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## Real Estate Crowdfunding – Modern Trend or Restructured Investment Model?: Have the SEC’s Proposed Rules on Crowdfunding Created a Closed-market System?

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# **REAL ESTATE CROWDFUNDING – MODERN TREND OR RESTRUCTURED INVESTMENT MODEL?: HAVE THE SEC’S PROPOSED RULES ON CROWDFUNDING CREATED A CLOSED- MARKET SYSTEM?**

CORY BAKER<sup>1</sup>

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#### ABSTRACT

Crowdfunding is one of the fastest growing and most controversial segments of online purchasing and investing. Crowdfunding projects have been increasingly geared towards real estate development and are changing the scope of investment by enabling developers to solicit securities-based funding from the public. When the Securities and Exchange Commission (SEC) proposed its rules to allow crowdfunding under the Jumpstart Our Business Startups (JOBS) Act, it raised the issue of whether crowdfunding would be a viable option for building and owning large-scale projects. Offering developers new ways to finance projects, small investors a way in, and the socially conscious an avenue to support local communities, crowdfunding seems to have created a temporary boon to our economy. However, the legislative impacts on financial reform and securities law, as well as the economic impacts on investors and future development remain at the forefront of debate.

#### I. INTRODUCTION

Crowdfunding is one of the fastest growing and most controversial segments of online purchasing and investing. More and more frequently, crowdfunding projects have been geared towards real estate acquisition and development, and in turn, have changed the scope of real estate investment, enabling developers to solicit securities-based funding from the public sector. When the Securities and Exchange Commission (SEC) proposed its rules to allow crowdfunding under the Jumpstart Our Business Startups (JOBS) Act, it raised the issue of whether crowdfunding would be a viable option for the

construction, renovation, and overall ownership of large-scale real estate developments. Offering developers new ways to finance projects, small investors a way in, and the socially conscious an avenue to support local communities, crowdfunding seems to have created a temporary boon to our economy. However, the legislative impacts on financial reform and securities law, as well as the economic impacts on investors and future development remain at the forefront of debate.

This Comment evaluates these arguments before concluding that there must be more scrutiny of the JOBS Act, which is critical to monitoring the securities market and informing investors of real estate deals. Part I reviews the formation of crowdfunding and how it has reshaped the real estate market. This part also discusses the legislative history and intent behind the SEC's proposed rules on crowdfunding before addressing how Congress and the SEC plan on implementing and applying such rules. Part II then provides a general overview of crowdfunding and how different securities function within the SEC's existing regulatory framework. Part III explores the crowdfunding debate, focusing on the social, business, and legal impacts, and how crowdfunding has reshaped the playing field for investors. Part IV examines the shift away from the SEC's regulatory framework towards a more imprecise framework rooted in the JOBS Act and how this recent trend is potentially restructuring Securities Law. Part V analyzes the scope of real estate crowdfunding, highlighting its ease and accessibility, but also warning against its exclusivity and difficulty of regulation—specifically, whether a fair-market system can provide adequate consumer protection. Finally, Part VI looks at related policy concerns, since some crowdfunding platforms are not feasible in their current form due to exclusivity or ease of control by the securities industry. However, two proposals that make a strong case for crowdfunding are creating a private market intermediary and changing the requirements for accredited investors.

#### A. *What is Crowdfunding?*

Today, the term “crowdfunding” has become increasingly common to real estate investors, much more than we could have previously imagined.<sup>2</sup>

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<sup>2</sup> *The Statute of Liberty and America's Crowdfunding Pioneer*, BBC NEWS MAG. (Apr. 25, 2013), <http://www.bbc.com/news/magazine-21932675> (describing the history of crowdfunding at its earliest stages). Possibly a precursor to the now-online crowdfunding business model was the idea of “praenumeration,” better known as collective fundraising, which was a subscription business model used in the early 1600s to finance publications. Collective fundraising models remained advantageous financing models and were even seen in the late 1800s when *Pulitzer's New York World* newspaper was used to finance the Statute of Liberty:

While the idea of crowdfunding has been around for centuries, crowdfunding has recently grown from an online trend into a modern-day form of online shopping, investing, and business making.<sup>3</sup> While the average consumer may have previously shied away from these long-term investments, crowdfunding has brought ease to the investment process, turning exclusive projects and business ideas into user-friendly “deals” at the click of a mouse. Some crowdfunding experts have chiseled this formerly-complex idea into a simpler concept:

[Crowdfunding] finds its root in the broader concept of “crowdsourcing,” which uses the “crowd” to obtain ideas, feedback and solutions in order to develop corporate activities. In the case of crowdfunding, the objective is to collect money for investment; this is generally done by using social networks, in particular through the Internet (Twitter, Facebook, LinkedIn and different other specialized blogs). The crowd-funders (those who provide the money) can at times also participate in strategic decisions or even have voting right.<sup>4</sup> In other words, instead of raising the money from a very small group of sophisticated investors, the idea of crowdfunding is to obtain it from a large audience (the “crowd”), where each individual will provide a very small

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As the Statue of Liberty was shipped from France, efforts to raise funds for its pedestal stalled. But thanks to a newspaper campaign and the small donations of hundreds of residents, the base was eventually built . . . . By the summer of 1885, the Statue of Liberty was in New York in pieces, awaiting assembly.

*Id.*; see also David M. Freedman & Matthew R. Nutting, *A Brief History of Crowdfunding: Including Rewards, Donation, Debt, and Equity Platforms in the USA*, DAVID M. FREEDMAN 2 (June 22, 2015), <http://www.freedman-chicago.com/ec4i/History-of-Crowdfunding.pdf>. Jumping ahead to 2009—the increased use of the Internet, coupled with sense of community building, formed what is now modern-day crowdfunding, with the launch of Kickstarter. *Id.* “Kickstarter hosted over 180,000 funding campaigns, of which 40 percent were successful.” *Id.* “The 70,923 campaigns that succeeded raised a total of \$1.335 billion from more than 7.1 million backers.” *Id.* With nearly 30 percent of the campaigns raising over \$10,000, and another 2 percent raising over \$100,000, businesses funded through Kickstarter were becoming more and more popular. *Id.*

<sup>3</sup> Various companies have had success with the crowdfunding business model, and more companies are still joining the hype. See Rand, *infra* note 6 for a list of real estate “platforms” that have joined the market.

<sup>4</sup> Note that voting rights, and other rights consistent with business ownership are based on contractual agreements, rather than pure rights of law. See also Paul Belleflamme, Thomas Lambert & Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd*, 29 J. BUS. VENTURING 585, 585–609 (2014), [http://www.academia.edu/4143737/Crowdfunding\\_Tapping\\_the\\_Right\\_Crowd](http://www.academia.edu/4143737/Crowdfunding_Tapping_the_Right_Crowd) (further discussing the several caveats and clarifications of crowdfunding and the key elements in understanding why crowdfunding is embedded in the definition of crowdsourcing). The most important element of crowdfunding is “raising funds by tapping a general public (or the crowd),” meaning that “consumers can volunteer to provide input to the development of the product, in this case in form of financial help.” *Id.*

amount.<sup>5</sup>

Crowdfunding began as a donation-based system from which business owners or project creators could solicit contributions from a large group of people.<sup>6</sup> With the sweeping changes that have come with technology and Internet-use, crowdfunding has become the newest way to raise capital and has been gaining traction, with potentially far-reaching results.<sup>7</sup>

The traditional method of raising capital for a project would be for the “entrepreneurs or inventors to self-fund their [own] ideas or seek out banks and professional or institutional investors to secure the capital they needed to take their ideas to the next level.”<sup>8</sup> However, with the ease of crowdfunding, entrepreneurs can now raise capital from a “group of smaller investors” in a

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<sup>5</sup> Andrew C. Fink, *Protecting the Crowd and Raising Capital Through the Crowdfund Act*, 90 U. DET. MERCY L. REV. 1, 5 (2012).

The Crowd consists of individuals connected to other individuals through the Internet. The Crowd's influence draws exclusively from the aggregate and has altered the fundamental constructs of all societies connected to the Internet. In a short period of time, the Crowd has created an entirely new paradigm from which to view the world: it has overcome oppressive governments, produced new industries, and shaped the social and commercial avenues in which we interact.

*Id.*

<sup>6</sup> Ellen Rand, *Crowdfunding: A Game-changer in Finance?*, DEV. MAG. (Fall 2013), <http://www.naiop.org/en/Magazine/2013/Fall-2013/Finance/Crowdfunding-in-Commercial-Real-Estate.aspx>.

<sup>7</sup> Rob Ebrahimi, *How Crowdfunding Could Reshape Real Estate Investing*, FORBES (Dec. 12, 2013, 9:00 AM), <http://www.forbes.com/sites/rodebrahimi/2013/12/12/how-crowdfunding-will-impact-real-estate-investing-an-interview-with-realtyshares/>.

<sup>8</sup> *Id.* (further noting the “democratization” of investing and the ways crowdfunding has changed the scope of investments, opening the online market to far more investment opportunities that formerly predicted). By “democratizing” fundraising, those outside the traditional investor groups and lenders are able to join in on the process. *Id.* Kickstarter, for example, has remained the leading “platform” when it comes to creative consumer products, with over \$900 million pledged to over 125,000 unique projects. *Id.*

Since its beginning, crowdfunding has had the most success with tangible consumer products. For example, there might be an engineer who is building a more efficient bike seat and needs \$10,000 to get it to market. He can post the project on a crowdfunding website and immediately have access to thousands (if not millions) of people and customers who would like to support bringing the project to market. Once the funding goal is reached, the money is transferred and the project can start.

*Id.* Highlighting the relationship between the parties, that is, the entrepreneurs and investors, crowdfunding creates a win-win for both parties. “[F]or investors, crowdfunding means less risky, smaller dollar investments in projects they care about.” *Id.* “For entrepreneurs, crowdfunding is a better alternative to traditional investment capital that improves the likelihood of securing the capital required to stay in business.” *Id.*

secured and automated online system,<sup>9</sup> serving as an “alternative source of capital to support a wide range of ideas and ventures.”<sup>10</sup> Crowdfunding campaigns generally target certain amounts of funds to be raised, as well as the use of those funds.<sup>11</sup> So, what does this mean for the online consumers, and how will this change the scope of investing?

## B. Crowdfunding Models

### 1. Donation-based Crowdfunding

With donation-based crowdfunding, individual consumers interested in a crowdfunding campaign share information about a project, cause, idea, or business with each other and use the information to decide whether or not to fund the campaign based on the collective “wisdom of the crowd.”<sup>12</sup> Using this model, backers (or “supporters”) pledge amounts less than the minimum required to get a reward.<sup>13</sup> In other words, “rather than expecting a tangible reward, they simply want to support the project team and/or their product.”<sup>14</sup> While consumers have always had a “special place in the marketing literature,”<sup>15</sup> their role has changed over time, concurrently with the developments and evolution of the crowdfunding model, which has transformed the online shopper into an investor.<sup>16</sup>

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<sup>9</sup> *Id.*

<sup>10</sup> Crowdfunding, 78 Fed. Reg. 66,428 (proposed Nov. 5, 2013), <http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf> [hereinafter Proposed Rules]. Crowdfunding has some similarities to “crowdsourcing,” which is the concept that “the power of the many can be leveraged to accomplish feats that were once the province of the specialized few.” See Jeff Howe, *The Rise of Crowdsourcing*, WIRED, June 2006, [http://archive.wired.com/wired/archive/14.06/crowds.html?pg=1&topic=crowds&topic\\_set=](http://archive.wired.com/wired/archive/14.06/crowds.html?pg=1&topic=crowds&topic_set=).

