

Madness of Crowds or Regulatory Preconception? The Weak Foundation of Financial Crowdfunding Regulation in the US and Italy

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The purpose of this paper is to compare US and Italian financial crowdfunding regulation. Emphasis is given on the protection of crowdfunders. As a starting point, the paper outlines the theoretical framework underlying the classic retail investor protection argument. It then analyzes the recent doctrinal debate regarding the possible behavior of “crowds” in the context of financial crowdfunding, along with its regulatory implications. A comparison between US and Italian regulation of financial crowdfunding is then provided, showing how the theoretical dispute affected the policy choices carried out by regulators. In its last part, the paper challenges the simplistic policy assumptions underlying the regulations now in force, accordingly advising a different institutional approach to financial crowdfunding.

1. INTRODUCTION.

The purpose of this paper is to compare US and Italian financial crowdfunding regulation.¹ Its main focus is on how,

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with what policy goals in mind, by what technical means, and what theoretical assumptions, the US and Italian regulators²

¹ As to the US, see Sections 301-305 of The Jumpstart Our Business Startups Act (hereinafter, the “JOBS Act”), enacted on April 5th, 2012, Pub L No 112-106, 126 Stat 306 (2012). The rules proposed by the SEC to implement the JOBS Act are currently waiting for final approval: see SEC Rule Proposal of October 23rd, 2013, 17 CFR Parts 200, 227, 232, 239, 240 and 249 [Release Nos. 33-9470; 34-70741; File No. S7-09-13] (hereinafter, the “SEC proposed rules”). As to Italy, see article 30 of the Second Growth Decree (Law Decree 18th October, 2012, no. 179). The Italian National Commission for Companies and the Stock Exchange (hereinafter, “CONSOB”) has already issued a resolution implementing some provisions of the Legislative Decree 24 febbraio 1998, n. 58, “Testo Unico delle disposizioni in materia di intermediazione finanziaria”, (hereinafter, “Italian Financial Act - Consolidated Text”) as introduced by the Second Growth Decree (see CONSOB Resolution 26th June, 2013, no. 18592). For the sake of clarity, it has to be preliminary pointed out that in the US many debt instruments are “securities”, and the crowdfunding statute and the SEC proposed rules permit both debt and equity securities to be offered through funding portals: see on this topic A.A. SCHWARTZ, *Crowdfunding Securities* (2012), 88 *Notre Dame L. Rev.*, pp. 1457-1490, spec. p. 1482 ss. In Italy, on the contrary, debt-based crowdfunding is not permitted (see the express limitation arising from article 30 of the Second Growth Decree, clearly referring to “risk capital collection through online portals”), while it remains quite controversial what kind of equity instruments are eligible for crowdfunding: see, for some discussion, C.A. NIGRO, *Equity Crowdfunding e diritto societario*, in G.D. MOSCO (cur.), *Aspetti giuridici del crowdfunding* (2013), available at <www.slideshare.net>, pp. 28-37, spec. p. 32. Therefore, given the aforementioned differences between the two regimes, and in order to avoid any terminology confusion, throughout the paper we will use the broader US expressions “financial crowdfunding” as inclusive of both equity and debt-based crowdfunding transactions, “securities” as inclusive of both debt and equity instruments and “securities law/regulation” in lieu of financial instruments market law/regulation, with the only exception of the regulation adopted by the CONSOB, that will be referred to as the CONSOB Equity-based Crowdfunding Regulation.

² Both the CONSOB’s and SEC’s rules are based on very prescriptive requirements established in the JOBS Act and Second Growth Decree themselves. Unusually, the two statutes set out a series of very detailed conditions, that the two Commissions have no ability to change. Hence, if the Italian and US crowdfunding laws are too burdensome, as many argue, most of the blame is to be put on legislators rather than the CONSOB or the SEC: as for the US, see J.M. HEMINWAY, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments that Begs for a Happy Ending* (2014), 102 *Ky. L. J.*, pp. 865-889; and for Italy, V. SANTORO - E. TONELLI, *Equity Crowdfunding ed imprenditorialità innovativa*, *Riv. dir. banc.*, 24, 2014, pp. 1-10, spec. pp. 8-10). For this reason, throughout the paper, the terms Italian/US regulations and Italian/US regulators are to be intended as inclusive of both legislative and administrative rules and rule makers, whereas the discretionary nature of some of the rules carried out by the CONSOB or the SEC will be expressly indicated.

intended to protect crowdfunders.³ Besides this introduction, it consists of five other paragraphs.

The second paragraph concisely summarizes the retail investor protection argument in the field of securities regulation, showing how different theoretical characterizations correspond – or may correspond – to different policy approaches.⁴

The third paragraph intends to shed some light on the doctrinal debate regarding the possible behavior of “crowds” in the context of financial crowdfunding and the related regulatory implications.⁵

The fourth paragraph compares the US and Italian regulations, focusing on those key areas where the regulatory intervention has most notably been affected by the theoretical dispute.⁶

The fifth paragraph discusses the findings of our research, stressing the weak foundation of the present regulatory frameworks and advising a diverse policy and institutional approach to financial crowdfunding.⁷

Some final remarks then conclude the paper in the sixth paragraph.⁸

³ Despite some differences between the two, both the JOBS Act and the Second Growth Decree are aimed at relieving small companies and early stage ventures from regulatory burdens they typically face in accessing capital markets (see, for instance, S. HANKS, *Online capital-raising by small companies in the USA after the JOBS Act compared to the same process in the European Union* (2013), 8 *Capital Markets L. J.*, pp. 261-282). Nonetheless, financial crowdfunding clearly involves offers and sales of securities that could trigger the application of securities laws (see C.S. BRADFORD, *Crowdfunding and the Federal Securities Laws*, 1 *Colum. Bus. L. Rev.* (2012), pp. 1-150, spec. p. 3; and for Italian literature M. PINTO, *L’equity based crowdfunding in Italia al di fuori delle fattispecie regolate dal “Decreto Crescita”*, *Società* (2013), p. 818-831. Thus, the real regulatory challenge was to balance efficient capital formation and investor protection: on this crucial topic see D.H. JENG, *The JOBS Act: Rule 506, Crowdfunding, and the Balance between Efficient Capital Formation and Investor protection*, available at <www.ssrn.com>, spec. p. 2.

⁴ See below, § 2.

⁵ See below, § 3.

⁶ See below, § 4.

⁷ See below, § 5.

⁸ See below, § 6.

2. RETAIL INVESTOR PROTECTION: THE THEORETICAL FRAMEWORK

2.1 The retail investor definition challenge.

Despite being provided with quite an intuitive appeal,⁹ the retail investor protection argument triggers a fierce debate as soon as theorists attempt to establish how much and what kind of regulation is to be preferred. Indeed, when trying to determine how regulation might be best aimed in order to assure efficient capital allocation, while protecting those who are deemed to be largely inexperienced with market investments,¹⁰ a primary question appears necessary to be answered to at the very outset: who is the retail investor?¹¹

Unfortunately, answering this question has proved to be a laborious exercise thus far, given the difficulty of depicting “the “ordinary” individual who purchases an investment product and so becomes vulnerable to market risks as well as to intermediary and product risks”¹². And yet, pinning down the distinguishing mark (or a set of distinguishing marks) of the retail investor is something that cannot be omitted if regulatory intervention is to be effectively respondent to “real risks and not to be a function of regulatory empire-building or driven by woolly regulator perceptions of the nature of retail investor”¹³.

⁹ For thorough discussion, see N. MOLONEY, *How to Protect Investors. Lessons from the EC and the UK*, Cambridge, 2008, spec. p. 45.

¹⁰ See, for instance, D.C. LANGEVOORT, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, September 2008, available at <www.ssrn.com>, spec. p. 1. Investor protection also matters for supporting firms to reduce the cost of the capital they need to grow, innovate, diversify and compete. Without investor protection, the argument goes, securities markets fail to develop and banks become the only source of finance: see, for instance, F. MODIGLIANI - E.C. PEROTTI, *Security versus Bank Finance: the Importance of a Proper Enforcement of Legal Rules* (2000), available at <www.ssrn.com>, spec. pp. 3 ff.

¹¹ See N. MOLONEY, *How to Protect Investors*, cit., p. 30.

¹² N. MOLONEY, *The Investor Model Underlying the EU's Investor Protection Regime: Consumers or Investors* (2013), 13 *EBOR*, pp. 169-193, spec. p. 172.

¹³ *Id.*, p. 31.

2.2 The Efficient Market Hypothesis and the “rational investor” model.

Over the past decades, the debate has been strongly influenced by the law and economics school of analysis.¹⁴ According to its main assumptions,¹⁵ the L&E relies on what might be called the “rational expectations”¹⁶ or “empowered”¹⁷ model of investor.¹⁸ He is described as a savvy person who grasps market fundamentals, simply because, like the *homo economicus*, the rational investor is reasonable and circumspect. Consistent with these general observations, the rational investor is assumed to be able to fend for himself under any circumstance: if well-informed, he will be willing to pay a high price only to buy those securities that evidence demonstrates to be a high-quality investment; on the contrary, should the available information hint that the firm is doing poorly (or should the information prove inadequate for determining whether the issuer is performing well), he will refuse to pay a high price for the securities or to buy them at all: “[t]he end result is an “efficient” stock market in which the prices of corporate securities accurately reflect their fundamental values”.¹⁹ Under this theoretical analysis – better known as the Efficient Market Hypothesis²⁰ – only a minimal

¹⁴ Hereinafter, “L&E”. The influence of the L&E in the field of securities regulation has been well portrayed, for example, by L.A. STOUT, *The Investor Confidence Game* (2002), 68 *Brook. L. Rev.*, pp. 407-437, spec. pp. 410-415.

¹⁵ See, for instance, A. POSNER, *The Economic Approach to Law* (1975), 53 *Tex. L. Rev.*, pp. 757-782, spec. p. 761 (“The basis of an economic approach to law is the assumption that the people involved with the legal system act as rational maximizers of their satisfactions”).

¹⁶ See L.A. STOUT, *The Investor Confidence*, cit., pp. 410 ff.

¹⁷ See N. MOLONEY, *How to Protect Investors*, cit., pp. 47 ff.

¹⁸ Hereinafter, the “rational investor”.

¹⁹ See L.A. STOUT, *The Investor Confidence*, cit., p. 411 (summarizing the ultimate economic implications of the rational investor model).

²⁰ Hereinafter, the “EMH”. For the EMH, which basically assumes that market prices fully reflect all available information and consequent expectations by rational agents, see the foundational studies of P.

regulatory intervention is assumed to be needed in order to ensure that the markets behave efficiently: “[investor] protection is necessary only where market failures, primarily related to information asymmetries, arise”.²¹

2.3 The Deficient Market Hypothesis and the “irrational investor” model.

Despite its theoretical appeal and policy influence, the rational investor model has been put under severe scrutiny over time. By the start of the twenty-first century, the intellectual dominance of the EMH became far less universal.²²

An alternative strain of research on financial markets operation – known as behavioral finance²³ – began to attack the EHM by providing evidence of circumstances under which investors make choices inconsistent with the rational investor model and that may cause market prices to deviate from fundamental values, thus exposing a different reality, that of

SAMUELSON, *Proof that properly anticipated prices fluctuate randomly* (1965), 6 *Industrial Man. Rev.*, pp. 41-49; and E. FAMA, *The Behaviour of Stock-Market Prices* (1965), 38 *J. of Bus.*, pp. 34-105.

