“Transparency may be the most disruptive and far reaching innovation to come out of social media”

– Paul Gillin
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We represent nearly 50 public companies and numerous private companies in various industries including: shipping, biotechnology, medical devices, information technology, financial services, alternative energy, consumer products and business services throughout the world. We also represent hedge funds, investment banks, real estate developers (leasing, financing and buy/sell) and work on numerous corporate and partnership tax issues. The Firm also has a strong commercial litigation department that supplements our other practice areas. The Firm has clients throughout the world including Greece, England, the Netherlands, China, India and Israel. Our growth and successes led our firm to achieve improved rankings among all U.S. law firms. In 2011, EG&S was ranked: #1 in PIPEs/Registered Directs (agent’s counsel); #1 in SPAC Practice (total offerings and business combination representations) and #4 for IPOs (issuer counsel).

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The mission of GATE Global Impact is to fulfill the increasing global demand for market infrastructure that enables capital to identify and transact in investments that provide a sustainable social and/or environmental benefit and financial return. GATE has created a centralized electronic marketplace to facilitate the transactions of impact-focused investment products and has developed a utility that provides efficiency, transparency, liquidity and education that enables the transaction processes in a variety of markets.

GATE provides an end-to-end solution inclusive of information, performance metrics, settlement and clearance. These markets include private equity, private debt, microfinance and environmental credits. GATE Global Impact ultimately believes they will have a positive influence by providing investors and entrepreneurs a regulatory compliant marketplace to interact allowing for future job creation and stimulate economic growth.

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EXECUTIVE SUMMARY

President Obama called crowdfund investing “game-changing” when he signed the JOBS Act into law on April 5, 2012. In the United States, 2013 will likely be ‘the year of the entrepreneur’. Using equity or debt securities, this new US law creates a financial vehicle for community financing that the average American can use to invest in entrepreneurs they believe in and local businesses they trust. Prior to this law, only accredited investors (less than 2% of the US population) had this opportunity. If Americans invest just 1% of their savings via crowdfund investing, this policy change will deliver over $300 billion to the small businesses, which will stimulate entrepreneurship, innovation and job creation. These results are achieved without any US government spending.

Historically, countries with the strongest economic output enjoy both stability and strength, and today many countries face serious socioeconomic challenges. Three of the most pressing challenges are employment, economic growth, and rapid urbanization. We argue that crowdfund investing shouldn’t be a part of a solution to these crises in the United States alone, but that it can be a global solution as well. It promotes economic and political stability through entrepreneurship, innovation, and employment. Crowdfund investing is a unique strategy that engages large percentages of the population in building and supporting ecosystems of economic success. A unique feature of crowdfund investing is online engagement, which has the macroeconomic impact of extending existing government and non-governmental organization (NGO) development initiatives deeper into communities via social networks. Further, crowdfund investing provides access to capital for both community businesses (such as a bakery or a laundromat) and high-growth businesses.

Community financing is not new, it is simply a way to formalize something that’s been going on for a long time via the Internet. Crowdfund investing is Web 3.0: where the social Web meets small business financing. Now, startups and small businesses can raise money from communities not just based on geography but also on shared interests and common heritages as well.

This paper explores how governments can unlock the power of crowdfund investing by enabling companies to leverage the social Web to encourage community financing, community engagement, and business innovation. We will discuss how crowdfund investing was legalized in the United States
“When the public and private sectors combine intellectual and other resources, more can be achieved.”

- Gro Harlem Brundtland
Fmr. Prime Minister of Norway
at a time when Washington, D.C. was never more politically divided, and how capital markets can be augmented so that local communities can fund businesses to provide services like waste water and power generation and online communities can fund businesses that provide new products like mobile games or medical devices to their countries and regions. Governments that introduce a crowdfund investing framework to enhance their private capital markets will decentralize capital formation, unlock innovation, and encourage economic growth.