<sup>11</sup> Proposed Rules, *supra* note 10, at 66,428.

<sup>12</sup> *Id.* See also Richard Waters, *Startups Seek the ‘Wisdom of Crowds,’* FIN. TIMES (Apr. 3, 2012, 7:41 PM), <http://www.ft.com/intl/cms/s/0/c1f1695c-7da8-11e1-9adc-00144feab49a.html#axzz2b7QxIH5L> (“[T]he backers of [crowdfunding] argue that the hard work of making investment decisions – filtering out the best investments and limiting fraud – can be solved by tapping the ‘wisdom of crowds’ over the internet.”).

<sup>13</sup> *Id.*

<sup>14</sup> Freedman & Nutting, *supra* note 2, at 2 (further noting the risks involved with crowdfunding: “[e]ven when projects are fully funded, there is no guarantee that the entrepreneurs will fulfill their promises to backers, or do so on time . . . nor does Kickstarter mediate or intervene when funded companies fail to keep their promises”).

<sup>15</sup> ANDREA ORDANINI ET AL., CROWDFUNDING: TRANSFORMING CUSTOMERS INTO INVESTORS THROUGH INNOVATIVE SERVICE PLATFORMS 3 (2013), <http://www.crowdsourcing.org/document/crowdfunding-transforming-customers-into-investors-through-innovative-service-platforms-/5214>.

<sup>16</sup> *Id.*; see also THOMAS LAMBERT & ARMIN SCHWIENBACHER, AN EMPIRICAL ANALYSIS

## 2. Credit-based (Debt) Crowdfunding

Following the 2008–2009 financial crisis, many people were denied bank loans, but despite their initial failure to secure funding for business ideas and projects, borrowers were alleviated of these troubles with debt-based crowdfunding.<sup>17</sup> Debt-based crowdfunding, known as “peer-to-peer lending (or simply P2P) and more recently ‘marketplace lending’—has taken up some of the slack,”<sup>18</sup> emerging as an easier way for borrowers to attain loans. While individual borrowers were essentially applying for unsecured loans, if the loans were accepted by the platform, borrowers could receive their loan from the “crowd,” then pay it back with interest.<sup>19</sup> The P2P platforms serve as an extra element to the funding process, enabling borrowers to attain loans more efficiently, from a variety of sources.<sup>20</sup> The P2P platforms generate revenue by “taking a percentage of the loan amounts (a one-time charge) from the borrower and a loan servicing fee (either a fixed annual fee or a one-time percentage of the loan amount) from investors,”<sup>21</sup> essentially making the application process free for borrowers.

Assuming borrowers make timely payments, investors earn interest on each loan. There are high enough interest rates “to generate strong returns for investors (assuming sufficient diversification of their loan portfolios)—potentially better returns than traditional money markets and bonds, with less volatility than stocks—and a fairly reliable monthly cash flow of interest and principal payments throughout the term of the loan.”<sup>22</sup>

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OF CROWDFUNDING (2010), <http://www.crowdsourcing.org/document/an-empirical-analysis-of-crowdfunding-/2458>.

<sup>17</sup> Freedman & Nutting, *supra* note 2, at 3.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

From the borrower’s point of view, getting a P2P loan can be simpler, quicker, and cheaper than borrowing from a bank. It is cheaper (that is, fixed interest rates are generally lower) because most of the P2P platform’s services (application review and verification, credit check, loan disbursement, payment processing, collection, compliance and reporting, etc.) are automated. This results in lower overhead.

*Id.* at 4.

<sup>22</sup> *Id.* at 4.

From the investor’s point of view, although the minimum investment can be as low as \$25, P2P platforms are more complex than rewards-based platforms because they involve securities regulated by the SEC. Unlike the Kickstarter experience, you’ll need to spend quite a bit of time learning how the P2P system works, what the possible risks and returns are for each



### 3. Equity-based Crowdfunding

The success of the above-mentioned crowdfunding models triggered more intermediaries to enter the crowdfunding market. Whereas lending and fundraising were formerly two-party transactions, intermediaries (referred above as “platforms”) emerged, using their capital-raising expertise to bring together borrowers and investors.<sup>23</sup> Using the power of the Internet, platforms gather pertinent information for a particular business deal and “disclos[e] information and deal terms . . . [while] facilitating the investment transaction”<sup>24</sup> entirely online. Regulation D (Reg D) equity platforms allow “issuers to raise an unlimited amount of capital in each offering.”<sup>25</sup> Since issuers can sell equity through Reg D platforms “only to accredited investors, not to ‘the crowd,’”<sup>26</sup> many crowdfunding professionals do not refer to Reg D offerings as crowdfunding; rather, equity-based crowdfunding is seen more along the lines

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particular lending opportunity, and what kinds of secondary markets exist before you commit your money to a single borrower or a package of loans.

*Id.*

<sup>23</sup> *See generally id.*

<sup>24</sup> *Id.* at 5.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*; *see also* 17 C.F.R. § 230.501. As used in Regulation D (discussed below), an “accredited investor” means:

any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person: (1) Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(a)(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of \$5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of \$5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors.

17 C.F.R. § 230.501(a).

of common stock, preferred stock or other purchase options.<sup>27</sup>

The equity-model typically involves these securities, and when investors receive ordinary corporate stock in exchange for their contributions, they are undoubtedly purchasing securities.<sup>28</sup> Even when investors do not receive corporate stock, they receive “participation in the return of the business,”<sup>29</sup> thus, their investments would still be securities. Since crowdfunding investments typically do not guarantee the investor much involvement in the operation of the business in which they invest, equity investments are often seen as passive investments.<sup>30</sup>

Crowdfunding has allowed individuals to invest in projects and businesses that seemed otherwise inaccessible and brings together investors from around the country, or even the world, to partake in joint business ventures. However, with the increased use of the Internet comes more regulation of money flow. Ultimately, more regulation is needed for certain crowdfunding projects. When crowdfunding becomes more specialized, or when a company creates a particular “niche crowdfunding platform,”<sup>31</sup> there must be increased regulation. A particular type of crowdfunding that has been at the forefront of the debate for increased regulation is real estate crowdfunding.<sup>32</sup>

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<sup>27</sup> Freedman & Nutting, *supra* note 2, at 5.

<sup>28</sup> Steven C. Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 33 (2012).

<sup>29</sup> *Id.* (citing *United States v. Leonard*, 529 F.3d 83 (2d Cir. 2008) (LLCs); *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981) (partnerships)). “Interests in partnerships and limited liability companies, and other non-stock equity interests, are analyzed under the *Howey* investment contract test. The interests offered to investors on equity-model sites would clearly be investment contracts under *Howey*.” *Id.* Bradford further indicates:

Crowdfunding almost by definition involves a common enterprise among many different investors. The whole point of crowdfunding is to collect small amounts of money from a number of different investors. The business pools these investors' funds, and the investors share in the returns of the business. Although there is some disagreement among the lower courts about what exactly constitutes a common enterprise, all courts agree that horizontal commonality of this sort meets the *Howey* test.

*Id.*

<sup>30</sup> Bradford, *supra* note 28, at 34 (“Even if the crowdfunding site allows them some minor role, the ‘essential managerial efforts which affect the failure or success of the enterprise’ will be those of the entrepreneur.”).

<sup>31</sup> *Id.*

<sup>32</sup> *See generally id.*

## II. REAL ESTATE CROWDFUNDING – TREND OR INNOVATION?

### A. Key Players and Their Roles

There are three key players involved in crowdfunding projects: (1) the project initiator (the “company” or “borrower”) who proposes the idea and/or project to be funded; (2) individuals or groups (the “investors”) who support the idea; and (3) a moderating organization (the “platform”) that brings the parties together to launch the idea.<sup>33</sup> Despite each player’s individual role in the crowdfunding process, the SEC rules draw the players even closer together, since information pertaining to a particular project is now made available to potential investors.<sup>34</sup> While there is not an exhaustive list as to what a company would be required to disclose,<sup>35</sup> the SEC makes it easier for investors to be a part of the deal, allowing them to gain insight to the process and monitor how an investment is being used. For example, once a certain real estate project is placed on the platform, investors get a chance to look at it, perform their own due diligence, and then decide *themselves* whether or not they want to enter into a certain deal.<sup>36</sup>

Specialized crowdfunding companies<sup>37</sup> have become a prominent part of the crowdfunding world today, targeting both the investment- and rewards-driven investors.<sup>38</sup> This is especially true for real estate platforms, some of

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<sup>33</sup> See generally ORDANINI ET AL., *supra* note 15.

<sup>34</sup> Freedman & Nutting, *supra* note 2, at 3.

<sup>35</sup> *Id.* The list includes:

- (1) Information about officers and directors as well as owners of 20 percent or more of the company;
- (2) a description of the company’s business and the use of proceeds from the offering;
- (3) the price to the public of the securities being offered, the target offering amount, the deadline to reach the target offering amount, and whether the company will accept investments in excess of the target offering amount;
- (4) certain related-party transactions;
- (5) a description of the financial condition of the company; and
- (6) financial statements of the company that, depending on the amount offered and sold during a 12-month period, would have to be accompanied by a copy of the company’s tax returns or reviewed or audited by an independent public accountant or auditor.

*Id.*

<sup>36</sup> Interview with Gene Barash, VP of Operations & Asset Manager, Realty Mogul, in L.A., Cal. (Oct. 28, 2014).

<sup>37</sup> See *supra* note 3.

<sup>38</sup> STEVEN DRESNER, CROWDFUNDING: A GUIDE TO RAISING CAPITAL ON THE INTERNET (John Wiley & Sons 2014) (discussing how crowdfunding has gained considerable traction over the last few years, combining the Internet and social media with equity-based financing). Crowdfunding is on the brink of ushering in a new type of investor, which will change how early stage and small business financing transactions are carried out. *Id.* See *infra* Sections II.B.1,

which have grown into substantial businesses. As asset-based platforms, they pool together investors who can invest in pre-vetted projects, ultimately securing passive income with relatively small investments.<sup>39</sup> With the expansion of real estate investing via the Internet, those with more moderate investment funds have access to deals that have historically been reserved for those with deeper pockets. Crowdfunding removes the complexities of investing and specifically, “the barriers or difficulties involved with traditional real estate investing,”<sup>40</sup> ultimately eliminating the time constraints, expenses and need for a unique set of skills and local knowledge of the real estate market.

### *B. Selling Securities*

So, if crowdfunding is simply another way to fundraise business ventures, why is the SEC paying such close attention to online transactions? As different forms of crowdfunding have come to surface, more crowdfunding investments have been subject to Securities Law. But how does crowdfunding constitute a security?

As defined in the Securities Act of 1933 (Securities Act), a security is:

[A]ny note, stock, treasury stock, security future, security-based swap, bond,

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II.B.2 for a background on selling securities and the types of securities involved in real estate crowdfunding.

<sup>39</sup> DRESNER, *supra* note 38 (Real estate crowdfunding creates a marketplace for pre-vetted credited investors to invest in real estate deals. The marketplace component is an online market, like eBay or other bidding websites, where investors can shop for what it is he or she is looking for.).