²¹ N. MOLONEY, *How to Protect Investors*, cit., p. 46 and p. 48 (noting that also in the EC – despite its initial limited resonance, due to a long dominance of the retail market by intermediation and indirect investment – the model of the investor as rational and empowered agent has been eventually embraced by the EC policy of financial markets harmonization). As for the EMH regulatory implications, see also G. LA BLANC - J.J. RACHLINSKI, *In Praise of Investor Irrationality* (2005), available at scholarship.law.cornell.edu, spec. p. 9 (observing that “an efficient market creates [two particular problems]: an efficient market is a target of opportunity for fraud and is potentially a market for lemons. [...] The regulatory remedies for the problems that can affect an efficient market thus reflect efforts to combat these problems. EMH theorists support both scrupulous policing against fraud and broad mandatory dissemination of information”).

²² Since then, psychologists and, at later stage, a growing number of financial economists and legal scholars as well, identified a heterogeneous set of recurring anomalies in investor behavior and, in the light of this, started questioning the previously widely accepted assumption that individuals tend to act rationally. For detail discussions of the most common behavioral critiques to the EMH, see generally D.C. LANGEVOORT, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited* (1992), 140 *U. Pa. L. Rev.*, pp. 851-920; A. SCHLEIFER, *Inefficient Markets: An Introduction to Behavioral Finance*, Oxford, 2000.

²³ Hereinafter, “BF”.

financial markets filled with irrational (or at least imperfectly rational) investors.²⁴ By considering the interaction between several factors,²⁵ behavioral theorists came to envision a completely different scenario from that of their neo-classical peers, a scenario in which the market is populated by irrational investors who often make systematic errors in their assessments, and where the irrationality pervading the market leads securities prices to likely fail to reflect fundamentals. Therefore – they conclude – “cognitive mispricing undermine the proper functioning of securities markets [...] caus[ing] a misallocation of capital and hav[ing] adverse consequences to the individual investors”.²⁶

As a consequence, supporters of the BF insights – which can altogether be referred to as the “Deficient Market Hypothesis”²⁷ – generally maintain that, rather than encouraging the empowerment of investors, regulators should shield them from their own irrationality and that the goal of

²⁴ See G. LA BLANC - J.J. RACHLINSKI, *In Praise*, cit., p. 6 (noting that “the debate has been fierce. Behavioral economists lambasted finance theorists for their seemingly dogmatic worship of a model that seemed (from their perspective) to be so obviously wrong; finance theorists, for their part, ridiculed the behavioral economists for their lack of rigor, unqualified acceptance of psychology and seeming ability to generate a competitive theory”).

²⁵ Such as, *inter alia*, cognitive errors, bias and heuristics, the high costs investors would have to bear in order to collect valuable information and their limited ability to process it, the distortion that prices may suffer as a consequence of herding, the dramatically increased complexity of financial markets, products and risks. See, for instance, N. MOLONEY, *How to Protect Investors*, cit., pp. 68-70.

²⁶ See G. LA BLANC - J.J. RACHLINSKI, *In Praise*, cit., p. 14.

²⁷ Hereinafter, the “DMH”. See *id.*, pp. 14 ff. (where DMH is the expression used to epitomize the vision expressed by those who challenge the EMH).

curtailing investors' irrationality could be accomplished in several ways.²⁸

Recently, the spread of the global financial crisis has put the EMH under further pressure,²⁹ giving the BF advocates an enticing opportunity to show the failures of its theorization and call for regulatory reforms that take into consideration the way investors' irrationality – in their view – affects the functioning of securities markets. In the post-crisis environment, those who firmly support financial reforms claim a more interventionist public policy approach to the retail investor protection argument,³⁰ and it seems that – as noted by some prominent scholars – BF insights and the related irrational investor model have finally made their inroads into the reform process.³¹

²⁸ If retail investors make systematic errors, the first response might accordingly be restrictive strategies designed to prevent them from being a disruptive market force. Precluding individual investors from entering the market, however, could result in a much too intrusive form of intervention that would likely be labeled as highly paternalistic (see N. MOLONEY, *How to Protect Investors*, cit., p. 77). Therefore, less severe reforms have been sometimes suggested. For example, incentives might be introduced for retail investors to rely more on institutional intermediaries; investor education programs might attempt to correct investors' more frequent cognitive mistakes; and so on (see G. LA BLANC - J.J. RACHLINSKI, *In Praise*, cit., pp. 21-23).

²⁹ See N. MOLONEY, *How to Protect Investors*, cit., p. 61.

³⁰ In the aftermath of the crisis, the rationale for a disclosure-based regulatory regime has become highly controversial, since the assumption it relies on – namely, the fact that investors are rational actors able to adequately process information to make best investment choices – has proved to be, if not false, then surely flawed (see, for instance, S.M. SOLAIMAN, *Revisiting securities regulation in the aftermath of the global financial crisis: disclosure–Panacea or Pandora's Box?* (2013), 14 *J. of World Inv. & Trade*, pp. 646-671). As a consequence, a greater emphasis has been placed on the need for investor protection within the framework of the restructured financial system: see, for detail discussion, N. MOLONEY, *Regulating the Retail Markets: Law, Policy, and the Financial Crisis* (2010), 63 *CLP*, pp. 375-447.

³¹ See, among US scholars, D.A. SKEEL, *Behavioralism in Finance and Securities Law* (2013), available at <scholarship.law.upenn.edu>, spec. pp. 9-24 (highlighting the behavioral insights implicitly or explicitly assumed as a foundational basis for some regulatory reforms, such as the creation of the new Bureau of Consumer Financial Protection and the anti-bailout provisions introduced by the Dodd-Frank Act). As for the EU, what seems to be underway is a sort of “consumerization” of investor protection regulation leading to a more interventionist shift in retail market policy plan: see for detail discussion N. MOLONEY, *The Investor Model*, cit., pp. 177 ff.

3. PROTECTING CROWDFUNDERS: A CHALLENGING POLICY CHOICE.

3.1 The “crowd”, the Internet and securities markets regulation.

With respect to financial crowdfunding,³² the challenge of sketching investors’ profile in order to design an effective regulatory intervention becomes even trickier. Three main reasons underlie this policy puzzle. First, in this case the subject of the regulatory action would be the “crowd”, that is “an ill-defined group of potential and actual investors in securities offered and sold through crowdfunding”,³³ whose investing patterns, capacities and objectives are likely to be far from homogeneous. Second, the very collective nature of the subject stems from the fact that the individuals who form the group are connected both among themselves and to the issuer through the Internet, shaping crowdfunding’s inherent essence of largely unmediated capital-raising. Yet, “the instant access to investments on the Internet, unmediated by a broker, might be troublesome”,³⁴ having the potential to eventually result in a means of large-scale spread of poor investment decisions.³⁵

³² For an explanation of the dynamics, benefits and risks of financial crowdfunding, see, *inter alia*, E. KIRBY - S. WORNER, *Crowd-funding: an Infant Industry Growing Fast* - Staff Working Paper of the IOSCO Research Department no. 3/2014, spec. pp. 12-28.

³³ J.M. HEMINWAY, *Investor and Market Protection in The Crowdfunding Era: Disclosing to and for The Crowd* (2014), 38 *Vt. L. Rev.*, pp. 827-848, spec. p. 831.

³⁴ G. LA BLANC - J.J. RACHLINSKI, *In Praise*, cit., p. 23. See also T. FRANKEL, *The Internet, Securities Regulation, and Theory of Law* (1998), 73 *Chi.-Kent L. Rev.*, pp. 1319-1354, spec. pp. 1340-1353 (discussing some pros and cons of disintermediated investment activities allowed by the advent of the Internet).

³⁵ Some researchers, for example, have found that online investing may foster investors’ overconfidence: see B.M. BARBER - T. ODEAN, *Online Investors: Do the Slow Die First?* (2002), 15 *Rev. Fin. Stud.*, pp. 455-487, spec. p. 457 (positing that “online investors become more overconfident once online for three reasons: the self-attribution bias, an illusion of knowledge, and an illusion of control. [...] These aspects of online trading foster greater

Third, if we assume that one of the most distinguishing aims of any financial crowdfunding-related legislation should be to “democratize the market for speculative business investments, by allowing investors of modest means to make investment that had previously been offered solely to wealthy, so-called “accredited” investors”,³⁶ then it becomes quite obvious that any overly intrusive means of external intervention would likely be perceived as unnecessarily paternalistic.³⁷

These three are different facets of one major policy question that in turns revolves around a regulatory dilemma: how to treat the “crowd” with regard to its decision making process in financial crowdfunding transactions? As a group of reasonable investors, capable – if well informed – of acting rationally in order to pursue the goal of maximizing the economic benefit of its members? Or as a heterogeneous aggregate of individuals that may or (most likely) may not have the attributes of the rational investor, therefore being prone to encourage concerted irrational (or at least suboptimal) economic behavior?

3.2 “Wise” or “mad” crowd? The debate and its related regulatory implications.

It is self-evident that such dilemma represents nothing but a particular field where the theoretical clash between the EMH and the DMH surfaces in all its seriousness. In fact, the same

overconfidence. And greater overconfidence leads to elevated trading and poor performance”).

³⁶ A.A. SCHWARTZ, *Keep It Light, Chairman White: SEC Rulemaking Under the CROWDFUND Act* (2013), 66 *Vand. L. Rev.*, pp. 43-62, spec. pp. 44-45.

³⁷ See, for example, J.B. WILSON, *Paternalism and Securities Law*, July 21st, 2013, available at www.pointoflaw.com (noting that “[t]he idea behind crowdfunding, as expressed in Title III of the JOBS Act, is a rejection of the paternalism behind the accredited investor definition and the way it has been institutionalized in Regulation D. Crowdfunding was intended to empower individuals to make their own investment decisions in unregistered offerings of securities based on the availability of information over the Internet”). In this regard, see also D. GROSHOFF, *Kickstarter My Earth: Extraordinary Popular Delusions and the Madness of Crowdfunding Constraints and Bitcoin Bubbles* (2014), 5 *Wm. & Mary Bus. L. Rev.*, pp. 489-557, spec. pp. 449-450.

two narratives discussed above are widely used in the literature to describe possible crowd behaviors within the crowdfunding environment.

Leaving out some minority attempts to explain crowd behavior in pure individualistic terms,³⁸ the debate can be summarized as follows. On one side of the edge stand those who believe that “[e]ven if most of the people within a group are not especially well-informed or rational, it can still reach a collectively wise decision”. They call this collective intelligence the “wisdom of crowds”,³⁹ meaning that the “crowd” is capable of operating as a source of collective intelligence.⁴⁰ In the opposite corner, an alternative thread of scholarly literature fiercely contests the “wisdom of crowds” argument, and, by principally looking at the role of crowds in financial bubbles,⁴¹

³⁸ Such an attempt traces back to Mancur Olson’s 1965 book, in which crowd members are assumed to act as classical utility-maximizers, therefore pursuing, as normal, profit maximization and cost minimization, although under different contingent situations: see M. OLSON, *The Logic of Collective Actions. Public Goods and The Theory of Groups*, Cambridge - London, 1965.

³⁹ See J. SUROWIECKY, *The Wisdom of Crowds*, New York, 2005, at. xiii-xiv (assuming, basically, that the “crowd” is capable of obviating the individual human beings’ cognitive lacks and bounds of rationality, because “when our imperfect judgments are aggregated in the right way, our collective intelligence is often excellent”). Among those who, in crowdfunding literature, support this view, see, for example, M. STIERNBLAD - E. SKOGLUND, *The future of Equity Crowdfunding* (2013), available at <www.lunduniversity.lu.se>; J. ZHANG, *The Wisdom of Crowdfunding* (2013), 24 *Community&Banking*, pp. 29-31; E. MOLLICK, *Swept Away by the Crowd? Crowdfunding, Venture Capital, and the Selection of Entrepreneurs* (2013), available at <www.business.utah.edu>.

⁴⁰ For further discussion of the “wisdom of the crowds” standpoint, see J.M. HEMINWAY, *Investor and Market Protection in The Crowdfunding Era*, cit., pp. 840-843.

