouversun.com/2012/04/16/vancouver-born-entrepreneurs-pebble-smartphone-breaks-kickstarter-record/>.

30. Anthony Wing Kosner, *Pebble Watch for iPhone and Android, The Most Successful Kickstarter Project Ever*, FORBES (Apr. 15, 2012), <http://www.forbes.com/sites/anthonykosner/2012/04/15/pebble-watch-for-iphone-and-android-the-most-successful-kickstarter-project-ever/>.

31. Pebble Technology, *Pebble: E-Paper Watch for iPhone and Android*, KICKSTARTER, <http://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android> (last visited Dec. 10, 2013) (Pebble technologies has “gone from a tiny, 11-person outfit trying to deliver promised smartwatches to its Kickstarter backers to a growing 40-person business looking to cement its role as a serious player in wearable technology”).

Pebble Technologies has sold 190,000 Pebble smartwatches and nearly quadrupled its staff.³²

In addition to its fundraising capacity, crowdfunding also offers startup companies and small businesses a number of other benefits.³³ Notably, crowdfunding allows entrepreneurs to hedge risk by gaining market validation and avoiding equity sales before fully bringing a product to the market.³⁴ Additionally, crowdfunding campaigns are powerful marketing tools.³⁵ They have online profiles that may introduce a venture's mission and vision, and drive referral traffic through social media mechanisms incorporated within crowdfunding portal sites.³⁶ Crowdfunding campaigns also provide entrepreneurs with comments, feedback, and ideas from the crowd.³⁷ Thus, crowdfunding not only provides entrepreneurs with capital, but also helps prepare them to meet the demands of the market awaiting them.³⁸

B. THE FOUR MODELS OF CROWDFUNDING

Four basic models of crowdfunding have emerged: (i) the donation model, (ii) the reward model, (iii) the pre-purchase model, and (iv) the equity model.³⁹ Under the donation model, individuals give capital to a startup company, small business, or charity with no expectation of repayment in any form.⁴⁰ Under the reward model, investors make capital contributions in return for a reward, which may include any commodity, service, or even mere recognition.⁴¹ Under the pre-purchase model, investors make capital contributions in return for a product that is under development, to be received if and when the startup company developing the product successfully launches. If the project fails

32. Ina Fried, *With 190,000 Smartwatches Sold, Pebble Boosts iPhone Support*, ALL THINGS D (Nov. 6, 2013), <http://allthingsd.com/20131106/with-190000-smartwatches-sold-pebble-boosts-iphone-support/>.

33. See Tanya Prive, *Top 10 Benefits of Crowdfunding*, FORBES (Oct. 12, 2012), <http://www.forbes.com/sites/tanyaprive/2012/10/12/top-10-benefits-of-crowdfunding-2/>.

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.*

38. *See id.*

39. Sumners, *supra* note 12, at 40.

40. *Id.*

41. *Id.*

though, these investors do not receive the product and might even lose their investment.⁴² Finally, the equity model of crowdfunding (“equity-based crowdfunding”) gives investors actual equity ownership in a company in exchange for their capital contributions.⁴³

Of the \$2.7 billion in capital that was raised through crowdfunding portals in 2012, equity-based crowdfunding accounted for only \$116 million.⁴⁴ Lending sites that sell debt⁴⁵ accounted for \$1.2 billion, and the remaining \$1.4 billion went toward ventures offering non-financial rewards or collecting donations.⁴⁶ Equity-based crowdfunding is expected to increase once the SEC adopts rules that enable it under appropriate regulation.⁴⁷

C. CROWDFUNDING UNDER THE SECURITIES ACT

Equity-based crowdfunding has thus far been trailing behind other models of crowdfunding,⁴⁸ but this is because securities laws have essentially precluded this model.⁴⁹ The Securities Act mandates that any entity that sells or offers to sell or purchase a security across state lines must file a registration statement with the SEC.⁵⁰ Accordingly, the offer or sale of a security through a crowdfunding portal must be “registered” with the SEC, absent an applicable exemption from the Securities Act’s registration requirement.⁵¹ Filing a registration statement, however, is typically impractical for small business ventures.⁵² Therefore, startup

42. *Id.*

43. *Id.*

44. Maclellan, *supra* note 17.

45. Debt-based crowdfunding, which may also constitute a securities offering, is beyond the scope of this Comment.

46. *Id.*

47. *Id.*

48. *See id.*

49. Summers, *supra* note 12, at 42–43. The JOBS Act amends securities laws to facilitate crowdfunding. This topic is discussed in the following section. *See infra* Part II.C.1.

50. 15 U.S.C. § 77e (2012).

51. Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 907 (2011). A comprehensive review of the various exemptions set forth under the Securities Act is beyond the scope of this Comment.