<sup>40</sup> See Ebrahimi, *supra* note 7.

Accordingly, unless you’re willing to invest \$100,000 into a single asset and can afford the time and effort to actively manage and operate the property, it isn’t a viable investment option . . . . [Each crowdfunding platform] not only provides a level of access and transparency that has never before been possible for real estate but also greatly reduces the time and capital requirements needed to invest. That is because each investment is passive and investors don’t have to worry about the usual headaches that come with property management and the investment minimums are much lower. This allows investors to invest more quickly and also to allocate the same \$50–100,000 they may otherwise put into a single property, [and invest] across multiple properties in different geographies thereby achieving greater diversification. For example, someone at home in New York could browse for apartment buildings or single-family home investments in Los Angeles or Seattle from his or her laptop or tablet, and with a few simple clicks, can invest in those properties across the Nation. Only through crowdfunding, are these types of investment opportunities possible.

*Id.*

debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.<sup>41</sup>

Applying this lengthy definition, the Supreme Court in *Howey*<sup>42</sup> determined that a transaction constitutes an “investment contract,” and therefore, a “security” if there is: (1) an exchange of money (2) with an expectation of profits arising (3) from a common enterprise (4) which depends solely on the efforts of a promoter or third party.<sup>43</sup> Thus, any crowdfunding arrangement in which investors are asked to contribute money in exchange for potential profits based on work of others would be considered a security.<sup>44</sup> The applicable investment contract would have to be registered with a regulatory agency, unless it qualified for one of several exemptions.<sup>45</sup> The real estate

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<sup>41</sup> See Securities Act of 1933 §2, 15 U.S.C. § 77b(a)(1) (2012), <https://www.sec.gov/about/laws/sa33.pdf>.

<sup>42</sup> Sec. & Exch. Comm’n v. W.J. Howey Co., 328 U.S. 293 (1946). In this case, Howey owned a large citrus grove, whereby he solicited investors to participate in his business venture. *Id.* His business model included: (1) implementing a land sale contract for a small portion of the grove to the investor; (2) contracting a service agreement for the cultivation of that land (granting Howey the complete right to; and (3) once harvested, the investor would get an account for the produce yielded by their invested piece of land. *Id.* The Securities Exchange Commission sought an injunction against Howey use of interstate commerce because Howey had not established sales of registered securities, thus violating § 5(a) of Securities Act of 1933. *Id.*

<sup>43</sup> See *id.* (citing Sec. & Exch. Comm’n v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973); accord Sec. & Exch. Comm’n v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974)). Note that while the *Howey* court established the guidelines for what constitutes an investment contract, both the Supreme Court and lower courts have refined the *Howey* test—eliminating the word “solely” from the “efforts-of-others part of the test”—asking “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.” *Id.*

<sup>44</sup> *Howey*, 328 U.S. at 299.

<sup>45</sup> *Id.* (otherwise known as Regulation A or Rule 506 of Regulation D of the Securities Act of 1933); 17 CFR § 230.506. Aside from the general financial means to verify “accredited” investors, Rule 506 also includes means for third party issuers to take “reasonable steps” to verify an investor’s status. Rule 506 indicates:

[t]he issuer shall take reasonable steps to verify that purchasers of securities sold in any offering under paragraph (c) of this section are accredited investors. The issuer shall be deemed to take reasonable steps to verify if the

market, relying heavily on equity- and debt-based crowdfunding models do in fact fall under securities, as indicated in *Howey*.

Crowdfunding is used for investing in short-term debt and long-term equity. While short-term debt is usually recovered in three years or less, indicating a potentially stable stream of income, debt-based crowdfunding “may not provide the potential for investors to earn money when the properties appreciate in value.”<sup>46</sup> On the other hand, equity-based crowdfunding allows

issuer uses, at its option, one of the following non-exclusive and non-mandatory methods of verifying that a natural person who purchases securities in such offering is an accredited investor; provided, however, that the issuer does not have knowledge that such person is not an accredited investor.

*Id.* § 230.506(C)(2)(ii). In regard to whether the purchaser is an accredited investor on the basis of income, the issuer:

review[s] any Internal Revenue Service form that reports the purchaser's income for the two most recent years . . . and obtain[s] a written representation from the purchaser that he or she has a *reasonable expectation of reaching the income level* necessary to qualify as an accredited investor during the current year.

*Id.* § 230.506(c)(2)(ii)(A). The second verification method regards accreditation based on: an accredited investor on the basis of net worth, reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed.

*Id.* § 230.506(c)(2)(ii)(B). The type of documentation is broken into two groups:

(1) With respect to assets: Bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and (2) With respect to liabilities: A consumer report from at least one of the nationwide consumer reporting agencies.

*Id.* §§ 230.506(c)(2)(ii)(B)(1)–230.506(c)(2)(ii)(B)(2). Part (C) provides verification methods by: [o]btaining a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor . . . [which could be based on:] (1) A registered broker-dealer; (2) An investment adviser registered with the Securities and Exchange Commission; (3) A licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law; or (4) A certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office.

*Id.* § 230.506(c)(2)(ii)(C). Lastly, part (D) indicates that accreditation can be verified:

[i]n regard to any person who purchased securities in an issuer's Rule 506(b) offering as an accredited investor prior to September 23, 2013 and continues to hold such securities, for the same issuer's Rule 506(c) offering, obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor.

*Id.* § 230.506(c)(2)(ii)(D).

<sup>46</sup> Jay Samit, *The Six Secrets to Successfully Crowdfunding Real Estate*, REALTY MOGUL (May 14, 2014), <https://www.realtymogul.com/blog/the-six-secrets-to-successfully-crowdfunding-real-estate>.

investors to “benefit from depreciation while having the possibility for significant upside when the property is sold in the future.”<sup>47</sup>

### 1. Debt

In all debt structures, typically when investing in loans, “investors will either acquire a borrower payment dependent promissory note”<sup>48</sup> from the platform company or purchase a whole loan.<sup>49</sup> The promissory note (also known as a platform note) is an “unsecured, limited recourse obligation of [the platform] that corresponds with an underlying mortgage loan originated on [the platform].”<sup>50</sup> Borrowers interested in receiving loans from investors can do so online, by simply filling out an online application.<sup>51</sup> As long as the borrowers provide adequate information relating to their financials, and relevant information regarding their property or business, they will qualify for a loan.<sup>52</sup> Typically, most loan structures are for “purchase and refinance,” or for “commercial purpose mortgages,” and often serve as bridge loans<sup>53</sup> or for rehabilitation.

### 2. Equity

In most equity structures, a Limited Liability Company (LLC) or Limited Partnership (LP) will hold title to the real property. Investors utilizing a real estate platform will purchase shares in a platform-created LLC that in

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<sup>47</sup> *Id.*

<sup>48</sup> *Invest in Equity*, REALTY MOGUL, <https://www.realtymogul.com/help> (last visited Jan. 03, 2015).

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* (“Payments under the [p]latform [n]ote are made when, as and if payments are collected by [the platform] on the underlying mortgage loan, net of certain servicing fees.”).

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *See Bridge Loan*, EQUITYNET, <https://www.equitynet.com/crowdfunding-terminology/bridge-loan> (last visited Jan. 04, 2015). A bridge loan is:

a short-term loan that is used until a person or company secures permanent financing or removes an existing obligation. This type of financing allows the user to meet current obligations by providing immediate cash flow. The loans are short-term (up to one year) with relatively high interest rates and are backed by some form of collateral such as real estate or inventory . . . . As the term implies, these loans ‘bridge the gap’ between times when financing is needed. They are used by both corporations and individuals and can be customized for many different situations.

*Id.*



turn invests into the title-holding entity.<sup>54</sup> Investing in the platform-created LLC, rather than the title-holding entity, “minimizes overhead for the sponsors that work with the platform and allows the platform to access more investment opportunities for investors,” while also providing for “streamlined reporting, distributions and tax documentation through the platform.”<sup>55</sup>

The platform-created LLC is the “sponsor” who manages the LLC, even though it is not the largest holding member. The members of the LLC are the equity investors who hold an equity share in the property. They are not on title; the LLC is. The platform groups all of the investors that want in on a certain deal, into an LLC, and take that LLC, as a collective, to invest into a larger LLC. The platform’s LLC is operated by a governing agreement, which allows the platform LLC to communicate with investors who communicate with the managing LLC, ultimately providing direct communication.

### *C. Control and Regulation of Real Estate Securities*

Crowdfunding has led to a more complicated interplay between real estate and securities laws, bringing new challenges and concerns to lawmakers and officials who have been in the real estate business for many years. Securities regulation and enforcement, for example, are complex areas of the law, with stringent guidelines and tough penalties for violations, respectively. With the rise of this new method of investment, “grey area” has emerged as attempts are being made to apply existing securities regulations to real estate transactions occurring over crowdfunding platforms. In order for securities regulators to adequately understand a particular property investment or business venture, they must know exactly when to apply securities law and what their roles is in each step of each real estate transaction.<sup>56</sup> Some

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<sup>54</sup> Barash, *supra* note 36. As far as the sponsor is concerned, they do not have to deal with the fifty to one-hundred investors—if they did, the lines of communication between each individual investor would get crossed and create confusion. *Id.* Therefore, the platform enables the sponsor to deal with just one company that they know they have a rapport with; that they have cross-communication with; one that they do not think is going to call their cell phone at 1:00AM in the morning and ask them questions; about a check they expected to make, that hasn’t arrived; and its all governed by the operating agreements. *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> Barash, *supra* note 36; *see also*, Andy Sirkin, *Securities Law Primer for Real Estate Professionals*, SIRKIN LAW APC, <http://www.andysirkin.com/HTMLArticle.cfm?Article=171> (last visited Jan. 16, 2015) (“The starting point for determining whether securities law governs an investment real estate transaction is applying the ‘economic realities’ test first described by the U.S. Supreme Court in the 1936 case *SEC v. W.J. Howey*. To apply this test, ask whether someone will invest in a common enterprise with an expectation that profit will be earned substantially through the efforts of someone else. Since different parties in a joint real estate venture may have distinct powers and roles, this test must be applied separately for each



crowdfunding sites offer individual investors the chance to “invest in everything from single-family fixer-uppers to ground-up real-estate developments and even distressed mortgages, sometimes for as little as \$100.”<sup>57</sup> However, many of these new platforms were created in “response to the Jumpstart Our Business Startups [JOBS] Act of 2012, which eased restrictions on fundraising by small companies, and have been operating for less than a year.”<sup>58</sup>

The SEC regulates in a way that protects the public from making investments that are deemed too risky (i.e. not having enough funds or not being an *accredited investor*).<sup>59</sup> Many of these rules were created in the 1930s, before the age of the Internet. While this rationale made more sense eighty-five years ago, it does not make as much sense now. But today, it forces the SEC to ask whether or not these small investments are really that unsafe. There needs to be a balancing of interests—if regulators open up the market freely to everyone, it makes it easy for unaccredited investors to take advantage of the less educated individuals who really should not be taking such a big risk.<sup>60</sup>

Securities regulations generally distinguish “offerings marketed to the general public and those marketed privately.”<sup>61</sup> While public offerings require longer and more expensive registration and approval processes, private offerings are typically exempt from these requirements.<sup>62</sup> Although federal laws recognize the numerous types of offerings exempt from the strict registration and approval processes, many of the laws are either “loosely defined (making compliance more difficult and risky) or too restrictive to be useful.”<sup>63</sup> State regulation of securities adds another challenge, since a single transaction not only needs to comply with the securities regulations of the state where business is conducted, but also with the federal securities laws as well as the laws of ancillary states that may have contributed to the investment.<sup>64</sup>

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purchaser.”)