INTRODUCTION

The role of policymakers is changing as societies look for answers to grave social challenges. Sherwood Neiss, Principal at Crowdfund Capital Advisors (CCA) believes that “the primary role of government must be less focused on the command and control of an economy and more focused on engagement with the private sector and entrepreneurs to create a prosperous society through employment and innovation.” As youth unemployment soars, economies around the world struggle to recover from the “Great Recession,” and urban infrastructures are stretched to the limit, the approaches to these problems policy makers make will define the future prospects of citizens around the world.

One step in the right direction is taking hold in the United States. It is a new funding relationship powered by social media called “crowdfund investing.” Recently, Crain’s Business Journal ran a major piece on this financial innovation entitled “Mix VC, Social Media, Create Crowdfunding.” The title captures much of the essence of the innovation. Jason Best, Principal at Crowdfund Capital Advisors, describes the innovation like this: “Web 2.0 brought the rise of the social Web. Now with crowdfund investing, we have the the dawn of Web 3.0 - where the social Web meets capital formation.” American Sen. Scott Brown, who has been one of the political champions to help bring this innovation to market, recently editorialized about crowdfund investing and said, “for the first time, entrepreneurs [will] simply put their ideas up for investors’ consideration using Twitter, Facebook, and other social media. In today’s wired world, where an MIT student can start a profitable business right in his or her dorm room,

crowdfunding might just be one of the ideas that pushes us out of this economic downturn.” This paper offers readers an in-depth explanation of what crowdfund investing is and dives deep into its potential for building better societies across the globe.

**The Crowdfund Investing Backstory**

Before we dive into the history of crowdfunding, it is important to have a clear understanding about what crowdfunding is and how it is already transforming business and society. Wikipedia defines crowdfunding as “the collective effort of individuals who network and pool their resources, usually via the Internet, to support efforts initiated by other people or organizations.” Some of the most common examples of crowdfunding are charitable donations to a worthy cause, the funding of small loans on Kiva to entrepreneurs in Africa, or the collective funding of an art project. None of these examples provides individual donors with a financial return. Next, as we dive deeper into definitions and examples of crowdfunding, we will develop the concept more fully so that readers can get a more comprehensive understanding of the different kinds of crowdfunding and why one kind of crowdfunding—crowdfund investing—is a transformational socioeconomic development.

*How Beer Changed the Financial System in the United States*

The crowdfund investing narrative really begins in 2008, when the American beer company Pabst Blue Ribbon put itself up for sale for $300 million. One clever social media marketer named Mike Migliozzi saw how the power of social media had changed politics and business, so he decided to use the Pabst Blue Ribbon sale as an opportunity to run a sort of social experiment. With a partner, he started a website to collect small commitments from many individuals in order to buy Pabst Blue Ribbon with money raised from the “crowd.” The “crowd” has since come to signify a collection of hundreds or thousands of individuals who together, fund something via the Internet. In the case of Mr. Migliozzi, his experiment in raising capital from the crowd to buy out Pabst Blue Ribbon was extremely successful—

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so successful that the SEC was forced to take notice. The site they set up to buyout Pabst generated commitments of $282 million from investors before the SEC intervened. The investors funding the Pabst buyout attempt were regular investors, not accredited investors, and at the time, US law prohibited regular investors from participating in these kind of deals. The Pabst buyout attempt got the attention of the Wall Street Journal, and the publication wrote an article about the online buyout attempt soon after.

The Pioneers of Crowdfund Investing

As Mr. Migliozzi’s funding experiment took place, three American entrepreneurs, Sherwood Neiss, Jason Best, and Zak Cassady-Dorion were having their own frustration with outdated securities laws in the US. As investors, they were frustrated that they could give their money to people in different countries via platforms like Kiva, but that US securities laws prevented them from using the Internet to fund projects at home. Also, as entrepreneurs with experience raising tens of millions of dollars in capital, they were frustrated with the time, the cost, and the administrative burden involved in raising growth capital for small businesses. These frustrations were the foundation of their drive to create a framework to change small business funding practices in the US.