⁴¹ The most recurrent citation here is to Charles Mackay’s 1841 book, in which he cataloged numerous examples of crowd irrational behavior in through several crisis episodes in history: see C. MACKAY, *Extraordinary Popular Delusions and the Madness of Crowds*, Hertfordshire, 1995 (originally published 1841). At the end of the XIX century, another book, authored by a French sociologist, attempted to mark the transition from individual psychology to crowd psychology, concluding that simply by being part of a crowd, individuals are deprived of all sense of self and all sense of responsibility and, therefore, they result prone to sacrifice their personal interests: see G. LE BON, *The Crowd: A Study of the Popular Mind*, New York, 1896.

posits that crowds bolster collective irrational decisions, which are in turn caused by herding behavior that both reduces diversity of opinions and, eventually, produces suboptimal economic outcomes. They call this irrationality tendency of groups the “madness of crowds”.⁴²

From a regulatory perspective, it follows that were the first approach to be preferred, one should expect to see financial crowdfunding to be regulated through a (relatively) simple disclosure only-based regime designed to empower the “crowd” to make sound investment decisions.⁴³ On the contrary, if the second conceptualization were to prevail, one should expect to see financial crowdfunding to be regulated, among other things, by some more imperative devices (*e.g.*, prohibitions and limitations) intended to prevent the “crowd” from making poor investment decisions.⁴⁴

From review of the newly-introduced Italian and US regulations, it becomes quite clear that regulators’ interventions have been conditioned by the acknowledgment that the “crowd” may either prove to be “wise” or to be “mad”.⁴⁵ In other words, it appears that regulators were aware of such a diatribe, but

⁴² See J.M. HEMINWAY, *Investor and Market Protection in The Crowdfunding Era*, cit., pp. 837-840 (discussing in greater detail the “madness of crowds” argument). Recent researches additionally assume - and this would be relevant in the field of financial crowdfunding, given the absence of any certainty about the future directions of prices of the securities being crowdfunded - that “herding [among members of a given crowd] is even more pronounced for opinions or attitudes for which no predefined correct answers exist” (see J. LORENZ *et al.*, *How social influence can undermine the wisdom of crowd effect* (2011), 108 *PNAS* (2011), pp. 9020-9026, spec. p. 9025).

⁴³ See J.M. HEMINWAY, *Investor and Market Protection in The Crowdfunding Era*, cit., pp. 844 and 846 (positing that “[i]f the crowd has the capacity to be wise, then an issuer’s disclosure to the crowd of information important to decision making may be efficacious”).

⁴⁴ See *id.*, p. 844 (observing that “[i]f market decision making relies on information cascades, direct-benefit effects, or price-to-price feedback, however, then much of any mandated disclosure would have no impact on the decisions of securities crowdfunding investors”).

⁴⁵ See *id.*, pp. 829-830 (noting that “[s]cholarly literature outlines two principal ways in which the behavioral psychology of crowds interacts with securities markets. Crowds can be “mad”—irrational, foolish, and even stupid. On the other hand, crowds can be “wise”—rational, sensible, and intelligent”).

instead of picking one of the two alternatives, they rather passively opted for introducing two “omni-inclusive” regulatory regimes in which both “liberalistic” and “paternalistic” measures were peculiarly (and, to some important extent, contradictorily) combined,⁴⁶ thus also explaining the impressive bulk of the two set of rules we discuss in the next paragraph.⁴⁷

4 THE US AND ITALIAN FINANCIAL CROWDFUNDING REGULATIONS COMPARED.

4.1 Introductory remarks.

The first, self-intuitive hint of some kind of trust in the crowd, of course, is given by the liberal move through which, both in the US and in Italy, an exemption from the registration and prospectus requirements for public offerings of securities⁴⁸ has been introduced for financial crowdfunding.⁴⁹ In spite of

⁴⁶ See *id.*, p. 844 (noting that current financial crowdfunding regulations reveal a tension between conflicting understandings of the nature of crowds).

⁴⁷ Our main focus will be the US regulatory framework for financial crowdfunding, with which the Italian regulation will be compared. Nonetheless, an exhaustive explanation of all the regulatory measures the two sets of rules consist of wouldn't be possible here. For more information and discussion, see the literature cited to throughout the next paragraph.

⁴⁸ The JOBS Act, in its Title III, added a new exemption in the Securities Act (*see* Section 4(a)(6), as amended by Section 302(a) of the JOBS Act) to permit financial crowdfunding to be made without registration, provided that some statutory conditions are met. In the US, offers of securities to the public (which includes offers made over the internet) must be registered with the SEC under the Securities Act of 1933, unless an exemption from registration is available (*see* S. HANKS, *Online capital-raising*, cit., p. 267-269). Before the enactment of the JOBS Act, then-existing exemptions under federal and state law did not permit broad-based solicitation of investors through Internet platforms: *see* J.M. HEMINWAY - S.R. HOFFMAN, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933* (2011), 78 *Tenn. L. Rev.* (2011), pp. 879-972 spec. pp. 906-921. The Italian legislator, by amending existing securities law, allowed “Innovative startups” (as defined by article 25 of the Second Growth Decree) to offer securities of up to €5,000,000 without the obligation to register a prospectus (*see* M.L. VITALI, *Equity Crowdfunding: la nuova frontiera della raccolta del capital di rischio*, *Riv. soc.*, 2014, pp. 371-402).

⁴⁹ See J.R. BROWN JR., *Selling Equity through Crowdfunding: A comment* (2014), available at <www.ssrn.com>, spec. p. 2 (noting that, in

this, what is now observable in the US is a lot of criticism, whose underlying motivations closely resemble those currently animating the Italian debate.⁵⁰ The forecasts are not optimistic. Securities regulation experts believe the question of why it is highly realistic to assume that the new crowdfunding exemption will come up short in achieving its objectives can be answered to with just one word: “costs”.⁵¹ It has been estimated by some sources that for a raise of \$100,000, portal and compliance costs will amount to a sum between 12.9% and 39% of the money raised.⁵² And it is worth noting that a bill that would repeal the crowdfunding provisions of the JOBS Act to replace

reducing traditional investor protections, the crowdfunding exemption places significant emphasis on the “collective wisdom” of the crowd).

⁵⁰ Not differently from their Italian colleagues (see V. SANTORO - E. TONELLI, *Equity Crowdfunding*, cit., pp. 8-10), many US commentators argue that the Congress’ lack of expertise in securities regulation and corporate finance, along with a meaningless haste to regulate such a complex matter, eventually led to the arguably unnecessary employment of traditional tools of securities regulation (see C.S. BRADFORD, *The New Federal Crowdfunding Exemption: Promise Unfulfilled* (2012), 40 *Sec. Reg. L. J.*, pp. 195-249, spec. p. 222), which made the provisions regarding financial crowdfunding “a bit of a hodgepodge—a messy accumulation of enabling and protective provisions” (J.M. HEMINWAY, *How Congress Killed Investment Crowdfunding*, cit., p. 870). Unusually, the statute sets out a series of very detailed conditions that the SEC has no ability to change. As a consequence, the fairly conservative approach noted by some observers within the SEC’s approach to rulemaking is hardly surprising (see CROWDCHECK, *SEC Proposes Regulations Implementing “Regulation Crowdfunding” Under Section 4(a)(6) of the Securities Act*, October 2013, available at <www.crowdcheck.com>, spec. p. 1).

⁵¹ See J.M. HEMINWAY, *How Congress Killed Investment Crowdfunding*, cit., pp. 880-1 (pointing out that “[t]he costs for small business issuers and intermediaries that are built into the CROWDFUND Act simply are too high in comparison to the expected benefits, especially for small aggregate offering amounts”). For the same criticism, see also R.B. CAMPBELL JR., *The New Regulation of Small Business Capital Formation: The Impact – If Any – Of The JOBS Act* (2013-2014), 102 *Ky. L. J.*, pp. 815-848.

⁵² See S. NEISS, *It Might Cost you \$39K to Crowdfund \$100K Under the SEC’s New Rules* (2014), at <venturebeat.com> (reviewing the SEC’s low/high dollars estimates of costs for crowdfunding raise and compliance). However, some providers of services for crowdfunding, such as Crowdfund CPA – Crowdfund Audit & Review Experts (crowdfundcpa.com), give much lower estimates as for the costs of auditing and other services.

them with a simpler and more efficient registration exemption has been already introduced in Congress.⁵³

4.2 The “crowdfunding exemption”: an overview.

The financial crowdfunding exemption is subject to some statutory conditions.⁵⁴ First, the aggregate amount of securities sold to “all investors” may not exceed \$1 million in any 12-month period; second, the aggregate amount sold to any investor in any 12-month period may not exceed some differentiated thresholds;⁵⁵ third, the transaction must be made through an intermediary that is either registered as a broker or as a new entity called a “funding portal”.⁵⁶ And fourth, both the issuer and the intermediary must comply with the disclosure and other requirements set out in the statute.

4.3 Limitations on the aggregate amount of crowdfundable securities.

On its face, the JOBS Act crowdfunding exemption permits offerings only up to \$1 million, much lower than the €5 million limit established in Italy.⁵⁷ To many commentators,

⁵³ See Equity Crowdfunding Improvement Act of 2014, H.R. 4564, introduced by Rep. Patrick McHenry on May 6th, 2014. For a brief commentary see J.R. HEMPILL - L. LEWIS, *Crowdfunding 2.0: Proposed Equity Crowdfunding Improvement Act of 2014*, at <www.natlawreview.com>.

⁵⁴ See Section 302(a) of the JOBS Act.

⁵⁵ In greater detail, if either the annual income or net worth of the investor is less than \$100,000, the investor is limited to the greatest of \$2,000 or 5% of her annual income or net worth. If the annual income or net worth is \$100,000 or more, the investor is limited to 10% of her annual income or net worth to a maximum of \$100,000.

⁵⁶ The “funding portal” is a new entity that will be registered under the Securities Exchange Act of 1934 and with a self-regulatory organization (the only eligible SRO at present being FINRA).

⁵⁷ See article 2, letter g) of CONSOB Equity-based Crowdfunding Regulation (where reference is made to the quantitative limit stipulated in article 34-ter.1, letter c) of CONSOB Issuers Regulation of 14th May, 1999, no. 11971).

however, such cap appears quite high, if not in itself,⁵⁸ mainly because, in their view, the Congressional fear that (“mad”?) “non-accredited investors would desire to invest significant amounts of money in an offering of this size drove the inclusion of sundry investor protection provisions”.⁵⁹ It might also be argued that the raise amount limit has some macroeconomic significance, being primarily aimed at assuring market’s integrity, and only indirectly at protecting investors. In other words, by limiting the aggregate amount of financial crowdfunding offerings (*id est*, the overall mass of savings that retail investors are allowed to pledge into risky companies), regulators would attempt to constrain the adverse impact of possible “bubble” events, should the market for financial crowdfunding result too “exuberant”. However, it has to be noted that the effective size of a financial crowdfunding offering in the US could end up being much larger than \$1 million, for two reasons. First, though the language of the statute suggests that offering made under other exemptions might count toward the \$1 million limit, the SEC’s view is that the limit applies solely to sales made under the crowdfunding exemption, and that amounts sold under other exemptions will not affect the limit.⁶⁰ Second, it has also to be considered that the “retail crowdfunding” exemption is not the only exemption within the JOBS Act. The statute mandated the SEC to lift a previous ban against general solicitation and advertising in private placements,⁶¹ thus effectively expanding the ability of issuers to

⁵⁸ See, for instance, D. GROSHOFF, *Kickstarter My Heart*, cit., p. 546 (noting that, “[f]or example, game console developer Ouya crowdfunded approximately \$950,000 in eight hours on Kickstarter. What legitimate policy rationale could exist to prevent that company from crowdfunding additional capital?”).

⁵⁹ J.M. HEMINWAY, *How Congress Killed Investment Crowdfunding*, cit., p. 879. See also S.R. COHN, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution* (2012), 64 *Fla. L. Rev.*, pp. 1433-1446, spec. p. 1438.