<sup>57</sup> Ruth Simon & Eliot Brown, *Real-Estate Sector Moves Crowdfunding Beyond the Trinkets*, WALL ST. J. (June 11, 2014, 6:46 PM), <http://www.wsj.com/articles/real-estate-sector-moves-crowdfunding-beyond-the-trinkets-1402526777>.

<sup>58</sup> *Id.*

<sup>59</sup> Barash, *supra* note 36.

<sup>60</sup> *Id.* A person making \$40,000–\$50,000 a year who wants to invest \$30,000 into a real estate deal that is supposedly going to be making millions does not exactly seem like a good idea, due to this particular person’s financial situation. *Id.*

<sup>61</sup> Sirkin, *supra* note 56.

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

### III. THE CROWDFUNDING DEBATE

#### A. *Legal Impacts – A Change to Securities Law*

While changes in the real estate market have affected the business arena more so than the practice of law,<sup>65</sup> the crowdfunding debate has brought about legal issues which are gaining traction. Even though law itself is stubborn in nature, crowdfunding has brought to the forefront its reactive side. As the business changes, the effects on the economy and world as a whole will be more impactful, and the laws will catch up when there is more for the lawmakers to see. Now that companies are using the Internet to reach new groups of investors, the SEC has to keep up with technological changes to ensure uniformity and transparency, since these once secretive business deals that are now more readily available.

#### 1. *History of Securities Law*

Often referred to as the “truth in securities” law, the Securities Act of 1933<sup>66</sup> (Securities Act) has two basic objectives: (1) requiring that investors who receive financial information and other significant information concerning securities being offered for public sale; and (2) prohibit deceit, misrepresentations, and other fraud in the sale of securities.<sup>67</sup> The registration process for securities sold in the U.S. ensures that companies supply essential facts and information on the requisite forms, which in turn minimizes the

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<sup>65</sup> *The Laws that Govern the Securities Industry*, SEC. & EXCH. COMM’N, <http://www.sec.gov/about/laws.shtml> (last visited Dec. 19, 2014).

<sup>66</sup> Securities Act of 1933, 15 U.S.C. § 77a et seq. (2012), <http://www.sec.gov/about/laws/sa33.pdf>.

<sup>67</sup> *Id.* (highlighting how registration of securities ensures adequate disclosure of important financial information, enabling investors to make informed judgments about purchasing a company’s securities). The purpose of securities law and the SEC is to administer these goals based on:

[T]he disclosure of important financial information through the registration of securities. This information enables investors, not the government, to make informed judgments about whether to purchase a company’s securities. While the SEC requires that the information provided be accurate, it does not guarantee it. Investors who purchase securities and suffer losses have important recovery rights if they can prove that there was incomplete or inaccurate disclosure of important information.

*The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC. & EXCH. COMM’N, <http://www.sec.gov/about/whatwedo.shtml#laws>, (last modified June 10, 2013).

burden and expense of complying with the law.<sup>68</sup> In general, registration forms call for: (1) a description of the company's properties and business; (2) a description of the security to be offered for sale; (3) information about the management of the company; and (4) financial statements certified by independent accountants.<sup>69</sup>

Following the Securities Act was the Securities Exchange Act of 1934<sup>70</sup> (Securities Exchange Act), which gave the SEC broad authority over all aspects of the securities industry, including “the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self regulatory organizations (SROs).”<sup>71</sup>

The Investment Companies Act of 1940<sup>72</sup> (Investment Companies Act) was implemented to regulate the “organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public.”<sup>73</sup> The Investment Advisers Act of 1940<sup>74</sup> (Investment Advisers Act) regulates investment advisers, “requir[ing] that firms or sole practitioners compensated for advising others about securities investments must register with the SEC and conform to regulations designed to protect investors.”<sup>75</sup>

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<sup>68</sup> See *The Laws that Govern the Securities Industry*, SEC. & EXCH. COMM'N, <http://www.sec.gov/about/laws.shtml> (last modified June 10, 2013).

<sup>69</sup> *Id.*

<sup>70</sup> Securities Exchange Act of 1934, 15 U.S.C. § 77a et seq. (2012), <http://www.sec.gov/about/laws/sea34.pdf>.

<sup>71</sup> See *The Laws that Govern the Securities Industry*, *supra* note 68 (“The Act also identifies and prohibits certain types of conduct in the markets and provides the Commission with disciplinary powers over regulated entities and persons associated with them,” empowering the SEC to “require periodic reporting of information by companies with publicly traded securities.”).

<sup>72</sup> Investment Companies Act of 1940, 15 U.S.C. § 80-1 et seq. (2012), <http://www.sec.gov/about/laws/ica40.pdf>.

<sup>73</sup> See *The Laws that Govern the Securities Industry*, *supra* note 68 (“[R]egulation is designed to minimize conflicts of interest that arise in these complex operations . . . requir[ing] these companies to disclose their financial condition and investment policies to investors when stock is initially sold and, subsequently, on a regular basis.”). The focus of the Investment Companies Act is disclosure of information regarding “the fund and its investment objectives, as well as on investment company structure and operations.” See *supra* note 26.

<sup>74</sup> Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 (2012), <http://www.sec.gov/about/laws/iaa40.pdf>.

<sup>75</sup> See *The Laws that Govern the Securities Industry*, *supra* note 68 (“Since the Act was amended in 1996 and 2010, generally only advisers who have at least \$100 million of assets under management or advise a registered investment company must register with the Commission.”). See generally Investment Advisers Act.

## 2. Exemptions and Other Rulings

While SEC registration provides regulatory and practical advantages, registration has more or less created unviable propositions for many crowdfunding platforms due to “the expense and prolonged nature of the process.”<sup>76</sup> The proficiency and time-saving benefits of crowdfunding, along with other online businesses, has been halted due to “the amount of money and time required to register a securities offering,”<sup>77</sup> which in turn “will most often prohibit the offering from occurring.”<sup>78</sup> Thus, under present securities laws, “the only practical means by which crowdfunding websites and crowdfunded ventures can offer or sell securities is to find an applicable exemption for the security or offering.”<sup>79</sup> Crowdfunding platforms can avoid registration when exemptions arise, including<sup>80</sup>: (1) the private offering exemption in Section 4(2) of the Securities Act<sup>81</sup> or its regulatory safe harbor, Rule 506 of Regulation D;<sup>82</sup> (2) Section 4(5) of the Securities Act;<sup>83</sup> (3) Rule 504 of Regulation D;<sup>84</sup> (4)

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<sup>76</sup> Joan MacLeaodway Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 911 (2011).

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at 911–12.

<sup>80</sup> Bradford, *supra* note 28, at 44 (noting that the exemptions would only free entrepreneurs from the “registration” requirements of the Securities Act, not from the “antifraud provisions” of the Securities and Exchange Act, including Rule 10b-5). Offerings that are exempt from registration include: “private offerings to a limited number of persons or institutions; offerings of limited size; intrastate offerings; and securities of municipal, state, and federal governments,” which are detailed in specific rulings below. *Id.*; *see also* Heminway & Hoffman, *supra* note 76, at 916 (“[E]ach exemptive rule has unique attributes, but there is some overlap in the requirements. Common to all three rules, however, are three unifying principles. First, offerings made within six months of each other may be integrated and considered to be a single offering if they have certain specified common characteristics. Second, securities acquired in Regulation D offerings are considered restricted securities for purposes of the Securities Act and cannot be resold absent registration or the availability of an applicable exemption. Third, except in limited circumstances under Rule 504, issuers and their agents may not offer or sell securities under Regulation D using ‘any form of general solicitation or general advertising.’”).

<sup>81</sup> Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(a)(2) (2012).

<sup>82</sup> 17 C.F.R. § 230.506 (2015); *see* Heminway & Hoffman, *supra* note 76, at 917–18 (“Rule 506 is a Section 4(2) safe harbor included in Regulation D. Because it is not based on the SEC’s authority to grant exemptions under Section 3(b), Rule 506 does not limit the maximum aggregate size of an offering that is exempt under its provisions. Like Rule 505, Rule 506 specifies that no more than thirty-five non-accredited investors may purchase the securities and requires the same affirmative disclosures to all non-accredited investors. Consistent with its roots in Section 4(2), Rule 506 requires that that each non-accredited investor or the non-accredited investor’s ‘purchaser representative’ meet a minimum sophistication requirement or that the issuer ‘reasonably believes’ immediately prior to making a sale that each non-accredited purchaser or purchaser representative meets that sophistication requirement.”).

<sup>83</sup> Securities Act of 1933 § 4(5), 15 U.S.C. § 77d(a)(5) (2012).

Rule 505 of Regulation D;<sup>85</sup> or (5) Regulation A.<sup>86</sup> Unfortunately, none of these exemptions are conducive to an entirely flexible or open-market crowdfunding system.

### *B. Social & Business Impacts*

The majority of novice investors do not typically invest for the thrill of the ride; rather, they want to invest in something that will generate a profit but without much risk. They tend to shy away from incorporating real estate into their investment portfolio because they are unfamiliar with the markets or cannot find a local property to invest in. However, the real estate market has been changing, providing new ways for novice investors overcome the barriers to entry and allowing them to diversify their investment portfolios. With crowdfunding, investors can invest in “a variety of types and locations of real estate,” instead of just browsing their local markets for the highest return.<sup>87</sup>

Shifting the process of real estate transactions from traditional “meet-and-greets” to “one-stop shop[s]” has opened the market to unlikely investors. Through crowdfunding platforms, “individual investor[s] [have] access to real estate deal flow that was previously only available to the big boys.”<sup>88</sup> Now, competing alongside “hedge funds, private equity groups, and other financial institutions [that] have teams of high-paid executives looking for properties to invest in”, are the average consumers or online shoppers.

Crowdfunding has also gained much of its appeal from the borrower’s

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<sup>84</sup> 17 C.F.R. § 230.504 (2015); *see* Heminway & Hoffman, *supra* note 76, at 917 (“Rule 504 provides an exemption for certain offerings not exceeding an aggregate of \$1,000,000 within a twelve-month period. This exemption places no limits on the number of offerees or purchasers, and does not require the issuer to provide specific affirmative disclosure.”).

<sup>85</sup> 17 C.F.R. § 230.505 (2015); *see* Heminway & Hoffman, *supra* note 76, at 917 (“Rule 505 provides an exemption for offerings with a maximum aggregate offering price of \$5,000,000 within a twelve-month period. The rule limits the number of purchasers to thirty-five, not including ‘accredited investors,’ a term that generally refers to entities and individuals who are presumed to be able to bear the financial risk of the total loss of their investment (e.g., institutional investors and high-net-worth individuals). Additionally, Rule 505 requires disclosure of specific financial and non-financial information to any securities purchasers who are not accredited investors.”).