52. *See id.* at 910.

companies and small businesses that wish to offer securities through crowdfunding portals have been hindered by the Securities Act.⁵³

1. Equity-Based Crowdfunding Campaigns as “Securities” Offerings

As a threshold matter, equity-based crowdfunding campaigns are subject to the Securities Act’s registration requirement because they constitute interstate offers and sales of “securities.”⁵⁴ The Securities Act specifically defines a “security” to include numerous financial instruments, including an “investment contract.”⁵⁵ In *SEC v. Howey*, the Supreme Court interpreted an “investment contract” under the Securities Act to include any (i) investment of money, (ii) with an expectation of profit, (iii) in a common enterprise, (iv) predominantly dependent upon the efforts of others.⁵⁶

In *SEC v. Howey*, W.J. Howey Co. sold investors real property interests in Florida orange groves, as well as service contracts for the cultivation and development of the groves,⁵⁷ in exchange for a share in the groves’ profits.⁵⁸ The Supreme Court held that W.J. Howey Co. was not merely offering and selling land contracts together with service contracts.⁵⁹ Rather, the company was offering the opportunity to (i) invest money by purchasing land and service contracts, (ii) in a common enterprise of orange grove cultivation and development, where investors notably did not have physical access to their individual plots within the orange groves, (iii) with an expectation of profit for the investors, to be collected from the shared profits of the orange groves, (iv) that predominantly depended upon the efforts of other (i.e., the groves’ cultivators and developers who were parties to the service contracts).⁶⁰ Accordingly, W.J. Howey Co. was offering securities in the form of

53. *See id.*

54. *Id.* at 904 (“[I]t is probable that a court would find that crowdfunding interests that include a financial return are investment contracts.”); *see also* 15 U.S.C. § 77b (classifying “investment contracts” as a form of “securities” under the Securities Act); *see also* *SEC v. W. J. Howey Co.*, 328 U.S. 293, 300–01 (1946) (defining “investment contracts” under the Securities Act).

55. 15 U.S.C. § 77b(a)(1).

56. *Howey*, 328 U.S. at 300–01.

57. *Id.* at 295–96.

58. *Id.* at 299.

59. *Id.* at 299–300.

60. *Id.*

“investment contracts” under the Securities Act.⁶¹ The Supreme Court, therefore, held that W.J. Howey Co. had violated the Securities Act by offering and selling securities without filing an accompanying registration statement with the SEC.⁶²

SEC v. Howey thus sets forth four criteria for an investment contract,⁶³ and the application of this standard to equity-based crowdfunding campaigns is mostly straightforward.⁶⁴ Investments in equity-based crowdfunding campaigns involve an (i) investment of money—the purchase of equity,⁶⁵ with (ii) an expectation of profit—the expected increase in the value of the purchased equity⁶⁶ that (iii) predominantly depends upon the efforts of others—the members of the operating entity in which the equity is held.⁶⁷ The common enterprise criterion for an investment contract security, as interpreted by *SEC v. Howey*, however, warrants closer scrutiny.⁶⁸

The Supreme Court has not defined a “common enterprise,” but federal appellate courts have adopted three distinct standards for the commonality of an enterprise.⁶⁹ The narrowest standard requires “horizontal commonality,” the gathering of investors’ assets in one common investment fund.⁷⁰ Legal scholars disagree whether such horizontal commonality was actually present in *SEC v. Howey*.⁷¹ The predominant view is that horizontal commonality was indeed present, even though investors purchased distinct land contracts, because the “profit-generating scheme” relied upon these contracts in the aggregate.⁷² In other words, the success of an investment depended upon the success of the entire grove, rather than an individual tract of land.⁷³ A minority view exists among scholars, however, that horizontal commonality was absent in *SEC v. Howey* because investors purchased distinct tracts of land, and this distinction simply fails to constitute a

61. *Id.*

62. *Id.* at 300–01.

63. *Id.*

64. Heminway & Hoffman, *supra* note 51, at 901–04.

65. *Id.* at 901.

66. *Id.* at 902–03.

67. *Id.* at 903–04.

68. *See generally id.* at 901–02.

69. *See id.* at 887.

70. *See, e.g.,* Schofield v. First Commodity Corp. of Boston, 638 F. Supp. 4, 7 (D. Mass. 1985) *aff’d*, 793 F.2d 28 (1st Cir. 1986).

71. Heminway & Hoffman, *supra* note 51, at 887, n.37.

72. *Id.*

73. *See id.*

common pooling of assets in a single investment fund.⁷⁴ Under this view, the fact that the success of the venture depended upon the tracts in the aggregate is simply insufficient to render the venture a common enterprise.⁷⁵

The Ninth Circuit applies a less restrictive standard, requiring “strict vertical commonality” to constitute a common enterprise.⁷⁶ Strict vertical commonality requires the success of an investment in an operating entity to be proportionate to the success of the entity itself; the gain or loss incurred by the investor must be proportionate to the gain or loss incurred by the operating entity.⁷⁷ However, the Ninth Circuit is the only Circuit to adopt this standard.⁷⁸ Other Circuits apply a third, less restrictive standard, requiring “broad vertical commonality” to constitute a common enterprise.⁷⁹ This highly flexible standard requires the gain or loss incurred by an investor in an operating entity to be dependent upon the *efforts* of the operating entity.⁸⁰ The gain or loss of investors need not be proportionate to a gain or loss of the operating entity, however, and thus the operating entity need not share in the gain or loss of investors whatsoever.⁸¹

74. See *id.* (citing James D. Gordon III, *Defining A Common Enterprise in Investment Contracts*, 72 OHIO ST. L.J. 59, 73 (2011)).

75. See *id.*

76. See *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482, n.7 (9th Cir. 1973) (“A common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties.”); see also *Heminway & Hoffman*, *supra* note 51, at 888 (noting that the standard adopted by the Ninth Circuit has been coined “strict vertical commonality”).