They found broad support for their ideas. Prominent economists, securities lawyers, entrepreneurs, and legislators in the US felt that the economic meltdown of 2008 was further exacerbated by the unavailability of capital for small business growth, and it became clear that there were structural problems with the US financial system. Looking back on his experiences developing the crowdfund investing framework, Crowdfund Capital Advisors Principal Jason Best says he learned that “trying to pump federal dollars into a local economy is a short-term fix for long-term economic problems.” The consensus these three businessmen found as they developed the original crowdfund investing policy framework was that without capital efficiently flowing to startups and small businesses, job creation is virtually put on hold, which inhibits economic recovery.

The men behind the Startup Exemption framework took their case to the government. Upon

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attending meetings with the SEC they were told it would never happen - that it would take an “ACT OF CONGRESS” for crowdfund investing to be permitted in the US, even though it was clearly a compelling alternative for small business funding. They were able to demonstrate that in a pre-crowdfund investing market, businesses sometimes paid upwards of 25% of the funds they raised in funding costs, making the prospect of a seed round vanish. Because the team behind the Startup Exemption had both benefited from access to capital and been hurt by the economic downturn, they decided it was time to take their ideas directly to US legislators.

Their first step was to create a comprehensive regulatory framework that could be easily used by lawmakers to craft legislation that would allow for crowdfund investing in the future. The result of their work was called the Startup Exemption Framework (also known as the “Crowdfunding Exemption Framework”), which merged the principles of collective donations made via the Internet and early-stage business funding. Their framework would make it legal for entrepreneurs to raise up to $1M in capital from their friends, their family, and the community through solicitations on social networks via SEC-registered websites (called “funding portals”).

Next, Messrs. Best, Neiss, and Cassady-Dorion brought the Startup Exemption framework to Washington, D.C., meeting first with Darrell Issa’s office, the Chairman of the House Committee on Oversight and Government Reform. Issa believed in their policy framework and saw the potential it had to help create employment opportunities and to ease the administrative burden on small businesses. Issa’s first request was to have the Startup Exemption team compile a list of questions for senior people at the SEC. Using their questions as an outline, Issa sent a letter to the SEC to make further inquiries about the potential of legalizing crowdfund investing in the United States. In response to their questions, Mary Shapiro, Chairwoman of the SEC, said that the SEC had been “discussing crowdfunding and possible

“Web 2.0 brought the rise of the social Web. Now with crowdfund investing, we have the the dawn of Web 3.0 – where the social Web meets capital formation.”
- Jason Best

4 To see a history of the construction of the Startup Exemption policy framework, visit the Startup Exemption’s framework timeline online at http://bit.ly/OU0ySZ.
regulatory approaches with small-business representatives and state regulators.” Her forward-looking statement attracted media attention to the crowdfund investing story, because it was contradictory to how many people in Washington believed the SEC would respond.

How Crowdfund Investing Legislation Crossed the Finish Line

When the Wall Street Journal began to follow the story about the legalization of crowdfund investing, businesspeople and policymakers started to look at the issue more seriously. Discussions among policy makers and businesspeople began, and ultimately, significant momentum was created that would later ensure the passage of legislation based on the Startup Exemption framework as a part of the Jumpstart Our Business Startups (JOBS) Act. Chairman Issa called the first hearing on crowdfund investing and the White House subsequently reached out to the Startup Exemption team for more information about the framework they’d developed. Soon after, Representative Patrick McHenry from North Carolina called a second hearing on crowdfund investing and drafted the early legislation based on the Startup Exemption policy framework. Later, the bill legalizing crowdfund investing was voted on and passed the House by an astonishing margin of 407-17. In the Senate, Senators Merkley, Bennett, and Brown drafted complimentary legislation and included it in the JOBS Act, which was passed and signed into law in April of 2012. The Startup Exemption solution was one of the fastest bills outside of war legislation to pass through Congress and to be signed into law in US history. Describing the importance of the shift, an article in the Harvard Law and Policy Review said, “crowdfunding promises to decentralize and to generally transform corporate finance around the world.”