⁶⁰ See SEC Rule proposal, cit., pp. 16-17. Thus, the SEC permits crowdfunding offerings to be made concurrently with other exempt offerings, effectively allowing unlimited sizes of offerings to be made without registration (see CROWDCHECK, *SEC Proposes Regulations*, cit., pp. 1-2).

⁶¹ The private offerings we are referring to are those made under Rule 506 in Regulation D. The SEC lifted the ban by adopting a new 506(c)

crowdfund from accredited investors.⁶² Considering that “accredited crowdfunding” provides a far less regulated alternative,⁶³ one plausible conjecture is that, being concerned about the possible “madness” of retail crowds, the US regulators⁶⁴ wanted to incentivize new entrepreneurs to crowdfund among the accredited investor population, thus assuring that in the event of a follow-on or side-by-side retail crowdfunding offering the unsophisticated members of the “mad” crowd could rely on the sounder judgment of their accredited “wise” peers.⁶⁵ Should this interpretation hold true,⁶⁶

Rule (see 17 CFR 230.506(c)). In this regard, see J.W. PARSONT, *Crowdfunding: The Real and The Illusory Exemption*, *Harvard Bus. L. Rev.* (forthcoming), available at <www.ssrn.com>.

⁶² See Section 201(a) of the JOBS Act. For a thorough discussion of the “accredited crowdfunding” exemption, see J.W. PARSONT, *Crowdfunding*, cit., p. 4 ff. (observing that “[e]liminating the ban on general solicitation and advertising and facilitating direct access through the internet has the potential to significantly increase accredited investor participation in crowdfunding. [...] [T]his accredited pool controls over 70% of available capital in the country. So, “accredited crowdfunding,” which is less regulated but open to the same companies and more, creates a serious competitor to retail crowdfunding”).

⁶³ See BRADFORD, *The New Federal Crowdfunding Exemption*, cit., p. 222 (noting that under the “accredited crowdfunding” exemption “[t]he issuer would not have to sell through a broker or funding portal, or, for that matter, through any intermediary. The dollar amount of the offering would be unlimited, as would the amount that each investor could purchase. The issuer would avoid any significant mandatory disclosure requirements, and there would be no annual reporting requirement. Resales would be restricted, but the holding period for Rule 506 would be no longer than that under the crowdfunding exemption. And, as with crowdfunding, state disclosure and registration requirements would be preempted”).

⁶⁴ *Id est*, the Congress by the means of Section 201(a) of the JOBS Act, and the SEC through the non-application of the so-called “integration doctrine”.

⁶⁵ In fact, as it has been observed, “retail crowdfunding” will still offer the advantage of making possible the solicitation of a broader pool of potential investors, but “issuers will likely resort to this method only if they cannot succeed among accredited investors only” (J.W. PARSONT, *Crowdfunding*, cit., pp. 5-6).

⁶⁶ Our supposition seems to find confirmation in the SEC proposed rule 201(q), by which, in addition to the statutory disclosure requirements, the Commission, for each exempt offering conducted by the same issuer within the past three years, propose to require a description of the date of the offering, the offering exemption relied upon, the type of securities offered and the amount of securities sold and the use of proceeds.

such a policy approach would appear highly debatable. First, it would deprive retail crowdfunders of any plausible incentive to conduct their own due diligence, and, along with this, it would invalidate any possible rationale for the massive mandatory disclosure embedded in the retail crowdfunding regime.⁶⁷

Hence, and to sum up, even though by different technical means, but with a similar policy goal in mind, the US regulators, like their Italian colleagues,⁶⁸ seemingly believe that retail crowdfunders do need the presence of certain “stewards” in order to assure the soundness of their investment decisions in financial crowdfunding transactions.⁶⁹

4.4 The mandatory disclosure regime.

Under the JOBS Act, the issuer seeking (retail) crowdfunding is subject to mandatory disclosure.⁷⁰ From a regulatory perspective, determining an efficient degree of

⁶⁷ Why would a potential retail crowdfunder want to read all the information mandated by the JOBS Act when he knows that a more sophisticated investor has – perhaps and most likely – already invested a considerable bigger amount of money than he would be permitted to in the same company?

⁶⁸ In fact, one of the most striking features of the Italian regulatory framework is that a given share of the securities in an equity crowdfunding offering must be undersigned by some “sophisticated” investors (*see* article 30.3 of the Second Growth Decree, and article 24.2 of CONSOB Equity-based Crowdfunding Regulation, stating that “For the purpose of executing the offer on the portal, the portal manager must check that at least 5% of the financial instruments offered are undersigned by professional investors or by banking foundations or by innovative start-up incubators pursuant to article 25, paragraph 5, of the decree”). *See*, for some discussion, M.L. VITALI, *Equity Crowdfunding*, cit., spec. pp. 398-400.

⁶⁹ The main difference between the two regimes seems to be that, while the Italian legislator *mandates* the intervention of sophisticated investors in retail crowdfunding offerings, the US Congress and the SEC *incentivize* firms seeking for external capital to preferably turn to accredited investors.

⁷⁰ For a summary of the mandatory disclosure embedded in the JOBS Act crowdfunding provisions, *see*, for instance, R.B. CAMPBELL JR., *The New Regulation*, cit. pp. 24 ff. The SEC does not review, comment or in any way approve the information embedded in the mandated disclosure documents (*see* CROWDCHECK, *SEC Proposes Regulations*, cit., p. 5, where it is noted, however, that it would be foolish, however, to assume that the SEC will “look the other way if it sees information that it finds troubling”).

mandatory disclosure was, with no doubt, the most challenging task to fulfill.⁷¹

While it is quite certain that the mandated disclosure will create a high cost structure,⁷² and while some of the disclosure-related measures are simply technically flawed⁷³ or overreaching⁷⁴, what it is worth noting is that some pieces of information mandated by the crowdfunding provisions effectively try to address specific problems arising in the crowdfunding landscape. In fact, more traditional settings of early-stage ventures financing allow the entrepreneur to keep his plans for the company secret from the general public, since friends and family members or angel investors, for example, have the opportunity to perform due diligence in person with

⁷¹ And yet, also in this respect the statute “establishes a fairly detailed regulatory apparatus for the newly authorized market for crowdfunded securities” (A.A. SCHWARTZ, *Keep It Light*, cit., p. 51), leaving the SEC only the authority to discretionarily add further disclosure requirements (see Section 302(b) of the JOBS Act).

⁷² See J.M. HEMINWAY, *How Congress Killed Investment Crowdfunding*, cit., p. 867.

⁷³ See, for instance, M.C. HUTCHENS, *Hitting the Target: How New Disclosure Rules Could Improve the Jumpstart Our Business Startups Act* (2013), available at <www.ssrn.com>, pp. 9 ff. (observing that, since the issuer’s required degree of disclosure is determined by the aggregate of the *target* offering amounts of the issuer’s crowdfunding offerings over the past year “[a] company may choose to set its target offering at \$100,000, even if it expected to raise much more, so it can avoid the costs of additional disclosure requirements”). It has to be noted, however, that this technical problem with the statute has been somewhat fixed in the proposed regulation, as the SEC requires amounts raised in the preceding 12 months to be aggregated with the target amount in determining the financial statements required: see SEC proposed Instruction 1 to paragraph (t) of proposed rule 201.

⁷⁴ For example, under the SEC proposed rules, issuers would be required to file with the Commission, provide to investors and the relevant intermediary and make available to potential investors a complete set of their financial statements prepared in accordance with U.S. GAAP, covering the shorter of the two most recently completed fiscal years or the period since inception of the business (see SEC proposed Instruction 10 to paragraph (t) of proposed Rule 201). However, most small businesses prepare their financial statements on a cash basis, while US GAAP require accrual basis accounting. The SEC’s automatic assumption that financials should be prepared in the same way as for public companies imposes a big burden on the companies seeking crowdfunding, and yet for early-stage companies with no revenues, the basis of accounting is pointless as no meaningful comparison between investment alternatives can be made.

the entrepreneur. This is evidently impossible in the crowdfunding setting, where the potential funders are remote and have no opportunity to perform due diligence in person with the founder. Disclosure is, therefore, to some extent necessary in order to mitigate an otherwise ungovernable information asymmetry problem.⁷⁵ Thus, among many other things, the statute mandates disclosure of the target offering amount, along with the deadline to reach it. This disclosure requirement introduces a “provision point mechanism” aimed at addressing a classic coordination and free-riding problem in a multi-principal context, “namely, the problem due to “information cascades [...], where early funders generate a valuable (although noisy) signal for later ones through accumulated capital, [thus giving] investors an incentive to wait and see what others do”.⁷⁶ Moreover, under the SEC’s proposal issuers are required to state whether the issuer will accept investment in excess of the target amount and the maximum it will accept. If the issuer accepts investments above the indicated target, it must also state the method it will use to allocate oversubscriptions.⁷⁷ Similarly, the goal here is to resolve another typical agency conflict due to information asymmetry and a coordination problem as well, namely the risk that, having received more funds than she expected, the entrepreneur might alternatively lower his incentives to work effectively, assume excessively risky decisions or simply squander the money raised.⁷⁸

In this respect, the mandatory disclosure regime for US financial crowdfunding reflects a partly-empowering/partly-educating regulatory strategy, in the sense that it is not only designed to empower the crowd to make sound investment decisions, but also, and perhaps mainly, to assure its members

⁷⁵ See A. AGRAWAL et al., *Some Simple Economics of Crowdfunding* (2013), NBER Working Paper No. 19133, spec. pp. 20-21.

⁷⁶ *Id.*, p. 31.

⁷⁷ See SEC proposed rules 201(h) and 201(i).

⁷⁸ See M. STIERNBLAD - E. SKOGLUND, *The future of Equity Crowdfunding*, cit., p. 16.

may develop an effective awareness of their role as capital suppliers.⁷⁹

But this premise must not mislead the observer. In fact, in the pre-JOBS Act era some of the information asymmetry-corrective devices mandated by the statute were already applied by almost all crowdfunding platforms.⁸⁰ Thus, in some respects, what the statute is actually mandating are nothing but self-policing measures that the core market players had already developed and consistently observed. In other respects, instead, the statute mandates a one-size-fits-all disclosure model, which encompasses highly sophisticated matters that will force issuers to require legal assistance, eventually making compliance costs unduly burdensome for some issuers.⁸¹ Moreover, and above all, although the US mandatory disclosure regime might appear, in some regards, quite indulgent when compared to some corresponding provisions within the Italian regulatory framework,⁸² many other and far more intrusive crowdfunder

⁷⁹ See J.M. HEMINWAY, *Investor and Market Protection in The Crowdfunding Era*, cit., p. 846 (observing that a regulatory assumption of the crowd as capable of acting wisely would have made possible to limit the object of disclosure to core matters only).

⁸⁰ See A. AGRAWAL et al., *Some Simple Economics*, cit., p. 31 (noting that a “provision point mechanism” was already applied by “[a]lmost all non-equity crowdfunding platforms”); and J.M. HEMINWAY – S.R. HOFFMAN, *Proceed at Your Peril*, cit., pp. 900-901 (observing that “many equity-type crowdfunding business models provide that capital will be returned if a stated funding threshold is not met [by a certain stated deadline]”).

⁸¹ See, for instance, S. HANKS, *Online capital-raising*, cit., pp. 276-277 (noting that “[s]ome of [the] required disclosures [...] are sophisticated concepts and issuers may require assistance in drafting appropriate disclosure. [...] [U]nsophisticated issuers may not even be able to identify the disclosure that applies to their own situation”).