<sup>86</sup> 17 C.F.R. §§ 230.552–230.553 (2015); *see* Heminway & Hoffman, *supra* note 76, at 921 (“Regulation A exempts offerings not exceeding \$5,000,000 within a twelve-month period, provided that the issuer offers the securities using an offering statement on Form 1-A, a filing similar limited registration statement, and an offering circular, a disclosure and selling document similar to the traditional Section 10 prospectus that forms a part of the registration statement in offerings registered under the Securities Act.”).

<sup>87</sup> Samit, *supra* note 46.

<sup>88</sup> *Id.* (alterations in original).

standpoint—the “sponsors” no longer have to look to various sources for new capital investments; rather, they can visit a real estate crowdfunding platform, which serves as their “one-stop shop,” enabling them to “spend more time running their businesses instead of fund raising.”<sup>89</sup>

### 1. Market Successes

When crowdfunding entered the real estate market back in June 2013, many financial advisers were skeptical as to how risky these types of investments would be. What the financial advisers had failed to see was that crowdfunding platforms were approaching real estate investing “through a different lens,”<sup>90</sup> turning crowdfunding into more than just a method of investing in real estate—it became about “investing in one’s own community.”<sup>91</sup> Though crowdfunding is a new trend, it has grown rapidly, creating more collaboration among local communities, as well as motivating more entrepreneurs and investors to build relationships across the country.

So, why has crowdfunding caught on so quickly? There are infinite ways to structure a crowdfunding deal, but the true success lies in allowing investors to make the choice themselves and to calculate the risk based on their individual assessments, rather than some generalization. This type of accessibility gives investors a larger array of choices, whereas in the past, they had limited options—either coming up with a large cash sum (i.e. \$100,000) in order to gain approval from large companies, or having to buy into property on their own.

With the accessibility of online business deals, investors from opposite ends of the United States are able to work together and form a business venture. Historically, real estate was always considered very local or regional, forcing buyers and investors to physically be in that market where they feel comfortable investing. Now, someone from outside the area, who formerly knew nothing about the specific deals going on in that location, is invited to invest and partake in a business deal, without even stepping away from his or her computer. Someone from New York, Kansas, or North Carolina can invest in a project in California, and vice-versa.

Crowdfunding also enables investors to gather the information about a

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<sup>89</sup> *Id.*

<sup>90</sup> Jonathan O’Connell, *Fundrise Faces off with Skeptical Financial Services Industry over Crowd-funded Real Estate*, WASH. POST (June 9, 2013), [http://www.washingtonpost.com/business/on-it/fundrise-faces-off-with-skeptical-financial-services-industry-over-crowd-funded-real-estate/2013/06/07/78ba818a-cdeb-11e2-8845-d970ccb04497\\_story.html](http://www.washingtonpost.com/business/on-it/fundrise-faces-off-with-skeptical-financial-services-industry-over-crowd-funded-real-estate/2013/06/07/78ba818a-cdeb-11e2-8845-d970ccb04497_story.html).

<sup>91</sup> *Id.*; see also Simon & Brown, *supra* note 57.

particular location and company, making investing even more transparent than before. They can make informed decisions about properties that they would not otherwise know about, or even consider investing in. Investors like to invest in areas that they are familiar with and ones that they know or think are a good bet. The investor can choose where to invest, rather than being limited to a single location, and can do so with the click of a mouse.<sup>92</sup> A process that normally takes several months to initiate and finalize has now become a streamlined process. Also, it typically took eight to twelve months for an entrepreneur to find angels who were interested in an offer and even longer to negotiate a deal. Now, that same process can sometimes be measured in weeks or days (sometimes hours) due to the accessibility, and efficiency of equity crowdfunding platforms.

The public's interest in crowdfunding is rooted in collaboration, where individuals can "share [his or her idea] to millions across the Internet and then

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<sup>92</sup> Barash, *supra* note 36. There is a lot of information out there already for investors to see the market research and the financial performance; to see the track records of investors; and to see the business plans and other documentation of companies. *Id.* While some information is sensitive and businesses often do not want to provide every single detail of information, online crowdfunding creates a more efficient exchange of information, where both parties can quickly agree as to what information they would like to share. *Id.* Thus, if there is information that someone wants to see, the "platform" is able to provide it to the parties. *Id.* Whether or not an investor is accredited, Rule 502 (issues regarding general conditions) indicates the following requirement regarding the information disclosed:

(b) *Information requirements*—(1) *When information must be furnished.* If the issuer sells securities under § 230.505 or § 230.506(b) to any purchaser that is not an accredited investor, the issuer shall furnish the information specified in paragraph (b)(2) of this section to such purchaser a reasonable time prior to sale. The issuer is not required to furnish the specified information to purchasers when it sells securities under § 230.504, or to any accredited investor . . . . (2) *Type of information to be furnished.* (i) If the issuer is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, at a reasonable time prior to the sale of securities the issuer shall furnish to the purchaser, to the extent material to an understanding of the issuer, its business and the securities being offered: (A) *Non-financial statement information.* If the issuer is eligible to use Regulation A (§ 230.251-263), the same kind of information as would be required in Part II of Form 1-A (§ 239.90 of this chapter). If the issuer is not eligible to use Regulation A, the same kind of information as required in Part I of a registration statement filed under the Securities Act on the form that the issuer would be entitled to use. (B) *Financial statement information.* (1) *Offerings up to \$2,000,000.* The information required in Article 8 of Regulation S-X (§ 210.8 of this chapter), except that only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited.

17 C.F.R. §§ 230.502(b)(1)– 230.502(b)(2)(B)(1) (2015) (alteration in the original) (emphasis added).



receive funding in return.”<sup>93</sup> It is a new source of capital with huge potential, with some estimating that it would add over \$2 trillion in new investments.<sup>94</sup> For novice investors, crowdfunding gives them opportunities to join investor networks, successfully fundraise, and invest in opportunities where they would have previously been denied.<sup>95</sup> A recent statistical study<sup>96</sup> portrays the motivations behind crowdfunding, divided by the following factors: 1) demographics, 2) type of organizational form, 3) crowdfunding as a new phenomenon, 4) motivation, 5) source of funding, and 6) type of investment. These factors,<sup>97</sup> among others, show how widespread crowdfunding is, and how it has created a marketplace for everyone, not just the sophisticated investors.

## 2. Market Challenges

Real estate industry experts say the SEC’s loose regulations within the crowdfunding market has created skepticism over the “solvency of such investments”<sup>98</sup> since “[l]andlords and developers might turn to crowdfunding because they have failed to acquire financing from banks or other traditional sources, while investors might lack the knowledge necessary to scrutinize potential investments.”<sup>99</sup>

Crowdfunding has changed the scope of investment sources, resulting

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<sup>93</sup> Adrian Chiang, *How Entrepreneurs Can Crowdfund Renewable Energy Projects*, 8 J. BUS. ENTREPRENEURSHIP & L. 660 [hereinafter Chiang] (citing EARLY IQ, CROWDFUND IQ BENCHMARK STUDY (Mar. 2013), <http://www.slideshare.net/fullscreen/earlyiq/crowdfundiq-benchmark-study/1> (discussing how modern technology has revolutionized crowdfunding). EarlyIQ, Inc., a San Diego information and analytics company published this study on equity crowdfunding: 58% of all adults in the USA are interested to participate in Crowdfunding, average investment will be \$1,300; 61% said they will invest 1 to 2 times a year; 20% said they will invest 3 times a year or more; 69% of those making more than \$75,000 a year will participate in crowdfunding at \$1,980 per investment level, 3 times a year; 48% of those making less than \$75,000 a year will participate in crowdfunding at \$1,150 per investment level, 2.5 times a year; but 55% of respondents have fraud as their number one concern with crowdfunding. *Id.*

<sup>94</sup> *Id.*; see also Chance Barnett, *SEC Finally Moves on Equity Crowdfunding, Phase I*, FORBES (July 19, 2013), <http://www.forbes.com/sites/chancebarnett/2013/07/19/sec-finally-moves-on-equity-crowdfunding-phase-1/>. “Estimated U.S. market for Title II crowdfunding (accredited investors): \$20 Billion . . . .” *Id.* (citations omitted). “Estimated U.S. market for Title III crowdfunding (non-accredited investors): \$2 Trillion . . . .” *Id.* (citations omitted).

<sup>95</sup> Chiang, *supra* note 93, at 660.

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

<sup>98</sup> Rachel Norvell, *Real Estate Crowdfunding Platform Receives Major Financial Boost*, MORTGAGE PROF. AM. (Sept. 24, 2014), <http://www.mpamag.com/real-estate/real-estate-crowdfunding-platform-receives-major-financial-boost-19622.aspx>.

<sup>99</sup> *Id.* (alteration in original).



in a shift away from investment banking to online funding. Not only has crowdfunding created a physical change in the way business deals are done, but it has also introduced new parties to the table. As more investment opportunities surfaced all across the Internet, the online base grew, and more novice investors were entering into business deals. Crowdfunding represents a new type of investment and a new way for the average consumer to engage in the process. While real estate crowdfunding still remains very much exclusive, it has brought more inclusivity to certain business deals by its ability “its potential to tap into an enormous group of new investors.”<sup>100</sup>

While crowdfunding encourages safer meaningful investing from a new pool of investors, a financial mechanism that relies on investor engagement and even emotion may not be the best suited for real estate transactions.<sup>101</sup> As increased rules and regulations have been placed upon crowdfunding generally, additional specific regulation has been placed upon real estate crowdfunding. Thus, new investors who are entering the investment business just as quickly as deals are being fundraised are realizing soon thereafter that they are not as free to move about the market as they had anticipated.

From a free-market point of view, while the JOBS Act has seemed to create opportunities to all players in the market, the SEC exemption disqualifies certain companies, including:

[N]on-U.S. companies, companies that already are SEC reporting companies, certain investment companies, companies that are disqualified under the proposed disqualification rules, companies that have failed to comply with the annual reporting requirements in the proposed rules, and companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies.<sup>102</sup>

Despite these limitations, real estate crowdfunding has been “particularly popular largely because it is a tangible asset that people can look at and even visit,”<sup>103</sup> making “[i]t . . . easier to understand and value.”<sup>104</sup>

### *C. Changing the Playing Field for Investors*

Crowdfunding real estate projects has changed the playing field of real

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<sup>100</sup> Chiang, *supra* note 93, at 680.

<sup>101</sup> *Id.* at 681.

<sup>102</sup> *SEC Issues Proposal on Crowdfunding*, SEC. & EXCH. COMM’N (Oct. 23, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.VFExufD5gI>.

<sup>103</sup> Simon & Brown, *supra* note 57.

<sup>104</sup> *Id.*

estate development, as well as ordinary business dealings, shifting away from bank lending to online investments.<sup>105</sup> However, this shift could not be done without the middleman, better known as the crowdfunding platform. But what role does the platform play? And how can investors be certain that their money will be adequately handled? Investors—no matter how big or small, experienced or not—know that protection is key to any business deal. In order to protect investors, the SEC requires all crowdfunding transactions to go through an “SEC-registered intermediary, either a broker-dealer or a funding portal.”<sup>106</sup>

The SEC requires investments to occur solely online, which would oblige the platforms to: “(1) Provide investors with educational materials; (2) Take measures to reduce the risk of fraud; (3) Make available information about the issuer and the offering; (4) Provide communication channels to permit discussions about offerings on the platform; and (5) Facilitate the offer and sale of crowdfunded securities.”<sup>107</sup> Further, the platforms are prohibited from: “(1) Offering investment advice or making recommendations; (2) Soliciting purchases, sales or offers to buy securities offered or displayed on its website; (3) Imposing certain restrictions on compensating people for solicitations; and (4) Holding, possessing, or handling investor funds or securities.”<sup>108</sup> The platforms play a major role facilitating deals between the investors and companies, but further provide a business environment that is safe, and on par with the SEC requirements.