77. See *Glenn W. Turner Enters.*, 474 F.2d at 482 n.7; see also *Heminway & Hoffman*, *supra* note 51, at 888 (“[S]trict vertical commonality requires a link between investment performance and promoter remuneration.”).

78. Christopher L. Borsani, *A “Common” Problem: Examining the Need for Common Ground in the “Common Enterprise” Element of the Howey Test*, 10 DUQ. BUS. L.J. 1, 10 (2008).

79. See *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974) (creating the broad vertical commonality standard); see also *SEC v. ETS Payphones, Inc.* 408 F.3d 727, 732 (11th Cir. 2005) (adopting the broad commonality standard).

80. *ETS Payphones*, 408 F.3d at 732 (“[T]he requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy of the [operating entity].”).

81. See *id.*

Investments in equity-based crowdfunding campaigns typically satisfy each of the three judicial standards for a common enterprise.⁸² Horizontal commonality is always satisfied because the pooling of funds is the “essence” of any crowdfunding campaign, equity-based or otherwise.⁸³ The success of investors in a crowdfunding campaign depends upon the collective contributions of all investors in the campaign, rather than any individual participant, satisfying the liberal, majority-view of horizontal commonality.⁸⁴ Even the stricter minority-view of horizontal commonality is satisfied because all investors in a crowdfunding campaign contribute capital to one common fund.⁸⁵

Additionally, strict vertical commonality is generally satisfied in equity-based crowdfunding campaigns because the success of investors is generally proportionate to the success of the operating entity, insofar as increases or decreases in the value of equity sold to investors are proportionate to increases or decreases in the value of the equity held by the entity.⁸⁶ If the operating entity does not own any of its own equity though, then strict vertical commonality will in fact be absent in this scenario because investors may incur a gain or loss while the entity does not.⁸⁷ Finally, broad vertical commonality is satisfied in equity-based crowdfunding campaigns because the success of investors depends upon the efforts of the operating entity.⁸⁸ Therefore, equity-based crowdfunding campaigns will almost always constitute common enterprises, in addition to satisfying each of *SEC v. Howey*’s other criteria for securities in the form of “investment contracts.”⁸⁹

D. HOW SEC REGISTRATION CONSTRAINS EQUITY-BASED CROWDFUNDING

Insofar as equity-based crowdfunding campaigns constitute sales and offers of investment contract “securities” under *SEC v. Howey*,⁹⁰ the additional fact that crowdfunding campaigns are conducted over the Internet (i.e., across state lines) subjects them to the Securities Act’s

82. Heminway & Hoffman, *supra* note 51, at 901–02.

83. *See id.* at 901.

84. *See id.*

85. *See id.*

86. *See id.*

87. *See id.* at 901–02.

88. *See id.* at 901.

89. *Id.* at 902–03.

90. *Id.*; *see also* *SEC v. W.J. Howey Co.*, 328 U.S. 293, 300–01 (1946).

registration requirement.⁹¹ A recent example demonstrates that the Securities Act may thus apply to equity-based crowdfunding campaigns.⁹² In November of 2009, advertising executives Michael Migliozi II and Brian William Flatow began a crowdfunding campaign on their own portal website, BuyaBeerCompany.com, seeking to raise \$300 million in order to purchase Pabst Brewing Company (“PBR”).⁹³ The campaign offered investors a “crowdsourced certificate of ownership” and the value of their investment in beer.⁹⁴

1. The Campaign to Crowdfund Pabst Brewing Company

At the time, PBR was owned by a private charitable trust, which had been seeking a buyer for the company.⁹⁵ However, the attorney representing Migliozi and Flatow stated that the two were merely conducting an experiment.⁹⁶ Nonetheless, the campaign raised \$14.75 million during its first three weeks, and on February 22, 2010, Migliozi and Flatow issued a press release announcing that BuyaBeerCompany.com had received over \$200 million in pledges from over five million investors.⁹⁷ On March 15, 2010, an article in *The Daily Deal* announced that Migliozi and Flatow had retained an attorney, planned to incorporate Buy a Beer Company LLC, and intended to issue investors stock in the corporation instead of a certificate of ownership.⁹⁸ The SEC shut down BuyaBeerCompany.com for selling securities without filing a registration statement with the SEC, violating Section 5 of the Securities Act.⁹⁹ Migliozi and Flatow

91. 15 U.S.C. § 77e (2012).

92. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 6 (2012).

93. Migliozi, Securities Act Release No. 9216 (June 8, 2011), available at 2011 WL 2246317, 1 [hereinafter Migliozi, Cease-and-Desist Order] (Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order).

94. *Id.* at 2.