⁸² For example, while the JOBS Act is satisfied with simple disclosure of the terms of the securities being offered and of the risks to purchaser of the security relating to minority ownership, within the Italian regulatory framework some more imperative and structural limitations are observable. In fact, the CONSOB restricted to shares the range of crowdfundable equity (see article 2, letter h), of CONSOB Equity-based Crowdfunding Regulation), while the legislator itself instructed the CONSOB to insert in its regulation some disinvestment protections in order to prevent that the founder of the crowdfunded company may extract private benefits of control (see article 30.3 of the Second Growth Decree, implemented by article 24.1, letter a), of CONSOB Equity-based Crowdfunding Regulation, which makes the publication of the offer conditional upon the existence of tag-along or

protection devices have been put into force, all of which evidence the lip service that regulators pay to the “wisdom of the crowd” conception.

4.5 Limitation on individual subscriptions.

The (retail) crowdfunding exemption under the JOBS Act not only mandates the provision of information, but also limits the size of individual investments by reference to the investor’s wealth.⁸³ This is an unusual approach to investor protection in US securities law,⁸⁴ and it is evidently designed to shield the unsophisticated crowd from its expected “madness”. It is as if the Congress said to would-be crowdfunders “Ok, I will give you all the information (I think) you need, but since I disbelieve your supposed “wisdom”, and I expect you will not understand the provided disclosure, I am going to protect you from harming yourselves”.⁸⁵ As a commentator observed, given the investment annual cap “[i]t is practically impossible to lose one’s “life savings” in crowdfunding, no matter how unwise or unlucky one’s choices may be. By contrast, an investor can lose [his] life savings—quickly, easily, and legally—by investing in the stock market, gambling at a casino, or playing the state lottery”.⁸⁶

In this respect, and at a first glance, the Italian regulatory approach appears more “liberal” than the “paternalistic” US stance, since no individual investment limit is imposed.

withdrawal rights in favour of crowdfunders in the event of change of control). *See*, in both regards, M.L. VITALI, *Equity Crowdfunding*, cit., spec. pp. 391 and 396-398.

⁸³ *See* note n. 55 and accompanying text.

⁸⁴ *See* A.A. SCHWARTZ, *Keep It Light*, cit., p. 45 (noting that “[t]he CROWDFUND Act’s investment cap differs from the usual type of regulation found in federal securities laws. The usual way that federal law tries to protect investors is by mandating extensive public disclosure”).

⁸⁵ *See* S. HANKS, *Online capital-raising*, cit., p. 276 (noting that “[t]he JOBS Act not only mandates the provision of information, but also limits the damage that can be done by a poor investment decision by limiting the size of investment that may be made”); and A.A. SCHWARTZ, *Keep It Light*, cit., p. 50 (observing that “[b]ecause of Congress’s deep concern that investors in crowdfunded securities might be defrauded, the Act includes a structural protection for investors that limits their potential losses”).

⁸⁶ A.A. SCHWARTZ, *Keep It Light*, cit., p. 45.

However, this impression might prove more apparent than real. The CONSOB, in fact, introduced a bifurcated regulatory regime whereby different rules apply depending on the amount invested in a single transaction or over a one-year period. According to the CONSOB rules, higher investment amounts trigger the application of the MiFID regime.⁸⁷ Therefore, from a comparative perspective, it could be asserted that while the US financial crowdfunding regulation quantitatively *limits* the ability for retail investors to act as crowdfunders, the Italian regulatory framework, by mandating – under certain circumstances – the intervention of traditional financial intermediaries, *impedes* retail investors from acting as crowdfunders. This manifestly betrays the intrinsic logic of financial crowdfunding, practically caging it into the scheme of more traditional fully intermediated investment processes (which, moreover, is not cost-free).⁸⁸

Both the regulatory approaches show serious shortcomings. Basically, they obstruct any possibility of giving the crowd the right incentives to become “wise” and “expert” in the field of securities markets, in the sense that potential crowdfunders will alternatively underinvest in due diligence (this might likely be the case for the US, where only “little-skin-in-the-game” retail crowdfunders are admitted) or passively rely on the conduct and judgment of others (this might likely be the case for Italy, where would-be “significant-skin-in-the-game”

⁸⁷ In greater detail, if the amount contributed in a single transaction exceeds the limit of 500 euros per transaction or the cumulative threshold of 1,000 euros per year, transactions in equity-based crowdfunding offerings must be finalized through a firm authorized to provide financial services – thus triggering the application of the traditional financial services-related framework, and notably the usual investor protection safeguards that come with it (see article 17.3 and 17.4 of CONSOB Equity-based Crowdfunding Regulation).

⁸⁸ See P. HAAS et al., *An Empirical Taxonomy of Crowdfunding Intermediaries* (2014), available at <www.crowdinvesting.jura.unimuenchen.de>, pp. 4 and 14 (noting that “[o]nline-based businesses like crowdfunding might lower transactions costs and facilitate matching agents directly, both leading to disintermediation and redundancy of intermediaries. [...] Compared with traditional financial intermediaries, a substantial part of the tasks associated with financial intermediation is directly performed by the participating agents themselves and not by the intermediary anymore”).

retail crowdfunders need the assistance of professionals). Moreover, with such restrictive regulatory devices at play, it becomes almost unintelligible why regulators deemed it necessary not only to craft the massive mandatory disclosure regime discussed above, but also to further emphasize crowdfunder protection functions by charging funding portals with the nontrivial obligations and responsibilities discussed below.

4.6 Requirements for intermediaries.

The crowdfunding provisions of the JOBS Act provide that issuers seeking to crowdfund cannot do it on their own.⁸⁹ Securities (retail) crowdfunding transactions must be conducted through an intermediary registered either as a broker or as a funding portal.⁹⁰

The intervention of the intermediary has been introduced as a further crowdfunder protection element.⁹¹ It is doubtful, however, whether the Congress' iteration will prove beneficial. Indeed, while it is still somewhat debated what the exact legal qualification of funding platforms is,⁹² what seems undisputed

⁸⁹ See S.R. COHN, *The New Crowdfunding Registration Exemption*, cit., p. 1439 (noting that “[t]he crowdfunding transaction must be conducted through a broker or a registered funding portal. This is not an option, it is a mandate”).

⁹⁰ See note n. 56. Under the SEC proposed rules, the transactions must be effected exclusively through the intermediary's platform (see SEC proposed rule 100(d), where “*platform* means an Internet website or other similar electronic medium through which a registered broker or a registered funding portal acts as an intermediary in a transaction involving the offer or sale of securities in reliance on Section 4(a)(6) of the Securities Act”). Similarly, the Second Growth Decree provides that crowdfunding portals must be operated by either banks and financial firms, or by those who register with the Consob as “professional portal managers” (see article 30.2 of the Second Growth Decree), while the CONSOB rules define the web platform as the online platform through which the intermediary facilitates the collection of equity by eligible issuers (see article 2, letter d) of CONSOB Equity-based Crowdfunding Regulation).

⁹¹ See SEC Rule Proposal, cit., p. 12 (“Congress provided important investor protections for crowdfunding transactions under Section 4(a)(6), including individual investment limits, required disclosures by issuers and the use of intermediaries”).

⁹² See J.M. HEMINWAY, *The New Intermediary on the Block: Funding Portals under the CROWDFUND Act* (2013), 13 *UC Davis Bus. L.*

is that – not differently from the costs of mandated disclosure for small issuers – the statutory obligations charged on and the limitations imposed to the crowdfunding intermediary’s activity create a high cost structure that may make entering the market economically unfeasible for prospective funding portals.⁹³

The JOBS Act, among other things, requires a person acting as an intermediary in crowdfunding transactions to:⁹⁴

i. register with the SEC as a broker or as a funding portal and the applicable self-regulatory organization;

ii. provide such disclosures, including disclosures related to risk and other investor education materials, as determined by the SEC;

iii. take measures to reduce the risk of fraud, including obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20% of the outstanding equity of the issuer;

J., pp. 177-205, spec. p. 179 (noting that “[w]e do not know much about this new form of intermediary based on the CROWDFUND Act. The U.S. Congress scripted out a few key characteristics and obligations in the text of the statute, and left the rest to Securities and Exchange Commission (“SEC”) rulemaking”). *See also* C.S. BRADFORD, *Crowdfunding*, cit., pp. 51 ff. (discussing whether crowdfunding portals qualify as broker-dealers under the Federal Securities laws and regulations).

⁹³ *See* J.M. HEMINWAY, *How Congress Killed Investment Crowdfunding*, cit., p. 883 (reporting the concern expressed by a crowdfunding entrepreneur who estimated that the cost of entry will total several hundred thousand dollars). *See also* S.R. COHN, *The New Crowdfunding Registration Exemption*, cit., p. 1441, note n. 22 and accompanying text (reporting that at least one crowdfunding site committed to small business development (*Profounder*) shut down as a result of the new regulations).

⁹⁴ *See* Section 304 of the JOBS Act.

iv. send to the SEC and potential investors not later than 21 days prior to the first sale disclosure information provided by the issuer;

v. ensure that no investor exceeds the twelve-month investment statutory limits;

vi. comply with other requirements that may be prescribed by the SEC.

In addition, funding portals are subject to further specific limitations, including:⁹⁵

i. paying for finding potential investors;

ii. giving investment advice or recommendations;

iii. soliciting offers or sales to buy the securities offered on its portal;

iv. compensating anyone for such solicitation or based on the sale of securities on its portal;

v. holding or managing funds or securities.

Moreover, under the crowdfunding provisions of the JOBS Act a cause of action may be brought against issuers for omissions and misstatements,⁹⁶ and there is some concern that the intermediary, being required to check that the issuer has

⁹⁵ See Section 301(b) of the JOBS Act.

⁹⁶ See Section 301(c) of the JOBS Act.

met the conditions of the crowdfunding exemption,⁹⁷ may be subject to the same liability.⁹⁸

In light of the above, not only would new-entrant funding portals face huge costs in order to be compliant with the massive set of statutory obligations, but they have also been placed at competitive disadvantage compared to existing brokers.⁹⁹

Not differently from the Italian regime,¹⁰⁰ one of the most striking features of the new financial crowdfunding regulation in the US is investor education. The JOBS Act mandates the intermediary to provide this education.

Specifically, it must ensure that each investor:¹⁰¹

⁹⁷ See CROWDCHECK, *SEC Proposes Regulations*, cit., p. 18.

⁹⁸ For recent exploratory study of crowdfunding intermediaries' possible liability under the various antifraud rules, see also C.S. BRADFORD, *Shooting the Messenger: The Liability of Crowdfunding Intermediaries for the Fraud of Others*, *University of Cincinnati Law Review* (forthcoming), available at <www.ssrn.com>, spec. p. 44 (confirming that "crowdfunding intermediaries face a significant risk of liability for the fraudulent statements of issuers and others posted on their platforms", but also stressing that "[u]nfortunately, the exact extent of their liability is unclear"). Under the Italian regulation, instead, "[t]he issuer is the sole subject responsible for the completeness and truth of the data and information supplied by the same" (see CONSOB Equity-based Crowdfunding Regulation, Annex 3, point 1), the only obligation of the intermediary being to "make available to the investors all the information provided by the issuer about the offer, in a detailed, correct, not misleading manner and without omissions" (see article 13.2 of CONSOB Equity-based Crowdfunding Regulation).

⁹⁹ But see S.R. COHN, *The New Crowdfunding Registration Exemption*, cit., p. 1439 (speculating that "[m]ost crowdfunding offers are unlikely to employ registered brokers. The broker's potential liability engaging in such offerings will generally not be worth the commissions to be obtained. [...] Instead, most offerings are likely to be offered through funding portals. Although the combination of statutory and regulatory requirements are intended to prevent abusive offerings, the requirements will create transaction costs beyond those imposed by existing registration exemptions and undercut the availability of the exemption for legitimate small businesses").