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<sup>105</sup> *Id.* (“With real estate, ‘there is collateral, cash flow, a return and a projected exit time for the investment,’ says Joanna Schwartz, founder of EarlyShares.com, Inc., an online equity crowdfunding site that launched its first offering last year.”).

<sup>106</sup> *SEC Issues Proposal on Crowdfunding*, *supra* note 102. The number of participants in this market and the amounts raised through alternative sources indicate that this is a large market. In 2011, there were almost five million small businesses, defined by the U.S. Census Bureau as having fewer than 500 paid employees. *See Proposed Rules*, *supra* note 10, at 225.

<sup>107</sup> *SEC Issues Proposal on Crowdfunding*, *supra* note 102. Offerings made in reliance on Section 4(a)(6) might provide retail investors with additional investment opportunities, although the extent to which they invest in such offerings would likely depend on their view of the potential return on investment as well as the risk for fraud. This could broaden their user base and attract a group of investors different from those already participating in reward-based or donation-based crowdfunding. It is likely that some registered broker-dealers will find it profitable to enter the securities-based crowdfunding market and operate funding portals. *See Proposed Rules*, *supra* note 10, at 352.

<sup>108</sup> *SEC Issues Proposal on Crowdfunding*, *supra* note 102.

## IV. REGULATION &amp; CONTROL OF REAL ESTATE CROWDFUNDING

A. *Shifting Away from the SEC's Prior Regulatory Framework*

Investments executed via online crowdfunding can breach various securities laws because soliciting investments from the public is often illegal, unless the opportunity has been filed with an appropriate securities regulatory authority, such as the SEC.<sup>109</sup> As more individuals have now been able to invest in unlikely projects, the SEC needs to formulate rules and regulations to place on the online market. Online crowdfunding is still a recent trend, and is continuing to bring changes to the securities law daily, fueling “a debate as to whether the above securities law even applie[s] to crowdfunding financing, and if it [does], whether crowdfunding [should] fit within one of the registration exemptions.”<sup>110</sup>

The formerly heated debate simmered to a fairly concise solution with the creation of the JOBS Act,<sup>111</sup> establishing the foundation for a regulatory structure for startups and small businesses to raise capital through securities offerings using online crowdfunding. “The crowdfunding provisions of the JOBS Act were designed to help provide startups and small businesses with capital by making relatively low dollar offerings of securities less costly.”<sup>112</sup> The Act also permits Internet-based platforms to facilitate the offer and sale of securities without having to register with the Commission as brokers.<sup>113</sup> Since the “government has only recently in the last few years begun to allow this type

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<sup>109</sup> *Id.*

<sup>110</sup> Chiang, *supra* note 93, at 685.

<sup>111</sup> Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112–106, 126 Stat. 306 (2012), <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf> [hereinafter JOBS Act]; *see also* Rand, *supra* note 6 (discussing how the JOBS Act has “streamline[d] the process through which startups and small businesses could raise funds by selling equity capital and soliciting small investments over the Internet”).

<sup>112</sup> Proposed Rules, *supra* note 10, at 7 (citing 158 CONG. REC. S1781 (daily ed. Mar. 19, 2012) (statement of Sen. Carl Levin) (“Right now, the rules generally prohibit a company from raising very small amounts from ordinary investors without significant costs.”); 157 CONG. REC. S8458-02 (daily ed. Dec. 8, 2011) (statement of Sen. Jeff Merkley) (“Low-dollar investments from ordinary Americans may help fill the void, providing a new avenue of funding to the small businesses that are the engine of job creation. The CROWDFUND Act would provide startup companies and other small businesses with a new way to raise capital from ordinary investors in a more transparent and regulated marketplace.”); 157 CONG. REC. H7295-01 (daily ed. Nov. 3, 2011) (statement of Rep. Patrick McHenry) (“[H]igh net worth individuals can invest in businesses before the average family can. And that small business is limited on the amount of equity stakes they can provide investors and limited in the number of investors they can get. So, clearly, something has to be done to open these capital markets to the average investor . . .”).

<sup>113</sup> Proposed Rules, *supra* note 10, at 7. For more in-depth comments and analysis on each title of the JOBS Act, *see*: <http://www.sec.gov/spotlight/jobsactcomments.shtml>.

of crowdfunding,”<sup>114</sup> the SEC has had to rework existing securities regulations in order to keep up with the online market, and “protect investors against fraud.”<sup>115</sup>

*B. Changes Under the JOBS Act: Driving Interest in Crowdfunding*

The JOBS Act,<sup>116</sup> enacted on April 5, 2012, aims to help businesses raise funds in public capital markets by minimizing regulatory requirements. In accordance with the JOBS Act, the SEC’s new rules permit individuals to invest in real estate projects conditioned upon certain limits. Consequently, such rules “limit the amount of money a company can raise, require companies to disclose certain information about their offers, and create a regulatory framework for the intermediaries that would facilitate the crowdfunding transactions.”<sup>117</sup>

With the passage of the JOBS Act, online investors have experienced “ease [from] the regulatory burden placed on emerging businesses that go public.”<sup>118</sup> As a result, there has been increased “economic activity and job growth.”<sup>119</sup> The key provisions of the JOBS Act (Title I-III) lending themselves to the efficiency of the market, and growth of the real estate market are discussed in summary, and detailed below:

Title I of the JOBS Act generally reduces the financial reporting obligations of a new class of issuers called ‘Emerging Growth Companies.’ Title II permits general solicitation and advertising for securities offerings made pursuant to Rule 506 of Regulation D and Rule 144A of the Securities Act. Title III of the JOBS Act creates a registration exemption and lessens required issuer disclosures for certain companies seeking to crowdfund up to one million dollars over the course of a twelve-month period. Title IV grants the SEC the responsibility of crafting a new exemption for small private offerings of under fifty million dollars. Finally, Titles V and VI amend the number of record holders of a security permitted before mandatory registration requirements are

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<sup>114</sup> Chiang, *supra* note 93, at 684.

<sup>115</sup> *Id.*

<sup>116</sup> See JOBS Act, *supra* note 111. For updates and reviews of the laws, see the Classification Tables maintained by the US House of Representatives Office of the Law Revision Counsel, <http://uscode.house.gov/classification/tables.shtml>. See also Nickolas C. Jensen, *Fundraising on the Internet Crowdfunding, Kickstarter and the Jobs Act*, ARIZ. ATT’Y, Mar. 2013, at 22.

<sup>117</sup> SEC Issues Proposal on Crowdfunding, *supra* note 102; see also Proposed Rules, *supra* note 10.

<sup>118</sup> Jesse Scott, *The Jobs Act: Encouraging Capital Formation but Not IPOs*, 7 J. BUS. ENTREPRENEURSHIP & L. 367, 373 (2014).

<sup>119</sup> *Id.*

triggered under the Securities Acts.<sup>120</sup>

The limits on crowdfunding are highlighted in Title III,<sup>121</sup> adding § 4(a)(6), “which provides an exemption from the registration requirements of Securities Act § 5 for certain crowdfunding transactions.”<sup>122</sup> The qualifications for the exemption including the following:

[T]he amount raised must not exceed \$1 million in a 12-month period (this amount is to be adjusted for inflation at least every five years);<sup>123</sup> individual investments in a 12-month period are limited to: the greater of \$2,000 or 5 percent of annual income or net worth, if annual income or net worth of the investor is less than \$100,000; and 10 percent of annual income or net worth (not to exceed an amount sold of \$100,000), if annual income or net worth of the investor is \$100,000 or more (these amounts are to be adjusted for inflation at least every five years); and transactions must be conducted through an intermediary that either is registered as a broker or is registered as a new type of entity called a “funding portal.”<sup>124</sup>

### C. *The Future of the JOBS Act and Modification of Securities Law*

Under the JOBS Act, securities laws have been modified, increasing the number of investors in a particular firm by four hundred percent, leading to greater public investment into private firms.<sup>125</sup> This modification allows

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<sup>120</sup> Chiang, *supra* note 93, at 686–87 (citing Benjamin P. Siegel, *Title III of the Jobs Act: Using Unsophisticated Wealth to Crowdfund Small Business Capital or Fraudsters' Bank Accounts?*, 41 HOFSTRA L. REV. 777, 788 (2013)); *see also* Scott, *supra* note 118, at 374. Title I was designed to reopen the American capital market system to compliment the emerging growth of business, aiming to increase the number of smaller growth companies going public. *Id.* Title II was designed to provide more access to capital for the business that were creating more jobs due to the crowdfunding market. Ultimately, Title II was ordered to “revise Rule 506 of the Securities Act . . . ‘which exempts transactions by an issuer “not involving any public offering” from the registration requirements of Section 5 of the Securities Act.’” *Id.* at 377–78 (citations omitted).

<sup>121</sup> Title III of the JOBS Act is called the “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012,” or in shorter form, the CROWDFUND Act. § 301, 126 Stat. 315 (2012).

<sup>122</sup> Proposed Rules, *supra* note 10, at 9.

<sup>123</sup> Barash, *supra* note 36. Private real estate platforms utilize this conception of the “credited investor,” and determine an investor’s credibility based on whether: 1) they have a net worth over \$1,000,000, or 2) they have made a certain amount of income for the last 2 years. *Id.* If they fit into any of these buckets, they are a credited investor. *Id.* Ultimately, picking who can and cannot invest serves as the best ways of regulating the exchange of money and the exchange of contracts. *Id.* By focusing only on pre-vetted real estate deals, private platforms are able to underwrite its investors, since they have nearly hundreds on a daily basis, from people all over the world. *Id.*

<sup>124</sup> Proposed Rules, *supra* note 10, at 9–10. *See supra*, Section III.B. (regarding the regulatory changes made under the JOBS Act).

<sup>125</sup> Ruth Simon & Angus Loten, *Frustration Rises Over Crowdfunding Rules*, WALL ST. J.

companies to “raise funds from average investors online through a process known as ‘equity crowdfunding.’”<sup>126</sup> Congress tasked the SEC with proposing and adopting final rules of the new law, but how these rules are to be implemented will be an ongoing debate.

Equity crowdfunding, while guided by strict rules of the SEC, requires a close watch, before the safety net is taken away.<sup>127</sup> In addition, Title III indicates the following regarding transactions between parties:

(1) adds Securities Act § 4A, which requires, among other things, that issuers and intermediaries that facilitate transactions between issuers and investors in reliance on § 4(a)(6) provide certain information to investors and potential investors, take certain other actions and provide notices and other information to the Commission; (2) adds Exchange Act § 3(h), which requires the Commission to adopt rules to exempt, either conditionally or unconditionally, “funding portals” from having to register as brokers or dealers pursuant to Exchange Act § 15(a)(1); (3) includes disqualification provisions under which an issuer would not be able to avail itself of the § 4(a)(6) exemption if the issuer or other related parties, including an intermediary, was subject to a disqualifying event; and (4) adds Exchange Act § 12(g)(6), which requires the Commission to adopt rules to exempt from the registration requirements of § 12(g), either conditionally or unconditionally, securities acquired pursuant to an offering made in reliance on § 4(a)(6).