95. *Id.*

96. Bradford, *supra* note 92, at 6.

97. Migliozi, Cease-and-Desist Order, *supra* note 93, at 2.

98. *Id.*

99. *Id.* at 3; 15 U.S.C. § 77e (2012) (criminalizing the offer or sale of securities without filing a registration statement, as well as creating a private cause of action).

entered into a settlement agreement with the SEC, avoiding further penalties.¹⁰⁰

Similarly, under *SEC v. Howey*, the Securities Act requires all equity-based crowdfunding campaigns to file registration statements with the SEC, absent an applicable exemption.¹⁰¹ Filing a registration statement is typically impractical for startup companies and small businesses—the ventures that stand to benefit most from equity-based crowdfunding.¹⁰² This impracticality is due to (i) the disproportionately high cost of drafting and filing a registration statement; (ii) the exposure to criminal and civil liability that accompanies filing a registration statement; and (iii) the opportunity costs borne by the lengthy process of filing a registration statement.¹⁰³

2. *The Cost, Liability, and Operating Risk Associated with SEC Registration*

First, the costs associated with drafting and filing a registration statement include: (i) underwriter fees; (ii) SEC filing fees; (iii) legal fees; (iv) accounting fees; (v) printing and engraving costs; (vi) a Financial Industry Regulatory Authority filing fee; (vii) electronic filing fees, if applicable; and (viii) transfer agent and registrar fees, if a third party handles the issuer's stock records.¹⁰⁴ Completing a registration statement for a *small* business therefore costs over \$100,000 in third party services alone, in addition to valuable time expended by senior management in preparing a registration statement and marketing an offering.¹⁰⁵ The cost of drafting and filing a registration statement is thus disproportionately high relative to the total yield of an offering of securities to the public (a “public offering”) by a small business.¹⁰⁶

Second, filing a registration statement and engaging in a public offering expose an issuer to a wide range of both civil and criminal liability.¹⁰⁷ Under Section 11 of the Securities Act, an issuer is civilly liable to investors if the issuer's registration statement contains a false

100. Migliozi, Cease-and-Desist Order, *supra* note 93, at 3.

101. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 300–01 (1946).

102. Heminway & Hoffman, *supra* note 51, at 910.

103. *Id.* at 907–10.

104. *Id.* at 908.

105. *Id.* at 909.

106. *Id.* at 910.

107. *Id.* at 908–09.

statement of material fact or is materially misleading.¹⁰⁸ Under Section 12(a)(2) of the Securities Act, an issuer is civilly liable to investors if the prospectus in the issuer's registration statement, or an oral communication regarding an offering, asserts a false statement of material fact or is materially misleading.¹⁰⁹ Under Section 12(a)(1) of the Securities Act, an issuer is civilly liable to investors if the issuer offers or sells securities without filing a registration statement altogether,¹¹⁰ as well as criminally liable under Section 5 of the Securities Act.¹¹¹ Under Section 17(a) of the Securities Act, an issuer is also subject to SEC enforcement if the issuer engages in any fraudulent conduct relating to an offer or sale of securities, irrespective of the existence or contents of a registration statement.¹¹² Beyond the scope of the Securities Act, issuers also face liability for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 (the "34 Act"),¹¹³ as well as under Rule 10b-5 of the 34 Act.¹¹⁴

Third, the lengthy process of drafting and filing a registration statement may cause an issuer to miss "market windows" (i.e., passing favorable market conditions).¹¹⁵ Drafting and filing a registration statement usually takes a minimum of several months.¹¹⁶ This extended time period may cause issuers to miss important, passing financing opportunities in the market, due to the fact that a registration statement is pending approval by the SEC or not yet completed by the issuer.¹¹⁷ Missing such market windows could bankrupt a small business that absorbs the cost of filing a registration statement with the expectation of capitalizing on these unique opportunities in the market.¹¹⁸

The Securities Act's registration requirement has thus served to preclude equity-based crowdfunding campaigns by startup companies and small businesses.¹¹⁹ The costs of drafting and filing a registration

108. 15 U.S.C. § 77k (2012).

109. 15 U.S.C. § 77l(a)(2).

110. 15 U.S.C. § 77l(a)(1).

111. 15 U.S.C. § 77e.

112. 15 U.S.C. § 77q(a).

113. 15 U.S.C. § 78j(b).

114. 17 C.F.R. § 240.10b-5 (2014).

115. Heminway & Hoffman, *supra* note 51, at 910.

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

statement are simply prohibitively expensive.¹²⁰ Yet, even if these costs were not out of reach, filing a registration statement nonetheless opens the doors to a slew of criminal and civil liability.¹²¹ Additionally, the lengthy process of filing a registration statement may cause issuers to miss critical market windows, bankrupting businesses that have expended the necessary resources to file a registration statement.¹²² Therefore, the costs of filing a registration statement typically outweigh the benefits (i.e., raising capital by offering and selling securities to the public) for a startup company or small business.¹²³

II. CROWDFUNDING UNDER THE JOBS ACT

Part II.A. of this Comment outlines the exemption from registration that the JOBS Act applies to crowdfunding campaigns. Part II.B. presents the criticism of this exemption. Part II.B.1. describes the way in which fraudulent securities were offered over the Internet under Rule 504, and Part II.B.2. describes the fear of similar fraud under the JOBS Act. Part II.B.3. addresses the concerns over the hidden identities of crowdfunding campaign managers. Part II.B.4. presents what some critics view as the room for increased, rather than relaxed, regulation of crowdfunding campaigns.

A. THE JOBS ACT: TITLE III

In response to the deep economic recession that began in 2008, Congress sought to stimulate the growth of startup companies by providing business entrepreneurs with wider access to investment capital.¹²⁴ Specifically, Congress aimed to facilitate the nascent use of equity-based crowdfunding by creating a new exemption from the Securities Act's registration requirements.¹²⁵ Congress set forth this exemption in Title III of the JOBS Act, which permits startup companies to sell up to \$1,000,000 in securities per twelve-month period, through a registered crowdfunding-portal or broker-dealer, without filing a

120. *Id.*

121. *Id.*; see also 15 U.S.C §§ 77e, 77k, 77l(a)(1)–(2), 77q(a), 78j(b)); 17 C.F.R. § 240.10b–5 (2014).