¹⁰⁰ It has to be noted that, however, while in the US is the JOBS Act itself the source of the intermediary's obligations relating to investor education (see Section 302(b) of the JOBS Act), in Italy that was a discretionary choice carried out by the CONSOB (see Article 15.2 of CONSOB Equity-based Crowdfunding Regulation).

¹⁰¹ See Section 302(b) of the JOBS Act. The SEC proposed rules would require the intermediary to deliver to investors, at account opening,

- i. reviews investor-education material;
- ii. affirms that he understands the potential risk of loss or the entire investment and that he could bear such a loss;
- iii. answers questions demonstrating an understanding of (a) the level of risk generally applicable to investments in start-ups, emerging businesses, and small issuers (b) the risk of illiquidity; and (c) such other matters as determined by the SEC.

Accordingly, the SEC's proposed rules require the intermediary to obtain an investor representation and completed questionnaire before accepting any investment commitment.¹⁰²

Theoretically, such mandatory investor education could be read as a sign of regulators' trust in and intent to leverage the "wisdom of the crowd". Investor education-based regulatory strategies, aimed at correcting cognitive bias and lack of financial sophistication, in fact, can and should support the goal of empowering investors.¹⁰³ However, we believe this is not the case here. As designed through the financial crowdfunding provisions, in fact, investor education is part of a highly exclusionary paternalistic regulatory strategy. Indeed, in the case of failing the "education test" the investor is not admitted to make any investment – which means that the investor is not

education materials that are in plain language and designed to communicate effectively specified information (*see* SEC proposed rule 302(b)(1)).

¹⁰² *See* SEC proposed rule 303(b)(2)(ii).

¹⁰³ *See* N. MOLONEY, *How to Protect Investors*, cit., pp. 58 ff., and spec. 374 ff. (observing, *inter alia*, that "[s]tronger investor education may mitigate the heightened risk of household investment mistakes and hold the most long-term promise for more rational decision-making by addressing, or at least highlighting, the biases under which investors labour").

simply made aware of his financial illiteracy and made responsible for his choice as to whether to invest or abstain. Even more remarkably, should – on the contrary – the investor “pass the test”, the investment limitation cap discussed above would still apply. In other words, in spite of his certificated understanding, the retail investor would find his freedom of choice limited by the Congress’ skepticism of the retail market for financial crowdfunding. A less intrusive and more stepped regulatory strategy could have been, for example, that of making the investor simply aware of his incomplete understanding of the risks associated to crowdfunding investments as well as of the statutory right to reconsider his contingent investment decision and to cancel his commitment,¹⁰⁴ while applying the individual investment cap exclusively to such investors who failed the test.¹⁰⁵

One thing the SEC has to be given credit for is that its proposed rules require the intermediary to provide channels through which potential crowdfunders can communicate with one other and with the issuer about offerings made available on its platform.¹⁰⁶ It has to be stressed, however, that in the

¹⁰⁴ See Section 302(b) of the JOBS Act; and SEC proposed rules 302(b) and 304(a)).

¹⁰⁵ Most likely, a prime determiner of the regulatory strategy followed by the JOBS Act is the traditional emphasis put on investor’s wealth as a proxy of his financial sophistication, bargain power and need for protection. A full discussion of such a complex matter is beyond the scope of this article, but it is, however, important at least to stress that it has recently become the object of a fierce debate among scholars and commentators: see, for example, W.K. FINGER, *Unsophisticated Wealth: Reconsidering the SEC’s “Accredited Investor” Definition Under the 1933 Act* (2009), 86 *Wash. U. L. Rev.*, pp. 733-767.

¹⁰⁶ See SEC proposed rule 303(c). Although the statute does not impose this requirement, the SEC’s believes that “Congress contemplates that there would be such a mechanism in place for [crowdfunding] offerings” (see SEC Rule Proposal, cit., pp. 175-176, notes n. 435-436 and accompanying text, citing to a statement of Sen. Scott Brown, according to which “[i]n addition to facilitating communication between issuers and investors, intermediaries should allow fellow investors to endorse or provide feedback about issuers and offerings [...]. Investors’ credentials should be included with their comments to aid the collective wisdom of the crowd”). The rules pertaining to registered broker-dealers and funding portals differ in regards to communication channels. While a broker-dealer may participate in the communications, a funding portal may not: see CROWDCHECK, *SEC Proposes Regulations*, cit., p. 12.

crowdfunding environment, interactive communication is a double-edged sword. In fact, despite being a prominent characteristic of crowdfunding itself,¹⁰⁷ interaction among the members of the “crowd” – if not subject to a good discipline – might result in such mayhem that would be almost impossible to ensure it functions as a leverage of the power of the crowd, rather than a conduit of an otherwise uncontrollable “madness”.¹⁰⁸ Thus, while it is quite surprising that the CONSOB remained silent on such an important matter,¹⁰⁹ the SEC’s approach reflects some thinking about the issues that crowd behavior may pose, somewhat attempting to mitigate them.¹¹⁰ Nonetheless, as discussed in further detail below, the SEC missed the opportunity to further leverage the inherent potential that technology may have in creating a “useful” crowd,¹¹¹ which in turn would have helped lower the costs

¹⁰⁷ After all, any aggregate of potential subscribers in a public offering of securities may constitute an undefined “crowd”. What defines crowdfunding’s inherent essence of largely unmediated investment process though, giving the “crowd” a more precise “identity”, is the fact that potential investors are connected both among themselves and to the issuer through the Internet and can exchange information and their respective views, evaluations and ideas about the project to be financed.

¹⁰⁸ See, for some remarks, J.R. BROWN JR., *Selling Equity through Crowdfunding*, cit., pp. 2 ff.

¹⁰⁹ No rule within the CONSOB Equity-based Crowdfunding Regulation, indeed, expressly copes with such matter.

¹¹⁰ For example, the SEC proposed rules would require the intermediary to i. permit public access to view the discussions made in the communication channels; ii. restrict posting of comments in the communication channels to those persons who have opened an account with the intermediary on its platform; and iii. require that any person posting a comment in the communication channels clearly and prominently disclose with each posting whether he or she is a founder or an employee of an issuer engaging in promotional activities on behalf of the issuer, or is otherwise compensated, whether in the past or prospectively, to promote the issuer’s offering. On the contrary, the CONSOB declared, although implicitly, that the use of multiple platforms for the same offering will be tolerated (see CONSOB, Equity-based Crowdfunding Regulation, “*Esiti della procedura di consultazione*”, July 12th, 2013, p. 49).

¹¹¹ It has been noted that “[t]he SEC does not provide guidelines for operating a communication channel. Presumably, intermediaries could determine whether their registered users must post under their real names or under aliases. Either choice will affect the quality of communications presented. For example, real names might limit participation, but aliases could encourage inaccurate or abusive posts” (CROWDCHECK, *SEC Proposes*

associated with the traditional tools of regulation that have, for the most part, been applied to financial crowdfunding.

5. DISCUSSION AND PROPOSALS FOR REFORM.

5.1 The weak foundation of the Italian and US regulatory approaches.

As discussed above, both the Italian and US regulators have acknowledged the “madness” *vs.* the “wisdom” of the crowd diatribe, without establishing a clear viewpoint of their own. More precisely, if one should ask “What kind of crowd have the Italian and US authorities assumed?” we think the answer is that they haven’t really thought about the issue at all.¹¹² As pointed out earlier, however, the burden and the type of the regulatory measures at play seem to imply that regulators expect the “mad” crowd to show up. As a result, the regulations only pay lip service to the “wisdom of the crowd” with no consideration of the extent to which appropriate best practices could force the creation of a “useful” crowd.¹¹³

Regulations, cit., p. 12). Furthermore, the non-application of the “integration doctrine” (see note n. 64 and accompanying text) would in fact permit – it has been stressed – issuers to easily circumvent the prohibition against the use of multiple platforms (see SEC proposed Instruction 1 to paragraph (a)(3) of proposed Rule 100), and, as a result, the creation of “multiple” crowds (see J.R. BROWN JR., *Selling Equity through Crowdfunding*, cit., p. 10).

¹¹² There has been no real analysis of the nature of the crowd, neither in the CONSOB and SEC rulemaking, nor in the legislation underlying the rules. See, in this regard, CONSOB, *Equity-based Crowdfunding Regulation*, AIR, July 12th, 2013, p. 20 (where it is stated that, among some other indicators that *will* be taken into account in order to measure the quantitative impact of the Equity-based Crowdfunding Regulation, the CONSOB *will* try to understand what kind of investors really operate through funding portals. The fact itself that such an analysis is scheduled to be part of an *ex post* – instead of an *ex ante* – impact assessment activity clearly demonstrates how the CONSOB had no definiteness about the nature of the “crowd” it was supposed to protect). As for the SEC proposed rules, it has been similarly noted that its knowledge or intuition about the crowd remains unclear (see J.M. HEMINWAY, *Investor and Market Protection in The Crowdfunding Era*, cit., p. 844).

¹¹³ See, for instance, A. AGRAWAL et al., *Some Simple Economics*, cit., pp. 14-32 (exploring the way creator/issuer, platform and crowdfunder incentives might play a critical role in preventing the market for crowdfunding from failing).

We believe that such a regulatory has not a solid foundation, and can be criticized on several grounds.

First, the crowd psychology literature out of which the “madness of crowds” argument is supposedly carved is gloomily outdated, historically decontextualized and, above all, the speculation embedded therein can be actually considered “a theory without a referent”.¹¹⁴ Experts of social identity have stressed that the vision of crowd behavior as intrinsically pathological undermine the possibility of neutrally observing how collective action can sometimes bring new ideas, perhaps sparking the restructuring of entire fields of both human activity and thinking.¹¹⁵

Indeed, and this is the second reason, we still know too little about crowdfunders’ real behaviors¹¹⁶ and motivations¹¹⁷ to make assumptions that will underlie regulations which, as a result, will likely be untested and poorly designed.¹¹⁸ Therefore,

¹¹⁴ See S. REICHER, *The Psychology of Crowd Dynamics*, in M.A. HOGG - R. SCOTT TINDALE (eds.), *Blackwell Handbook of Social Psychology: Group Processes*, Malden – Oxford, 2002, p. 2 of the document available at <www.uni-kiel.de> (pointing out that, in traditional crowd psychology, “[r]ather than starting from a set of phenomena that are in need of explanation, a set of explanations were elaborated in order to underpin certain ideological presuppositions about the crowd”).

¹¹⁵ See *id.*, p. 3 of the document accessed online.

¹¹⁶ See, for instance, G. BURTCH et al., *An Empirical Examination of the Antecedents and Consequences of Contribution Patterns in Crowd-funded Markets* (2013), available at <www.ssrn.com>, spec. p. 3 (observing that “many aspects of crowd-funding have yet to receive rigorous examination. The behavior of participants, a key factor that must be considered in any policy formulation effort, is not yet well understood”).

¹¹⁷ See U. BRETSCHNEIDER et al., *Motivations for Crowdfunding: What Drives The Crowd to Invest in Start-ups?* (2014), available at <ecis2014.eu> (empirically investigating possible motivations leading the crowd to engage in equity-based crowdfunding initiatives for start-ups, and speculating that the obvious goal to obtain a profit and/or capital gains on the invested capital might result far from being the unique motivation behind funding decisions).