These complicated rules and procedures do not make for easy regulation or implementation. Since crowdfunding is a new market, statistics are scant, definitions vary, and many crowdfunding platforms are hiding the ball when it comes to amounts raised, or numbers of investors.<sup>128</sup>

With the passing of the JOBS Act, the real estate market has become less restricted, “loosen[ing] an 80-year-old federal law prohibiting companies from advertising investment opportunities to the general public.”<sup>129</sup> In response to the liberated market, many crowdfunding platforms have taken “advantage of new marketing freedoms provided by the JOBS Act.”<sup>130</sup> While there are still many restrictions governing these types of real estate transactions, the rules may again be stretched to include “ordinary investors” who did not formerly qualify as “accredited investor[s].”<sup>131</sup>

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(April 30, 2014, 7:12 PM), <http://online.wsj.com/articles/SB10001424052702304163604579532251627028512>.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> Simon & Brown, *supra* note 57.

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> *See id.*

## V. IMPACT AND SIGNIFICANCE

Of course, the type of crowdfunding method used to finance a project will determine the type of and amount of regulation involved. Certainly “crowdfunding as a donation” model rather than equity or debt models will require less regulation by the SEC.<sup>132</sup> The SEC’s proposed rules address the latter, that is, the crowdfunding models that entail a return on investment (ROI). Generally, when companies sell securities to the public, each transaction requires compliance with the SEC.<sup>133</sup>

### A. Critiques – Congress’s Take on Crowdfunding?

While crowdfunding is only a recent trend, “[it] is in a very early and noticeably unsettled state . . . [c]omprised of a rapidly changing set of Internet business models . . . .”<sup>134</sup> The flexibility of the crowdfunding models has made the online market “less transparent and more intangible to investors and regulators.”<sup>135</sup> Since the many supporters of crowdfunding consist of thousands of unknown investors and entities, crowdfunding “shares many of the overall negative attributes of small business and start-up capital formation.”<sup>136</sup> Just like a start-up company, real estate investors who perform their business through crowdfunding platforms may not be well-informed of the market trends or educated in real estate itself. This creates “many traps for the unwary in this relatively new, rapidly developing, faceless transactional environment.”<sup>137</sup>

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While many restrictions still apply, businesses are now freer to promote investments on the Internet to individuals who are known as accredited investors—generally those with an annual income exceeding \$200,000 or a net worth, excluding their primary residence, above \$1 million. The Securities and Exchange Commission is working on rules that would allow ordinary investors to funnel modest sums into private companies.

*Id.*

<sup>132</sup> James Montgomery, *SEC Clarifies Crowdsourcing Rules, What’s the Impact on Renewables?* RENEWABLEENERGYWORLD.COM (Nov. 04, 2013), <http://www.renewableenergyworld.com/rea/news/article/2013/11/sec-clarifies-crowdsourcing-rules-whats-the-impact-on-renewables>.

<sup>133</sup> *Id.*

<sup>134</sup> Heminway & Hoffman, *supra* note 76, at 933.

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

<sup>137</sup> *Id.* (further commenting on the volatility of the crowdfunding model).

Small businesses, especially start-ups, fail at a relatively high rate, and investors are likely to lose all of their investment. In fact, it may be easier for investors who lack corporate finance expertise or knowledge of relevant



Although the real estate crowdfunding market provides more flexibility to borrowers and investors, the market itself is unpredictable, with evident limits and obstacles to overcome. While this portion of the real estate market has certainly seen success, “[a]t this point, the money raised through [crowdfunding] is [still] tiny compared with other real-estate investments.”<sup>138</sup> For example, “[t]he total market value of publicly traded real-estate investment trusts [alone] is over \$700 billion.”<sup>139</sup>

### 1. A Limited System?

Some market experts and experienced investors have “skepticism that crowdfunding [will not] become anything more than a niche.”<sup>140</sup> Concerns over this “loosely regulated market” are based on notions that “many investors aren’t sophisticated real-estate professionals and the scrutiny of potential investments and other practices vary widely.”<sup>141</sup> The increased “pressure is enormous for [this] undisciplined real estate industry to change its approach to the project creation and development process, capital markets, and technology.”<sup>142</sup> However, the online real estate market is “rapidly evolving to service and capitalize new stakeholders, and will continue to require capital that aligns with increasingly efficient asset programs . . . .”<sup>143</sup>

Since most real estate investments are *inherently risky*, especially in the early stages of investment, “real estate has been limited to sophisticated,

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industries to lose their savings through online investments. The SEC provides specific guidance to retail investors engaging in online trading: Online trading is quick and easy, but online investing takes time.

*Id.* at 933–34.

<sup>138</sup> Simon & Brown, *supra* note 57.

<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

<sup>141</sup> *Id.* (“But some established fundraisers in real estate see potential in crowdfunding, and are taking advantage of the looser rules. For instance, property-investment advisory firm Carlton Group, which used to solicit funds out of public view, has started a crowdfunding website aimed at those investing large sums, typically more than \$1 million. Some participants in the property business believe the numbers soon could grow into the tens of millions of dollars for projects.”)

<sup>142</sup> Elizabeth S. Kulik, *Crowdfunding Real Estate Deals: Technology Meets Transactions, The New Power Couple*, REALCOMM (Feb. 28, 2014), <http://www.realcomm.com/advisory/advisory.asp?AdvisoryID=626>.

<sup>143</sup> *Id.* Crowdfunding provides an alternative form of investment and in an “era when every real estate development is a new version of public/private partnership, the Crowd is becoming a powerful source of ideas, time, goods/services, expertise, and capital.” *Id.* “This is a remarkable opportunity for the public to become stakeholders in the next generation of real estate development and investment.” *Id.*



accredited, high net worth institutional and fund investors.”<sup>144</sup> Due to these strictures, “[p]rivate investors and the general public have had limited access.”<sup>145</sup> Creating a less limited or non-exclusive market requires stakeholders to pay closer attention to risk management, which requires investors (whether novice or seasoned) to build the “best technical, social and real estate practices to generate a pipeline of qualified investments and sustainable returns.”<sup>146</sup>

## 2. *Viability of a New Market?*

Crowdfunding “raises the question of whether it is really a viable financing option for building and owning projects, except maybe very small projects.”<sup>147</sup> The size of a transaction plays a significant factor in real estate deals, because generally, the bigger a project, the more difficult it becomes to finance, file and complete. Nonetheless, even though crowdfunding remains a “relatively immature and under-developed sector,” a market providing some flexibility and growth to new investors not only will lead to larger deals in the near future, but the deals will continue to keep getting larger.<sup>148</sup>

Analyzing “emerging crowdfunding phenomen[a]” and evaluating the funding potential for commercial real estate deals, it is evident that crowdfunding is becoming a “viable funding alternative for commercial real

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<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> David Prosser, *Small Talk: Crowdfunding Must Now be Taken Seriously by Rivals*, THE INDEPENDENT (Jan. 13, 2015), <http://www.independent.co.uk/news/business/comment/small-talk-crowdfunding-must-now-be-taken-seriously-by-rivals-9975075.html>. Prosser further comments:

This isn't how crowdfunding started out. When small businesses first began looking to sites such as Funding Circle and Ratesetter for finance, they were typically in need of much smaller amounts – tens of thousands of pounds, or even less – and were perceived as a source of finance for ventures struggling to get bank funding. Those businesses will continue to find the finance they need from crowdfunding, but the sector's expansion at the top end will make it a credible competitor in a market that is currently the preserve of corporate financiers. That assumes, of course, that the platforms are able to raise sufficient sums to lend or invest in the larger deals. There is reason to be confident: the supply of funding has kept pace with demand, and government support for the sector (through direct assistance, tax breaks and the inclusion of peer-to-peer lending in the individual savings account regime) should be an impetus for growth.

*Id.*

estate deals,” but it depends on the type of deal on the table.<sup>149</sup> Unlike other types of securities, “the relatively high preferred return required by most equity crowdfunding companies . . . isn’t suitable for a pure yield ‘buy and hold’ investment because the cash flow or returns aren’t there to support it.”<sup>150</sup> However, equity-based crowdfunding, compared to the other crowdfunding models, has shown to be the most viable funding model since it is most suitable “for value-add or development opportunities for which you can add significant value in 2-3 years.”<sup>151</sup> Thus, equity-investors can “build value and finance the crowdfunding out, replacing it with more conventional (and cheaper) financing.”<sup>152</sup>

### 3. *Letting in the Novice Investor?*

Will the real estate crowdfunding become more inclusive to the novice investor? Many market analysts have commented on the exclusivity of this market, since only *accredited investors* maintain “control [over] the funds for \$800 billion of privately-placed investments annually.”<sup>153</sup> However, the SEC has been “reevaluating the requirements to be considered an accredited investor, potentially updating those criteria to the most significant degree in 30 years.”<sup>154</sup> The definitions and interpretations of the accredited investor is

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<sup>149</sup> Michael Blank, *Is Crowdfunding a Viable Financing Option for Commercial Investors?*, BIGGERPOCKETS BLOG (Sept. 15, 2014), <http://www.biggerpockets.com/renewblog/2014/09/15/is-crowdfunding-viable-financing-option-for-commercial-investors>.

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

In this respect, crowdfunding is a bit like hard money, but it typically doesn’t require the high points at closing, and it’s much more flexible in terms of how it plays with other kinds of financing you may also have in the same deal . . . . While equity crowdfunding may not be ideal for every buy and hold commercial real estate deal (right now), it deserves strong consideration for value-add or development deals for which you can finance out the crowdfunding equity in 2-3 years. In combination with cheap traditional debt financing, crowdfunding can provide a way for you to raise unlimited funds with reasonable terms for your next commercial real estate investment.”

*Id.* (emphasis added).

<sup>153</sup> Scott Lichtman, *Who Gets to Invest via Crowdfunding? The Evolving Definition of ‘Accredited Investor,’* IFUNDING (Aug. 13, 2014), <https://www.ifunding.co/blog/who-gets-to-invest-via-crowdfunding-the-evolving-definition-of-accredited-investor/>.

<sup>154</sup> *Id.* (“Today, ‘accredited investor’ is defined as someone whose income exceeded \$200,000 in each of the past 2 years (and is likely to do the same in the current year); or whose income exceeds \$300K jointly with one’s spouse, or who has a net worth over \$1 million (individually or jointly with spouse, excluding the value of your primary residence).

unpredictable, since there has been a “review of the accredited investor definition every four years,” which is specified under the Dodd-Frank financial regulatory reform act.<sup>155</sup>

Just like other types of securities, the pros and cons of real estate crowdfunding boils down to the amount of risk and how much investors want to dedicate to learning how the online market functions. Both real estate developers and investors can “reap significant financial returns through crowdfunding,”<sup>156</sup> but both need to learn how to spread their risks, and weigh the pros and cons of each investment:

Pros: (1) Investors get access to the real estate market with small amounts of money; (2) Investors get to work directly with real estate developers and have a voice in the process; (3) Investors can choose which real estate projects in which they want to invest their money; and (4) Investors have access to myriad projects, so choice and options aren’t a problem. Cons: (1) Investors have the same issues as every real estate investor. If the market goes south, they will likely lose money; (2) The risk of investment default (from real estate developers) is higher for crowdfunding compared to peer-to-peer and direct real estate investment funding; and (3) A lack of liquidity, as the absence of a secondary market restricts easy selling access for investors.<sup>157</sup>

While the shifting nature of the SEC and Dodd-Frank definitions provides hope for investors who do not quite meet the basic criteria for accreditation, there is a “possibility that the net income or net worth thresholds will be increased.”<sup>158</sup> But shouldn’t the credibility of investors be based on more than just their annual income?<sup>159</sup> The SEC has taken into account other factors, beyond finances, to determine credibility; “ask[ing] for public comments on whether financially ‘sophisticated’ individuals—CPAs, investment advisors, traders or chartered financial analysts, potentially even MBAs or lawyers—can achieve accredited investor status, regardless of their

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Representatives of banks and certain investment companies also qualify.”)