122. Heminway & Hoffman, *supra* note 51, at 907–10.

123. *Id.*

124. Sumners, *supra* note 12, at 42–43.

125. *Id.*

registration statement with the SEC.¹²⁶ Instead of filing a registration statement, startup companies and small businesses offering exempt securities under Title III need only provide investors with information that explains the nature of the security being offered and the risks with which it is associated.¹²⁷ In addition to this relaxed regulation, the JOBS Act further incentivizes startup companies and small businesses to utilize equity-based crowdfunding by requiring investors to hold securities purchased via crowdfunding portals for a minimum of one year before selling.¹²⁸

While Title III of the JOBS Act thus relaxes the regulation of securities offered through crowdfunding portals, the provision correspondingly provides a measure of investor protection, restricting the dollar amount that individuals may invest in such unregistered securities per twelve-month period.¹²⁹ Individual investors with an annual income or net worth under \$100,000 may invest up to the greater of \$2,000 or 5% of their annual income or net worth.¹³⁰ Individual investors with an annual income or net worth at or above \$100,000 may invest up to 10% of their annual income or net worth, but no more than \$100,000.¹³¹ In addition to these caps on individual investments, the JOBS Act offers further protection to investors in crowdfunding campaigns by requiring companies offering exempt securities under Title III to nonetheless comply with any future regulatory rules adopted by the SEC.¹³²

On April 5, 2012, President Barack Obama signed The JOBS Act into law,¹³³ commencing a 270-day time period for the SEC to propose regulatory rules that enact the legislation while duly protecting investors.¹³⁴ On October 23, 2013, the SEC finally voted, unanimously,

126. Jumpstart Our Business Startups Act of 2012, Pub. L. No. 112-106, § 302(a), 126 Stat. 306. The JOBS Act thus creates a new form of registration, requiring crowdfunding portals, rather than issuers, to register with the SEC.

127. *Id.* § 302(b).

128. *See id.*

129. *See id.* § 302(a).

130. *Id.*

131. *Id.*

132. *See id.* § 302(b).

133. Sumners, *supra* note 12, at 42.

134. Jumpstart Our Business Startups Act, of 2012, Pub. L. No., 112-106, §§ 302–04, 126 Stat. 306.

to propose rules implementing Title III of the JOBS Act.¹³⁵ The SEC's proposed rules were published in the Federal Register on November 5, 2013,¹³⁶ roughly ten months after the original deadline.¹³⁷ The SEC's proposed rules then opened to public comment for a period of ninety days, which concluded on February 3, 2014.¹³⁸ The SEC must now review the public comments and determine whether to adopt or amend the proposed rules.¹³⁹ At the time of this Comment's publication, this review and subsequent determination are still pending.

B. CRITICISM OF THE JOBS ACT

Various critics have opposed the crowdfunding exemption in Title III of the JOBS Act.¹⁴⁰ The capacity to utilize crowdfunding for fraud has driven much of the criticism, which is natural in light of the Securities Act's focus on protecting investors from fraud.¹⁴¹ Section 7 of the Securities Act prohibits fraud, false statements of material fact, and material omissions in a registration statement.¹⁴² Section 10(b) of the Securities Act and Rule 10b-5 of the 34 Act further prohibits fraud, false statements of material fact, and material omissions in connection with the purchase or sale of securities, even beyond the statements

135. SEC, *SEC Issues Proposal on Crowdfunding*, SEC.GOV, <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.Uq5rwGRDtlw> (last visited Dec. 10, 2013) [hereinafter SEC Press Release].

136. Crowdfunding, 78 Fed. Reg. 66428-01 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

137. Some have attributed this delay to the concerns of Mary Schapiro, whose term as Chairwoman of the SEC ended in December of 2012, over her personal legacy. See Telis Demos & Jean Eaglesham, *SEC Chief Delayed Rule Over Legacy Concerns*, THE WALL STREET JOURNAL (Dec. 2, 2012), <http://online.wsj.com/news/articles/SB10001424127887324205404578153693968634504>.

138. Crowdfunding, 78 Fed. Reg. 66428-01 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

139. SEC Press Release, *supra* note 135.

140. See Heminway & Hoffman, *supra* note 51, at 935–36; see also David M. Cromwell, Comments on Proposed Rule: Crowdfunding, Release No. 33-9470, 1 (Oct. 27, 2013), available at 2013 WL 6000302 [hereinafter Cromwell, Comments on Proposed Rule]; see also Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1763–68 (2012).