As the SEC makes rules that will regulate crowdfund investing in the US, other countries are

taking notice. Member of the Startup Exemption team and Crowdfund Capital Advisors Principal, Jason Best believes that crowdfund investing is an elegant solution that is easily adopted by governments. “Crowdfund investing provides a compelling opportunity for different political parties and branches of government to come together to support the democratization of capital. We believe this is an issue that political leaders and regulatory authorities in many countries can rally around to provide significant benefit at very little cost.” Now, let’s look at exactly how crowdfund investing is transforming how economies operate.

Disambiguation of Crowdfund Investing and “Token Crowdfunding”

There are two different forms of “crowdfunding”—crowdfund investing and “token crowdfunding.” The former, crowdfund investing—which is the focus this paper—describes a funding relationship wherein the investor receives some claim on a business’ future assets in return for investors’ capital pledges. The latter, “token crowdfunding,” is a form of donation or consumption. While both can be extremely useful in helping underserved business communities access capital, the main focus of this paper will be on crowdfund investing. In a crowdfund investing scenario, an investor makes a (usually, relatively small) commitment of capital to some business so that the business can grow and in return, they get a claim on the future assets of that business. In the United States, crowdfund investing will be regulated by the SEC, because securities are involved in these funding relationships. So, crowdfund investing turns regular citizens into “micro angel investors,” people who make relatively small capital pledges like those made by existing “angel investors” to power ideas and business expansion.

There are restrictions on participation. In the US, the restrictions on regular investors are: (1) they must be a US resident and (2) they can commit a maximum of 5% of their annual income or $2,000 to crowdfund investing projects per year if their income is under $100,000 annually and 10% of their annual income (up to $100,000) if their income/net worth is greater than $100,000. Of course, these parameters are modified by policymakers outside the US to suit their particular economic environment.
How Crowdfund Investing Changes Financial Systems

Allocating More Funds to Socially Conscious Businesses

Crowdfund investing changes the variables needed to get seed round and business expansions funded. When banks and venture capital firms are determining whether or not to make an investment in a traditional fundraising effort they are examining multiple criterion such as:

- Availability of collateral
- Credit scores of a project’s directors
- Quality of the business plan
- Offline relationships with key players

The variables likely to determine the success of a crowdfund investment effort are different. They are more related to personal credibility and to communication. For example, with a crowdfund investment offering, the following criteria might determine success or failure:

- Perception of the “social value” of a project or a business
- Quantity of the team’s connections on social media networks
- Quality of the team’s connections on social media networks
- Online credibility, credentials, and persona of the team
- Ability to communicate with individuals via social networks

In a venture funded using a crowdfund investment strategy, finding the right audience of potential investors, possessing the ability to formulate and to communicate a compelling argument to the right people, and finding projects with social value are critically important factors. This implies that with a crowdfund investing framework in place, additional “socially-conscious” ventures are likely to receive funding. This is especially relevant to governments that are struggling to fund a broad array of necessary social programs. So, crowdfund investing allows those with ideas to harness the power of the Internet
to target one's personal network rather than relying on traditional financial institutions for capital to fund their businesses and ultimately, to create jobs.

“Naturally” Diversifying Investors

Crowdfund investing changes what “investment” means to the average citizen and how investments are made. This new asset class offers investments that are much smaller, made for different reasons (like “fun,” social value, etc.), and made through novel investment channels (websites called “funding portals”). With respect to diversification, it is likely that citizens who invest using crowdfund investing websites—the “funding portals”—will invest in many, not few projects, and thus be very well diversified. For example, an individual investor might allocate $3,000 to 10 businesses with an average commitment of $300 per project in a given year rather than committing the money to relatively few, large, publicly listed firms. This implies that the crowdfund investor's capital is relatively well diversified simply because of the nature of the funding system. With crowdfund investing, investors are likely to invest in many projects with small amounts of capital. In the long term, the advantages of the crowdfund investing system are likely to drive the evolutions of entire financial systems.