¹¹⁸ For example, some scholars, while acknowledging that accumulated capital invested in projects effectively serves as a noisy signal of project quality, confess they still know little about whether information cascades have positive or negative effects on crowdfunding investments, especially when multiple projects are competing simultaneously for funding: see S.C. PARKER, *Crowdfunding, Cascades and Informed Investors* (2014), IZA Discussion Paper no. 7994, available at <www.ssrn.com>.

it can be asserted that, while to some extent undoubtedly opportune, both US and Italian financial crowdfunding regulations are premature in time with respect to their heavy touch. After all, we can't still know whether the market for financial crowdfunding will perform efficiently or not in the long-run.¹¹⁹

Third, given the aforesaid high degree of uncertainty, and, more generally, the acknowledged difficulty of effectively incorporating the BF insights into securities regulation,¹²⁰ a more prudent approach would have been preferable. Since the most obvious danger of incorporating BF findings into regulation is the possibility for regulators to “misinterpret investors’ behavior and over-regulate as a result”,¹²¹ and given the well-known costs associated with over-regulation,¹²² we here embrace a more careful standard whereby “efforts to reduce the adverse consequences of irrationality should not be adopted without comparing the costs of these regulations with their potential benefits”.¹²³

Nor does the global financial crisis and the huge harm it caused to many households worldwide represent a plausible

¹¹⁹ See A. AGRAWAL et al., *Some Simple Economics*, cit., pp. 32-39 (highlighting the current uncertainty about whether – and how – it will be capable of producing a net positive effect on social welfare, though optimistically concluding that, in spite of some predictable failures, “[a]s usual, eventually, the market will likely solve many of its own problems through innovation”).

¹²⁰ See, recently, D.A. SKEEL, *Behavioralism in Finance and Securities Law*, cit., pp. 24-25 (noting that “[b]ecause the psychological biases identified by behaviorists are so varied, they often are difficult to translate into clear policy prescriptions”).

¹²¹ See *id.*, p. 25.

¹²² See N. MOLONEY, *How to Protect Investors*, p. 77 (observing that “[e]xclusionary policies could [...] damage liquidity and asset pricing. While it may be sacrificial, widespread market participation has been found to contribute to asset pricing, while retail investor sentiment has been studied given its impact on pricing and resource allocation”). For further remarks, see also G. LA BLANC - J.J. RACHLINSKI, *In Praise*, cit., p. 24.

¹²³ G. LA BLANC - J.J. RACHLINSKI, *In Praise*, cit., p. 4. See also D.A. SKEEL, *Behavioralism in Finance and Securities Law*, cit., p. 25 (observing that “[g]iven the risk of over-regulation when behavioral findings are incorporated into rulemaking, it makes sense to begin with a presumption against its use, and in favor of traditional cost-benefit analysis”).

argument for supporting an “at-any-cost” highly intrusive protection of crowdfunders. That would be, indeed, a specious motivation, since in the context of the crisis the inappropriateness of regulation became clear with specific regard to very complex segments of the market,¹²⁴ whose failure would not justify an indiscriminate overhaul of the investor protection agenda without taking into due account the associated regulatory costs (in the case of financial crowdfunding, the costs of capital raising for small businesses and start-ups).¹²⁵ Alternatively, one can assume that the real concern of regulators was crowdfunding’s potential for investor fraud.¹²⁶ This is not a completely persuasive argument, either. While episodes of fraud have clearly occurred,¹²⁷ some academics have asserted that “the rate of fraud in crowdfunding is currently very low”,¹²⁸ and although that may not hold true in all forms of crowdfunding and in the future,¹²⁹ there is some evidence of fraud being detected by the crowd itself.¹³⁰ Besides,

¹²⁴ See S.L. SCHWARCZ, *Regulating Complexity in Financial Markets*, 87 *Wash. U. L. Rev.* (2009), pp. 211-268; and G. ROMANO, *La riforma dei derivati “OTC” negli USA: dalle regole di common law al Dodd-Frank Act* (2013), *Riv. dir. comm.*, I, pp. 137-203 (both discussing the complexity of MBSs, CDOs and derivatives markets as one of the main causes of the crisis).

¹²⁵ See A. CORTESE, *Pennies From Many* (2011), available at www.nytimes.com (asking “isn’t this the type of innovation we should be encouraging? Unlike exotic derivatives and super-fast trading algorithms, crowdfunding generates capital for job-creating small businesses”). For further remarks, see also D. GROSHOFF, *Kickstarter My Heart*, cit., pp. 545-547.

¹²⁶ For detail discussion of such concern throughout the legislative debate, T.L. HAZEN, *Crowdfunding or Fraudfunding? Social Networks and The Securities Laws—Why The Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure* (2012), 90 *N.C. L. Rev.*, pp. 1737-1770.

¹²⁷ See A. STEPHENSON, *First crowdfunding fraud enforcement action by State Attorney General* (2014), available at www.crowdcheck.com.

¹²⁸ See E. MOLLICK, *The dynamics of crowdfunding: An exploratory study* (2014), in 29 *J. Bus. Venturing*, pp. 1-16, spec. p. 14.

¹²⁹ See *ibid.* (the study focuses on 48,500 projects launched on *Kickstartet.com*, which uses the reward-based model).

¹³⁰ See, for example, A. AGRAWAL et alt., *Some Simple Economics*, cit., p. 29 (reporting a case in which two potential investors in the project flagged the project as fraudulent – it actually was – and notified others).

and above all, while fraud concerns could possibly justify a mandatory disclosure regime aimed at prohibiting any misleading statements and omissions of material facts,¹³¹ it couldn't explain the panoply of restrictive rules discussed earlier.

5.2 The need for recalibrating the regulatory interventions.

As discussed above, the failure to first conceptualize the “crowd” has forced regulators to make certain decisions with respect to crowdfunder protection that may not be warranted, and has led to regulations that may discourage the development of any significant vehicle for capital formation. Moreover, as discussed further below, the regulators may have missed an opportunity to shape the nature of the crowd.

Financial crowdfunding relies on the revolutionary assumption of making the online crowd a democratic basis for efficient capital allocation in early-stage ventures.¹³² To make this possible, however, financial crowdfunding is not something to be dealt in an idealistic way. On the contrary, it needs a highly realistic regulatory approach that should be primarily aimed at assuring that crowdfunders learn how to make themselves conscious venture financiers. While challenging the skepticism embedded in the newly-introduced US and Italian regulations, we do recognize that the market for financial crowdfunding shows several critical differences compared to

¹³¹ See T.L. HAZEN, *Crowdfunding or Fraudfunding?*, cit., p. 1763 (noting that “in order to give proper deference to investor protection, any exemption applicable to crowdfunding should be conditioned on mandatory disclosures”). See also H. LEO, *Stop using the F-word!* (2013), available at <www.crowdcheck.com> (reminding that “fraud” in the context of securities regulation “means something much broader than a Dr. Evil plotting to run away with your money. It also includes liability for misleading statements and omissions”).

¹³² See K. LAWTON - D. MARON, *The Crowdfunding Revolution*, 2010 (self-published e-book).

more traditional settings.¹³³ However, altogether considering that: *i*) regulation has its costs;¹³⁴ *ii*) issuers may face disincentives in using crowdfunding;¹³⁵ *iii*) a cost-benefit analysis is crucial in order to avoid over-regulation,¹³⁶ especially when the to-be-regulated market is a nascent one;¹³⁷ *iv*) there is mixed evidence on how the crowd will be capable to prevent fraud (most likely, it is going to be good at detecting fake campaigns or plagiarism, less good at detecting material misstatements, which is the definition of securities fraud)¹³⁸; we believe that the regulatory emphasis should have rather been put on the role of funding platforms and on the incentives they have as reputational gatekeepers.¹³⁹ This could have been made

¹³³ See for detail discussion A. AGRAWAL- C. CATALINI - A. GOLDFARB, *Some Simple Economics*, cit., spec. pp. 7, 8 and 19 (noting that “the most critical differences between equity and non-equity crowdfunding will arise due to the amplification of information asymmetries. Whereas the asymmetry problem currently concerns the feasibility of and the creator’s ability to deliver the product, in the equity setting the asymmetry problem includes the above as well as the creator’s ability to generate equity value by building a company rather than just delivering a product”).

¹³⁴ See D. GROSHOFF, *Kickstarter My Heart*, cit., p. 554 (noting that “[a]ny government interference in the marketplace creates a cost”).

¹³⁵ See A. AGRAWAL et al., *Some Simple Economics*, cit., pp. 16-17 (stressing that while “[o]ther sources of funding [...] allow creators to keep their innovation secret from the general public, [...] crowdfunding requires creators to disclose their innovations in public forum [...]. The disclosure risk is accentuated in the equity crowdfunding setting since creators must disclose their plans for the company (e.g., strategy key employees, customers, costs) in addition to their new product or service”).

¹³⁶ See J.M. HEMINWAY, *How Congress Killed Investment Crowdfunding*, cit., p. 886 (arguing that “[s]olving the puzzle to support and encourage any individual desired securities offering market requires that regulators effectively balance the costs and benefits to the core players in the market—the three I’s: issuers, investors, and intermediaries—to best ensure that each is incentivized to participate”).

¹³⁷ See, for instance, L. HORNUF - A. SCHWIENBACHER, *Which Securities Regulation Promotes Crowdinvesting?* (2014), available at <www.ssrn.com>, spec. p. 5 (assuming that “strong investor protection [...] may hurt entrepreneurial initiatives that rely on security offers, because smalls firms are not able to support the costs related to compliance, in contrast to large firms for which stronger investor protection is beneficial”).

¹³⁸ See *supra*, notes n. 124-129 and accompanying text.

¹³⁹ See J.M. HEMINWAY, *The New Intermediary on the Block*, cit., p. 191, note n. 67 and accompanying text (stressing the reputational intermediary status of early crowdfunding websites and noting that certain

through a few cost-efficient rules designed to foster such incentives,¹⁴⁰ in order to stimulate a market design where the competition among portals could represent the spark to the adoption of best practices aimed at resolving some of the most striking problems that might challenge the efficient operation of the market for financial crowdfunding.¹⁴¹ After all, funding portals are in the position to observe both sides of the market,¹⁴² and some recent evidence demonstrates that they are beneficially trying to build a strong reputation, which functions as a valuable signal for potential crowdfunders.¹⁴³

5.2.1 Decoding the crowd nature.

To begin, as for the crowd characterization, we first observe that the issue is not binary: it is not a question of “wise”

longer term players, like *Kickstarter.com* and *Kiva.org*, “have begun to develop the notoriety and positive course of dealing that generate reputational intermediary status”).

¹⁴⁰ On the contrary, excessive costs might incentivize intermediaries to indiscriminately look for a high number of funding clients, underinvesting in issuers “curation”: see, for example, J.M. HEMINWAY, *How Congress Killed Investment Crowdfunding*, cit., p. 883.

¹⁴¹ For a similar opinion see A.A. SCHWARTZ, *Keep It Light*, cit., p. 58 (supporting the idea that “to the extent that there are other cost-effective means of reducing the risk of fraud in securities crowdfunding, market forces will encourage intermediaries to adopt them.”). For further remarks, see also A.C. FINK, *Protecting the Crowd and Raising Capital Through the JOBS Act (2012)*, available at <www.ssrn.com>, spec. pp. 33-35.

¹⁴² See P. HAAS et al., *An Empirical Taxonomy*, cit., p. 5 (describing the functions through which crowdfunding intermediaries enable the matching between capital-giving and –seeking agents. Among such functions the Authors mention: capital-seeking agents credits assessment; investment opportunities (projects) pre-selection and comprehensive agents and projects information bundling; relationships and agents networks enablement; neutral, trustworthy and objective market place integrity verification).

¹⁴³ For thorough discussion see A. AGRAWAL et al., *Some Simple Economics*, cit., pp. 16, 19 and 22 ff. (noting that almost all crowdfunding platforms employ a revenue model based on a transaction fee for successful projects, and, by doing so, have the objective to maximize the number and size of successful projects. This, they add, makes the funding portals interested in “designing the market to attract high-quality projects, reduce fraud, and facilitate efficient matching between ideas and capital (e.g., by increasing the degree of disclosure by the entrepreneurs and allowing for effective search on the side of the funders)”).

us. “mad”. Rather, there are so many sub-types of crowd that any given crowd belongs on a continuum, not in bucket A or bucket B. Second, crowd behavior is dynamic, not static; the nature of crowd interaction makes this inevitable. Any given crowd can move from one place on the “wise-mad” continuum to another, often quite quickly. Third, it is possible for appropriate regulation and gatekeeper action to influence where on the “wise-mad” continuum the crowd should be, and to keep it there.