141. See Heminway & Hoffman, *supra* note 51, at 935–36.

142. 15 U.S.C. § 77q (2012).

within a registration statement.¹⁴³ Yet, in spite of these laws, the Internet has nonetheless been widely utilized to engage in securities fraud,¹⁴⁴ so much so that the SEC created a web page dedicated to educating investors about online fraud well before Congress passed the JOBS Act.¹⁴⁵ Critics of the JOBS Act thus view Title III's crowdfunding exemption as opening the door to unprecedented levels of securities fraud on the Internet, by removing the measure of investor protection afforded by the filing of an issuer's registration statement with the SEC.¹⁴⁶

1. Fraudulent Securities Offered Under Rule 504

Critics of Title III's crowdfunding exemption who fear that it will lead to fraud look to the history of Rule 504 under the Securities Act.¹⁴⁷ As originally drafted, Rule 504 provided an exemption from registration for non-public companies offering \$500,000 or less in securities.¹⁴⁸ In fact, Rule 504 originally had no specific disclosure requirements whatsoever.¹⁴⁹ Rather, Rule 504 only prohibited an issuer from engaging in the general solicitation of investors, unless an issuer's offering satisfied state law disclosure requirements.¹⁵⁰ Rule 504, however, lacked any restrictions on secondary trading, which is the resale of securities by an investor.¹⁵¹ Therefore, as the Internet became more widely utilized for securities offerings, fraudsters took advantage of Rule 504's exemption to engage in fraudulent offerings of exempt securities on the secondary market.¹⁵²

In response, the SEC amended Rule 504 by restricting secondary trades of exempt securities under Rule 504, in addition to its original restriction on general solicitation, unless such securities comply with the

143. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5 (2014).

144. See Heminway & Hoffman, *supra* note 51, at 935.

145. See *id.*; see also SEC, *Internet Fraud*, SEC.GOV, <http://www.sec.gov/investor/pubs/cyberfraud.htm> (last visited Dec. 10, 2013).

146. See Hazen, *supra* note 140, at 1763-68.

147. *Id.*; see also 17 C.F.R. § 230.504 (codifying the current version of Rule 504).

148. See Hazen, *supra* note 140, at 1763.

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

disclosure requirements of at least one state.¹⁵³ This amendment removed the opportunity for the general public to invest in unregistered Rule 504 offerings that do not comply with any state law's disclosure requirements.¹⁵⁴ Critics of the JOBS Act therefore fear that scammers will take advantage of Title III's exemption in order to defraud the general investing public, just as they took advantage of Rule 504's exemption before it was amended to remove that opportunity.¹⁵⁵

2. The Opportunity for Fraud in Crowdfunding

Critics who fear that Title III's crowdfunding exemption will lead to fraud are not cooled by the provision's cap on individual investment.¹⁵⁶ First, critics argue that the cap will not deter fraudsters, who can collect small investments of \$250 to \$500 from myriad investors.¹⁵⁷ Second, critics argue that the defrauding of many small investors deserves as much protection as the defrauding of a few large investors.¹⁵⁸ Even though Title III's investment caps limit each individual investor's exposure to risk, critics argue that this limitation does not justify an exemption from filing a registration statement without substantially meaningful disclosure.¹⁵⁹ Critics point out that small investors may be least able to bear the risk of an investment in a speculative business.¹⁶⁰ Therefore, critics find that Title III's cap on individual investment will neither deter scammers nor sufficiently protect investors in crowdfunding campaigns.¹⁶¹

3. The Masked Identities of Crowdfunding Campaign Managers

In addition to their capacity for fraud, crowdfunding campaigns have also been criticized for masking the identities of even legitimate business owners anonymously raising capital on the Internet.¹⁶² David

153. *Id.* at 1763–64; 17 C.F.R. § 230.504 (2014) (prohibiting the resale of securities offered under Rule 504's exemption from registration, unless the offering complies with state disclosure requirements).

154. *See Hazen, supra* note 140, at 1763–64.

155. *See id.* at 1765.

156. *See id.*

157. *See id.*

158. *See id.*

159. *See id.*

160. *See id.* at 1765–66.

161. *See generally id.* at 1763–68.

162. *See Cromwell, Comments on Proposed Rule, supra* note 140.

M. Cromwell, Adjunct Professor of Entrepreneurship at Yale School of Management and former head of the venture capital investment business at JPMorgan, posted in a public comment upon the SEC's proposed rules implementing Title III of the JOBS Act:

The Crowd Funding concept is not going to work. Small investors will lose all their money most of the time, not many extra new ventures will start up and succeed, and only a few new jobs will be created on a sustained basis.

Authors of the legislation clearly do not understand successful venture capital investing and the key success factor. The key consideration is the management ability of [the] management team behind the idea, not the idea itself. Can the founders / entrepreneurs make the idea happen, can they execute the business plan? This is a tough decision to make and requires a lot of exposure to the management team.

Incompetent management causes more failures in new business ventures than all of the other reasons, combined. . . .

As [a] venture investor, you cannot judge the abilities of the management team over the Internet. Real venture capitalists do not make their investments over the Internet—they spend hours and hours interviewing the founders / management team, in person. Small investors cannot successfully invest over the Internet, either.¹⁶³

In short, Cromwell argues that crowdfunding campaigns fail to allow investors to make properly informed decisions because investors cannot evaluate the management team leading a crowdfunding campaign, and that this is the key consideration in a venture investment.¹⁶⁴

4. The Room for Increased Regulation of Crowdfunding Campaigns

Some critics of the JOBS Act not only oppose Title III's crowdfunding exemption, but also argue that crowdfunding campaigns should be subject to *heightened* disclosure requirements.¹⁶⁵ As a baseline, crowdfunding campaigns rely upon general solicitation, which

163. *Id.*

164. *Id.*

165. *See Hazen, supra* note 140, at 1766.