<sup>155</sup> *Id.*

<sup>156</sup> Brian O’Connell, *Real Estate and Crowdfunding: A New Path for Investors*, INVESTOPEDIA (July 25, 2014), <http://www.investopedia.com/articles/investing/072514/real-estate-and-crowdfunding-new-path-investors.asp>.

<sup>157</sup> *Id.*

<sup>158</sup> *Id.*

<sup>159</sup> *Id.* (“Numerous players have entered the field. Although each of these platforms has its own niche and strategy, with different levels of minimum investment, all are geared toward accredited investors who meet specific requirements for net worth and/or annual income. By contrast, crowdfunding under the JOBS Act will open the field to many more smaller investors.”) (internal quotations omitted).

income [or] net worth.”<sup>160</sup>

*B. Inter-market Competition – The Old Versus the New*

The increased number of participants (or investors) in the online real estate market, combined with the amount of funds raised through crowdfunding, indicates that this is a progressively large market, with potential issues of instability and increased tension.<sup>161</sup> A phenomenon that is growing increasingly fast, crowdfunding raises the question of whether “two disparate investment markets—one old and one new—[can] get along without driving each other crazy?”<sup>162</sup> The “old versus new” question has surfaced with the development of technology, and is simply an interplay between traditional business methods and modern-technological advances. Many traditional business methods are faced with the challenge of keeping updated, and adapting to modern consumer trends.

The three biggest ways crowdfunding (the “new”) is changing the face of traditional commercial real estate (the “old”) are based on: 1) the number of options available to current and prospective investors; 2) the increased access to the market; and 3) the cost-benefits of transforming the market from offline to online.<sup>163</sup>

Does crowdfunding create the same options that traditional real estate investment methods have? As the market moves from an exclusive and private

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<sup>160</sup> *Id.* The author contends that:

The financial sophistication of consumers is [not] the most important point. The most important point is that the SEC’s 30-year experiment with Regulation D has shown that the danger of opening private investment to individuals is far lower than many people believed. The SEC could have changed the definition of accredited investor at any time without Congressional authorization. The reason the SEC has left the definition alone is that Regulation D as a whole, and Rule 506 in particular, have been pretty ‘clean,’ meaning free of fraud and other abuse, even as the \$200,000/\$1,000,000 limitations have grown smaller and smaller with inflation. There is no reason to believe that would change if the thresholds were lower.

*Id.*

<sup>161</sup> *Id.*

<sup>162</sup> *Id.* (“That’s the key question for crowdfunding and the real estate market. It’s a question being answered in positive ways in 2014, as the two ‘odd couples’ appear to be pairing up quite nicely and giving investors a new way to leverage profits from the burgeoning U.S. real estate market.”)

<sup>163</sup> Adam Chapnick, *How Crowdfunding is Changing the Face of Commercial Real Estate*, NAT’L REAL ESTATE INV. (Nov. 12, 2014), <http://nreionline.com/viewpoints/how-crowdfunding-changing-face-commercial-real-estate>.

market, to a more inclusive and public one, crowdfunding will still follow the “basic supply and demand” formula “dictat[ing] that when there is market demand for something but not enough supply, an opportunity exists for someone to step in to fill the void.”<sup>164</sup> As the “demand for commercial real estate loans [has] steadily increase[ed], . . . traditional lending companies are less inclined to lend money and are moving at a glacial pace to deploy capital to borrowers still in need of funds.”<sup>165</sup> At times when the market was slow and unresponsive, “borrowers [were] forced towards a small range of lenders available to them.”<sup>166</sup> However, with the emergence of real estate crowdfunding “borrowers [and investors] suddenly have access to more options.”<sup>167</sup>

From the investors’ standpoint, increased access to the market has reshaped the number of opportunities for novice investors and has generated alternative ways for projects to be funded since “[c]ommercial real estate loans offer investors an opportunity to put their money into a fixed income vehicle backed by a hard asset.”<sup>168</sup> While this was formerly “an asset class that the wealthy love and traditionally only a few select members of the investing world were able to access,” real estate crowdfunding has provided more leeway for the non-traditional investors. Even though “accreditation standards for individuals remain high,” various crowdfunding platforms have opened the door to “small” investors, who will now be able to gain “access to senior level deals because of the bulk and quality of deals [that] platforms are able to underwrite.”<sup>169</sup>

The final change that crowdfunding has brought to the real estate market is savings. With the influx of technology, traditional methods of real estate investing have become “outdated fee models [that] are ripe for innovation.”<sup>170</sup> Since the real estate industry has “remain[ed] unchallenged for decades and even centuries,”<sup>171</sup> there has been “massive inefficiencies build-up, creating higher overhead for financial institutions, who then have to pass those costs on to their clients in the form of higher and often confusing feed.”<sup>172</sup> However, “[a]s commercial real estate platforms scale, they’re able to

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<sup>164</sup> *Id.*

<sup>165</sup> *Id.*

<sup>166</sup> *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> *Id.*

<sup>169</sup> *Id.*

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

leverage technology not only to reduce their own overhead but also to largely disintermediate the traditional chain of touch points in the lending process.”<sup>173</sup> As a result, because platforms have “reduced overhead and fewer unnecessary touch points,”<sup>174</sup> investors and borrowers are able to enter into real estate deals with “unprecedented transparency and a significantly lower fee structure.”<sup>175</sup>

As the SEC continues to delay implementation of formal guidelines, many states have begun to establish their own crowdfunding rules. While this may seem like a hindrance to the SEC, state oversight may just be the thing that “rescues crowdfunding from a regulatory death grip.”<sup>176</sup> More than two years have passed since the SEC’s December 2012 deadline, and this has caused many to question the efficacy of the SEC and whether or not the SEC’s proposed rules will ever make their way off of the discussion board. The longer it takes to establish federal securities regulations of real estate crowdfunding, the more States will begin to establish their own rules, and the more diluted the rules may become.<sup>177</sup>

While this federal standstill may provide benefits to the *current*

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<sup>173</sup> *Id.*

<sup>174</sup> *Id.*

<sup>175</sup> *Id.*

<sup>176</sup> Steven D. Solomon, *SEC’s Delay on Crowdfunding May Just Save It*, N.Y. TIMES (Nov. 18, 2014, 2:56 PM), [http://dealbook.nytimes.com/2014/11/18/s-e-c-s-delay-on-crowdfunding-may-just-save-it-2/?r=0.&\\_r=0](http://dealbook.nytimes.com/2014/11/18/s-e-c-s-delay-on-crowdfunding-may-just-save-it-2/?r=0.&_r=0).

<sup>177</sup> See Robert N. Rapp, *Securities & Capital Markets: As SEC Rules Languish, States Step Up the Initiative on Equity Crowdfunding*, CALFEE (Nov. 5, 2014), <http://calfee.com/wp-content/uploads/2014/11/02758929.pdf>.

On October 1, 2014, and October 22, 2014, respectively, Washington and Texas joined the increasing number of states that are establishing a mechanism and regulatory structure to permit intrastate equity, or “investment,” crowdfunding in order to assist start-up companies in accessing capital through small securities offerings. Thirteen states and the District of Columbia have adopted laws or rules allowing small businesses in those states to raise up to \$1 million annually in securities offerings carried out entirely within the state. Although the emergent laws and rules in all of these states are not entirely uniform in their mechanics and limitations, these initiatives reflect general frustration with the lack of progress on the implementation of crowdfunding rules by the U.S. Securities and Exchange Commission (SEC) under the mandate of the Jumpstart Our Startups (JOBS) Act signed into law in 2012. [Furthermore,] [c]rowdfunding acts, or regulatory exemptions are already in place in Michigan, Wisconsin, Georgia, Kansas, Indiana, Texas, Alabama, Colorado, Idaho, Maine, Maryland, Minnesota, Tennessee and the District of Columbia. Several other states, including Illinois and New Jersey, have proposed laws working their way through the legislatures, or related rulemaking under way. There is currently no equity crowdfunding legislative or rulemaking initiative in Ohio.

*Id.*

crowdfunding market, lack of proper guidelines will lead to a scattered system that lacks a formal system of procedural and substantive legal supervision. These continued delays (as we have seen since the early beginnings of the crowdfunding boon) and lack of guidance from the SEC have created turmoil amongst the start-up community between long-time borrowers and novice investors, who were “eager to link up through the new online portals.”<sup>178</sup> Whether the delays come from academics and policy makers’ contention of the new market, or the SEC’s own backlogged system, it is evident that adequate rules must be put in place before the market becomes too unstable. Despite these delays, the real estate crowdfunding market is growing exponentially, as States have commandeered the crowdfunding market, initiating rules on their own grounds to bring equity crowdfunding deals closer to their own regulatory reach. Each State’s exemption structure is designed in a way that “qualif[ies] the offering under the federal intrastate offering exemption without regard to SEC rulemaking that would deal with crowdfunding on a national level.”<sup>179</sup> By using the crowdfunding criteria established by Congress under the federal JOBS Act, these States have “proceeded expeditiously to establish intrastate equity crowdfunding aimed to facilitate efficient capital formation by small businesses and entrepreneurs in their states, supported by small investors, and with a substantially reduced regulatory burden.”<sup>180</sup> So, as the crowdfunding market reaches across more and more localities, we must ask ourselves whether this is a system worth preserving. If the answer is in the negative, we must further understand current market trends and anticipate where the market will be in the future. We must lobby regulators, lawmakers, and decision makers to implement rules that will not only keep the current crowdfunding market thriving, but more importantly, to find a regulatory system that protects the rights of the individual consumer. If the answer is in the affirmative, we must remain hopeful that real estate crowdfunding will continue to grow from a former trend, into a New-Age system of interstate commerce that allows for inclusivity, viability, and profitability.

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<sup>178</sup> J.D. Harrison, *Crowdfunding Delays, SEC Silence Spark Hostility on Capitol Hill*, WASH. POST (Apr. 08, 2013), <http://www.washingtonpost.com/business/on-small-business/crowdfunding-delays-sec-silence-spark-hostility-on-capitol-hill/2013/04/08/655715d2-a090-11e2-9c03-6952ff30>

5f35\_story.html. (“[E]qually frustrated are the entrepreneurs actually building the new sites, who jumped at the opportunity when lawmakers authorized crowdfunding but are still waiting to set their new ventures in motion.”).

<sup>179</sup> *Id.*

<sup>180</sup> *Id.*