Whilst the Italian market is still perhaps too unripe,¹⁴⁴ from interactions on existing US securities and donation/rewards crowdfunding sites,¹⁴⁵ several distinct types of crowd behavior can be identified, some having some aspects of the classical “wise” or “mad” behavior patterns and others behaving in a less easily-pigeonholed manner.

In this heterogeneous amalgam we distinguish:

i. The “expert crowd”.

Some online investment platforms are targeted at specific industries and/or specific investor subgroups. *Poliwogg*¹⁴⁶ and *AngelMD*¹⁴⁷, for example, are US sites that focus on investments in health and life sciences companies, and targets medical professionals and scientists as potential investors. Although not all of these platforms provide investor comment or Q&A

¹⁴⁴ A recent comparative study has showed that, in spite of other European countries, the Italian market for financial crowdfunding is still quite static: see L.HORNUF - A. SCHWIENBACHER, *Which Securities Regulation*, cit., p. 20.

¹⁴⁵ It has to be remembered that in the US financial crowdfunding to retail investors is not established yet. Some platforms, such as *AngelList* in cooperation with *SecondMarket*, however, permit equity-crowdfunding but for accredited investors only. Unfortunately, we lack data to thoroughly investigate crowd behavior on such platforms, since accredited platforms are not required to provide a comment/Q&A function. However, through the means of speculative adaptations of the evolutions thus far occurred in the reward/donation setting, some prominent academics have started to make useful attempts to predict the possible functioning and problems of the market for financial crowdfunding in the future: see A. AGRAWAL et al., *Some Simple Economics*, cit.

¹⁴⁶ See www.poliwogg.com.

¹⁴⁷ See www.angelmd.com.

functions, it might be reasonable to expect that the combination of specialized site and targeted “crowd” might produce useful feedback for both the issuer and for other potential investors. In the event a platform does succeed in attracting an expert crowd, regulators and intermediaries will have to give some thought to how to leverage that crowd’s knowledge, and how to temper investor expectations. It takes more than just a good idea to make a successful company. The company must, for example, own that idea, and have the human and financial resources to execute it. If a known investor with verified professional expertise in the area in which the company seeking funds operates praises the company’s business plan and says it is likely to succeed, the platform (or regulators) should make sure that other investors consider, and do due diligence on, the other factors necessary for success, ensuring that lay investors are not “blinded by science”.

ii. The “mob”.

“Mob” behavior occurred a number of times on donation/reward crowdfunding sites. Sometimes the crowd starts to turn on the issuer. This happened with the LUCI Project on *Kickstarter.com*.¹⁴⁸ At first the commentary was positive and then doubts started to build and the crowd piled on, alleging fraud. Because the project sponsor withdrew the crowdfunding campaign, citing alternative funding, it was not possible to tell whether the project was in fact fraudulent. Sometimes mob behavior is generated from within the mob, and sometimes it is prompted by an outside agent. This was the case in the HealBe calorie-counting wristband project on *Indiegogo.com*. The project was about to close when a journalist from Pando Daily raised questions about whether it could work from a scientific point of view.¹⁴⁹ The potential backers started demanding their money back. Mob behavior generally falls on the “madness of crowds” side of the equation, although mobs

¹⁴⁸ See J.D. ALOIS, *LUCI Advanced Dream Inducer Cancelled on Kickstarter, Fraud Allegations Mentioned* (2013), at www.crowdfundinsider.com).

¹⁴⁹ See pando.com/tag/healbe/.

can also illustrate the dynamic nature of the crowd. The crowd can in some cases start wise and descend into madness and can also start deluded and be brought to its senses. In particular, the role played by provocateurs (whether journalists, competitors or troublemakers) should be taken into account by regulators and intermediaries.

iii. The “crowd of trolls”.

The phenomenon of “internet trolls” is well known, and has caused some online publications to cut off the comment function altogether.¹⁵⁰ The comment section of many political and news sites is so replete with irrelevant, monomaniacal and aggressive comments that no useful information can be gained from them. The “crowd of trolls” differs from the “mob” in that no consensus as to the topic under consideration is ever achieved; there might be individual madness but the crowd itself is not mad, just politically polarized. Since it seems to be a basic human instinct to want to announce one’s own opinion on any topic to the world at large, it seems likely that trolls will appear on financial crowdfunding sites, unless those sites impose some of the crowd-handling techniques discussed below.

iv. The “cult crowd”.

The “cult” crowd is just as “mad” as the classic “mad” crowd, but is united by specific motivations. One classic scam that has existed on the internet for some years is the “free energy machine” which goes under several different names. Despite being completely scientifically unproven, a version of this machine (under the name “Home Quantum Energy Generator”) raised more than \$18,000 (on a \$7,610 goal).¹⁵¹ The backers of this project seem to assume the scientific viability of the project, and the interaction between backers and project

¹⁵⁰ See, for instance, S. LABARRE, *Why We're Shutting Off Our Comments* (2013), at <www.popsoci.com>

¹⁵¹ See <www.indiegogo.com/projects/home-quantum-energy-generator>.

creator (no comments raise any questions with respect to the feasibility of the project) gives the impression of religious acolytes praising the project creators for changing the world.

v. The “MMORPG” fan chatroom.

This phenomenon is most often observed among fans of online games, especially “massively multiplayer online games” (“MMOG”), where fans of a particular game maker expect to interact extensively online both with the game creator and each other. While these fans are truly wise with respect to the specific product offering, when 145,000 comments are made with respect to a particular game,¹⁵² and the commenters are mostly interested in the minutiae of the product, there is little chance that other potential investors will ever be able to devote the time to leverage the wisdom of this crowd.

vi. The “absent crowd”.

Sometimes a project is so patently fake that people don’t bother to make any comments; they just steer clear. If there are no comments at all with respect to a project, this could be a message, although some perfectly legitimate projects fail to get traction.

5.2.2. Creating a “wise” crowd: how may funding portals help this develop?

In the light of the above, we believe that rather than having to guess whether the crowd will be composed of “wise” reasonable investors or of amateurs subject to irrational behavior, the regulators, in the first place, could have specified criteria that would have created a grass-roots information-forcing process that could have responded to the specific requirements of the potential investors as opposed to forcing all companies seeking funds into a one-size-fits-all disclosure model that may prove to be unduly burdensome for some issuers. One option might have been to specify the base information that every company seeking funds must provide

¹⁵² See, for instance, the case of Camelot Unchained (<www.kickstarter.com/projects/13861848/camelot-unchained>).

(e.g., financial statements for two years; names of officers and directors) and then require crowdfunding portals to provide a process whereby the crowd could demand specific additional information. This would be a partly-empowering/partly-educational/partly-paternalistic process whereby the portal would provide information and guidance. There could be many different categories of information that investors could, in effect, “vote” on. Thus, a portal could have a section where various items of information are described and investors could choose whether they wanted the information.¹⁵³ The portal’s internal rules could impose obligations to produce extra information if a certain percentage of investors require it, or could merely present this information to the issuer to decide whether to increase the information it had already provided.¹⁵⁴ In any case, the portal would have to show the crowd what the other members of the crowd were demanding and how the issuer responded. Various portals could take different approaches to the information-seeking process, since this would be easy to do from a technological point of view. The regulators have indeed ignored some of the options for increased investor participation that technology offers. Compared to the CONSOB’s agnosticism, the SEC, at least, has said that investors have to be able to communicate with each other,¹⁵⁵ but a more explicit explanation of how this could work could have lessened the burden on issuers and given the crowd more control to decide what information is important to them, with appropriate guidance and education.

¹⁵³ For example, Portal X might have a section in its “additional information” section where it says “Companies that have been operating more than three years might be assumed to have the ability to produce financial statements for three years rather than the two that the SEC demands”. The advantage to having an extra year of financial statements is that potential crowdfunders see how the company’s revenues have grown over time: “Click here if you would like to have an additional year’s financial statements”. The options for a crowdfunder to click could be “essential (I will not pledge funds without this)”, “would like but might still invest without” or “don’t care”.

¹⁵⁴ In this regard, see also M.C. HUTCHENS, *Hitting the Target*, cit., p. 20 (observing that attention to public comments by investors could also help an issuer ensure a successful follow-up offering).

¹⁵⁵ See *supra*, note n. 106 and accompanying text.

In the second place, we believe it is incredibly important to focus on the conditions under which the crowd could be useful and where the crowd could be misled. Several further steps could have been made by regulators in this regard. For a start, comment from a potential crowdfunder is far more useful when the person comments with his real name and where his credentials are verified. A useful example might be *Coursera's* Signature Track.¹⁵⁶ It is a double verification system that uses a combination of photo verification and typing pattern recognition to confirm users' identity.¹⁵⁷ Furthermore, in order to avoid "noisy" behaviors such "mobbing" and "trolling", the role played by provocateurs (whether journalists, competitors or troublemakers) should be anticipated by regulators and, in the first place, by the intermediaries themselves, for example, by implementing active comment moderation functions. Those platforms that can't afford to hire an adequate numbers of moderators might alternatively be required to state they don't have any active comment moderation function, and provide information explaining the potential dynamics of "mobbing" and "trolling". This also would be a party-empowering/partly-educational/partly-paternalistic light-touch regulatory measure capable of making the crowd more responsible in its decision-making process.

The measures listed above are just some of the rules that platforms might be required to implement in order to encourage or even create a "wise" crowd. Further and more accurate

¹⁵⁶ *Coursera* is an education platform that partners with top universities and organizations worldwide to offer online courses for free: see <www.coursera.org/about>.

¹⁵⁷ See <<http://help.coursera.org/customer/portal/articles/1167999-how-does-identity-verification-work->> (where it is explained that "[w]hen you register for the Signature Track, you create a Signature Profile by submitting a short typing sample, a webcam photo of a photo ID document, and a webcam photo of your face. Throughout your course, we request another typing sample and face photo after you complete each graded assignment. Your typing pattern is unique to you - like a fingerprint - and can be matched by analyzing key characteristics such as the time (in milliseconds) between your keystrokes and the length of time for which you press a key down. Your face photo is matched to the face photo submitted at registration. This double-verification system gives us high confidence that you are participating in the course and submitting your own work").

proposals for reform, of course, would need more study and data. In this respect, it will be crucial to monitor how the market responds to and interacts with the regulations.

6. CONCLUSIONS.

From reviewing the newly-introduced Italian and US regulations, it appears clear that the two exemptions for financial crowdfunding are not as friendly as one might wish. The regulations are undesirably rigorous: simply too discouraging for investors, and potentially too costly for small businesses and new-entrant funding portals. It seems regulators' interventions have been conditioned by the acknowledgment that the "crowd" may either prove to be "wise" or to be "mad", which explains the "omni-inclusive" regulatory regimes, where both "liberalistic" and "paternalistic" measures have been peculiarly (and, to a significant extent, contradictorily) combined. The concern that, at some point, the crowd will show its intrinsic "madness" has, however, eventually prevailed. In other words, the regulations rely on the implicit belief that the market for financial crowdfunding will inevitably be a "market for lemons" in the long-run. In this paper we assume that the classic "wise" *vs.* "mad" crowd portrayal is too simplistic, and that the judgment and the choices made by regulators are premature in time. Accordingly, we suggest recalibrating the regulatory interventions in such a way that the combination of a few cost-efficient regulatory expedients along with a self-policing market design may foster good competition, thereby stimulating the spontaneous formation of a "useful" crowd. Financial crowdfunding should be given a better chance to prove whether the "crowd" can play the role of effective capital supplier, rather than offhandedly assuming that its members simply are, and will always remain, nothing but naïve geeks. With no changes within the current regulations, the forecasts for financial crowdfunding are not rosy at all.