invites more unsophisticated investors who are in need of the protections normally provided by the Securities Act.¹⁶⁶ But some critics go further, arguing that crowdfunding campaigns warrant even greater disclosure due to the impersonal nature of the Internet, which limits the available information about a company to that which the company itself posts on the portal website hosting its crowdfunding campaign.¹⁶⁷

III. HOW ESCROW MAY PROTECT CROWDFUNDING INVESTORS

Escrow accounts may be used to protect investors in crowdfunding campaigns against fraud, as well as to mitigate the overall risk of investing in a startup company or small business¹⁶⁸. This Comment recommends that the SEC adopt the use of escrow accounts to these effects in its rules that regulate Title III of the JOBS Act.¹⁶⁹ The SEC's proposed rules do in fact incorporate some use of escrow accounts in order to protect crowdfunding investors against fraud.¹⁷⁰ This Comment, however, argues for a much more extensive use of escrow accounts than that embraced by the SEC's current proposal.¹⁷¹

Part III.A. outlines the use of escrow in the SEC's current proposed rulemaking. Part III.B. explains the shortcomings of this use in adequately protecting investors. Part III.B.1. therefore recommends that the SEC require crowdfunding campaign managers to keep crowdfunding contributions in escrow after the conclusion of a campaign, to be distributed to the third parties responsible for the development of the business. Part III.B.2. further recommends a requirement for campaign managers to keep crowdfunding contributions that exceed a target offering in escrow for shareholder security. Finally, Part III.B.3. recommends that campaign managers only be permitted to expend crowdfunding contributions that exceed a target offering if they wait at least one year and first offer to repurchase shares from investors.

166. *See id.*

167. *See id.*

168. *See supra* Part II.B.

169. *See* Crowdfunding, 78 Fed. Reg. 66428-01 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

170. *See id.*

171. A review of the other anti-fraud measures in the SEC's current proposal is beyond the scope of this Comment.

A. THE USE OF ESCROW IN THE CURRENT SEC PROPOSAL

The SEC's proposed rules require crowdfunding portals to transfer all contributions to a crowdfunding campaign into an escrow account, which may only release the funds to the issuer that is operating the campaign if and when the issuer's target offering is met or exceeded.¹⁷² If an issuer fails to raise funds equal to, or greater than, their target offering by the conclusion of a crowdfunding campaign, then the escrow account must return all contributions to their respective investors.¹⁷³ The SEC explains that this use of escrow aims to prevent fraud upon either issuers or investors.¹⁷⁴ Specifically, the proposal's use of escrow prevents crowdfunding portals from stealing investor contributions from issuers that have met or exceeded their target offerings, as well as from investors who are due the return of their investment if and when a target offering is not met by the conclusion of a crowdfunding campaign.¹⁷⁵

B. THE NEED FOR FURTHER USE OF ESCROW

Indeed, the SEC is on the right track in recognizing the value of escrow accounts in the context of crowdfunding.¹⁷⁶ Namely, escrow accounts ensure that capital is received by its intended beneficiaries. This is particularly valuable to businesses and investors trading securities in startup companies and small businesses through intermediary websites on the Internet. However, the use of escrow accounts set forth in the SEC's proposal ceases upon the meeting of, or the failure to meet, a target offering.¹⁷⁷ Thus, the use of escrow accounts in the SEC's proposal only protects against fraud for the duration of a crowdfunding campaign.¹⁷⁸ But if and when a successful campaign reaches its target, and contributions are released from escrow, the issuer then takes full control over the assets.¹⁷⁹ This Comment argues for the use of escrow beyond this point, in order to protect investors *after* a crowdfunding campaign has concluded and a crowdfunding portal is no

172. *Id.*

173. *Id.*

174. *Id.*

175. *Id.*

176. *See id.*

177. *See id.*

178. *See id.*

179. *See id.*

longer being employed as an intermediary. The use of escrow accounts after the conclusion of a crowdfunding campaign may protect investors from future fraud by the *issuer*, as well as mitigate the overall risk of crowdfunding investment.

1. The Need to Keep Funds in Escrow After the Conclusion of a Campaign

First, a target offering should not be released from escrow directly to an issuer when a crowdfunding campaign meets its target, as the SEC's current proposal mandates.¹⁸⁰ Rather, the capital should be released from escrow directly to the parties necessary for the planned development or expansion of the business. This would require crowdfunding entrepreneurs to clearly state the intended purpose of the capital raised from a campaign, as well as the parties intended to realize that purpose. When funds are released from escrow to these parties, rather than an issuer, it prevents issuers from defrauding investors altogether, absconding with their contributions after the conclusion of a crowdfunding campaign. If the issuer decides to change the course of action for the initial funds received from the target offering, they should be required to get the consent of each investor or return their investment. Otherwise, issuers could tell investors that they are investing in a venture with a given plan, and then issuers could change that plan after the conclusion of the campaign, misleading investors entirely.

For example, if an entrepreneur operates a crowdfunding campaign in order to raise capital necessary for services such as industrial design, manufacturing, or advertising, then the capital raised from the campaign should be released from escrow directly to the third parties responsible for providing these services. If the capital is necessary to hire internal employees, then the funds should be released from escrow directly to the employees. If a business decides to use crowdfunded capital for a purpose other than that stated in the crowdfunding campaign, however, then the business must get the consent of each investor or return their investment.

The measure of protection afforded by this proposed use of escrow is indeed limited by the opportunity for businesses to defraud investors by paying false employees or service providers. Crowdfunding campaign managers may falsify employment records or service contracts, and create shell bank accounts to receive funds from escrow.

180. *See id.*

This opportunity for fraud will likely be seldom recognized, however, because crowdfunding entrepreneurs typically do not engage in crowdfunding campaigns in order to hire employees.¹⁸¹ They certainly may, but this is simply not the typical scenario. Further, even if crowdfunding entrepreneurs do have the aim to hire employees with crowdfunded capital, it would be slightly more difficult to defraud investors by paying false employees than if the capital were released directly to the issuers.

2. The Need to Keep Contributions Exceeding a Target Offering in Escrow

Second, escrow accounts may further protect crowdfunding investors against fraud and the overall risk of investing in a startup company¹⁸² by requiring crowdfunding entrepreneurs to maintain in escrow capital contributions that exceed a campaign's target. The SEC should require that these contributions are kept in escrow after the conclusion of a crowdfunding campaign, and released to investors, in proportion to their investment, if and when the business fails. This use of escrow mitigates the overall risk of investment, allowing investors to recover part or all of their investment if the business fails. This use of escrow also prevents issuers from defrauding investors of campaign contributions that exceed a target offering.

For example, if a crowdfunding campaign has a \$100,000 target and raises \$200,000, then \$100,000 must be kept in escrow after the conclusion of the campaign. In this scenario, if the business fails completely, investors will recover the full value of their investment, even though they will not see any profits. Naturally, this measure of protection has its limits. For example, if a crowdfunding campaign has a \$100,000 target and raises \$125,000, then investors will only recover 25% of their original investment. Further, if the campaign meets its target but does not exceed it, then if and when the business fails, investors will not recover any of their investment.

This use of escrow indeed constrains the flexibility of a business's capital expenditure, but this is not devastating to crowdfunding entrepreneurs. Crowdfunding entrepreneurs set targets that represent the capital necessary for the planned development or expansion of a

181. See *supra* Part I.A.

182. See Part II.B.

business. Therefore, if a business raises this necessary capital, it is not unreasonable to require the business to keep excess capital, which is not required for the planned development or expansion, in escrow for the protection of investors.

3. Criteria for Spending Contributions Exceeding a Target Offering

Third, if a business seeks to expend any capital from the pool of capital contributions that exceed a target offering, which must otherwise be kept in escrow as shareholder security, then the business should be required to satisfy two threshold criteria. First, the business should be required to wait at least one year before expending capital that exceeds the target offering, just as investors must wait one year before selling their shares under the JOBS Act.¹⁸³ Second, the business should be required to notify all investors of the plan to spend the excess capital, which is shareholder security, and offer to buy back equity from investors.

For example, if a crowdfunding campaign has a \$100,000 target and yields \$200,000 in shareholder equity, then the business may spend \$100,000 as proposed during the first year, and may only spend the other \$100,000 after both waiting one year and offering to buy out each investor at full value. If the value of the equity increases during that year, then the business will need to make up for the difference if investors choose to sell back their shares. This mechanism essentially renders it impossible for an issuer to defraud investors of capital contributions that exceed a target offering.

The SEC may thus utilize escrow accounts to protect capital contributions to crowdfunding campaigns even after the conclusion of a campaign. The SEC's current proposal does not go far enough by preventing crowdfunding portals from defrauding entrepreneurs and investors during a crowdfunding campaign.¹⁸⁴ Investors require measures of protection after the conclusion of a crowdfunding campaign in order to prevent fraudsters from absconding with capital contributions or expending capital contributions in a fashion other than that stated in a crowdfunding campaign. This protection can be achieved by requiring crowdfunding portals to release contributions directly to the parties

183. See Jumpstart Our Business Startups Act, PUB. L. NO., 112-106, § 302(a), 126 Stat. 306.

184. See Crowdfunding, 78 Fed. Reg. 66428-01 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

necessary for the planned development or expansion of a company. Investor protection may be further bolstered by requiring crowdfunding entrepreneurs to maintain contributions that exceed a target offering in escrow, as a sort of shareholder insurance fund. Surely, a venture may come to need this extra capital, and this need is balanced with the need for investor protection. Crowdfunding entrepreneurs should therefore also be required to wait one year after the conclusion of a campaign and offer to buy out investors before spending capital that exceeds a target offering.

CONCLUSION

Crowdfunding has the capacity to offer an unprecedented source of capital to startup companies and small businesses, and merely needs the appropriate regulation to protect crowdfunding investors. This protection may be found in escrow. This Comment therefore urges the SEC to require crowdfunding entrepreneurs to (i) place capital contributions into escrow and release them directly to the parties responsible for the development or expansion of the business, (ii) maintain capital contributions that exceed a crowdfunding campaign's target in escrow, to be paid to investors if and when the business fails, and (iii) wait one year and offer to buy out investors before expending capital that exceeds a target offering. These uses of escrow may adequately protect investors in crowdfunding campaigns, alleviating the majority of the criticism of the JOBS Act. Therefore, as Title III of the JOBS Act facilitates the power of crowdfunding, it is now only up to the SEC to protect investors from its abuse.