Industry experts in the United States expect that crowdfund investing will change the game for financial services. A recent Forbes article reports that Fred Wilson, partner of Union Square Ventures, a San Francisco VC firm, predicts that in 2013, crowdfund investing will unlock $300 billion of additional capital for American small businesses looking for funding.6 Mr. Wilson’s remarks have sparked an interest in crowdfund investing from traditional financial houses who see themselves competing in this space when the system matures. In the first half of 2012, angel investors, venture capitalists, and others from the startup communities in San Francisco and New York were the only ones interested in speaking with Crowdfund Capital Advisors, the consulting group authoring this paper. However, around the time that Mr. Wilson made his comments, the consultancy began receiving information requests from large financial institutions. So, while crowdfund investing began as a funding mechanism known only by a

handful of entrepreneurs and venture capitalists, traditional financial services firms are starting to sense that the legalization of crowdfund investing has big implications for their own futures. Eventually, many financial professionals believe that there will be an overall increase in “smart money” flowing into smaller ventures. CCA anticipates that this will result in the formation of “crowd-funds” that will change the funding landscape forever for promising start-ups and for community businesses.

**Case Study: A Crowdfund Investing Example**

Main Street Movies wants to raise funds via “the crowd” to open a new location. If Main Street Movies needed $500,000 to rent land and to build the new theater, it could offer 40% of its equity in return for $500,000 worth of pledges from individual investors who will make these commitments via a website or “funding portal.” These individual investors could be any persons that a regulatory regime specifies. If their issuance is successful, Main Street Movies can then open a new location, hire new employees, and contribute to the overall economy. In this example if they were able to attract around 3,500 individuals who meet these criteria and were willing to individually commit an average of around $150 each, the issuance would be funded and Main Street Movies can move forward with their plans. See Figure 1 for an illustration.
Crowdfund investing frameworks help create employment opportunities.

“What is important is that we guarantee decent and dignified work to all Chileans . . . what is important is that everybody has the same rights and the same opportunities.”

- Michele Bachelet
Fmr. President of Chile
HOW CROWDFUND INVESTING CREATES JOBS

The importance of job growth is clear to policy makers and still, employment problems plague many governments. Socially, many studies have connected youth unemployment with increased civil unrest, and economies that lack well-paying jobs have been clearly connected to increases in poverty, which connotes an increase in crime and long-term economic growth problems. Economically, output and job creation are intimately connected, and as Figure 2 reveals, the relationship between household savings and job creation is at the heart of an economic system. Now, we’ll illustrate the current problem with household savings and demonstrate how crowdfund investing encourages allocation of capital to productive, job-creating areas of an economy.

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Job-Creator #1: Bringing Capital in Off the Sidelines for Use by Small Businesses

The questions we feel any policy maker must ask themselves today are: “Are national savings being allocated to job-creating small businesses?” and “Could the introduction of a crowdfund investing framework be a step towards improving national employment situations?” We believe the answer to these questions is an unequivocal “yes.” To start with, we know that small businesses create the most employment opportunities in an economy. For example, according to the United States Small Business Association, 65% of all of the new jobs created in the past 17 years were created by small and medium-

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7 Particularly, see work from the Rutgers School of Management and Labor Relations e.g. “Income Inequality, Employment, and Injustice” accessed online at http://bit.ly/Ogc9bj on July 6, 2012.
sized businesses. We believe that crowdfund investing frameworks make additional capital available for small businesses, and thus, boost job creation. Crowdfund investing frameworks do this by fixing a problem with household savings.

The problem is the lack of trust in existing financial systems. Since the mid-2000s, ordinary citizens have been increasingly wary of traditional stock markets which has caused a massive withdrawal of capital from public equity markets. For example, a recent poll run by the Chicago Booth and Kellogg School of Business found that only 15% of Americans trust US equity markets (see Figure 3). Accordingly, between 2006 and 2011, investors withdrew $500 billion from US equity markets, preferring to invest their money in securities like US treasuries, which have virtually no yield and do not help small businesses grow. We have already identified evidence of similar trends in France, and we expect that further research would show the same results in many economies around the world. Sadly, the data also suggests that capital flight from equity markets will only accelerate. Research by the Investment Company Institute—the trade association for American investment firms—shows that the next generation of citizens is even less likely to invest in traditional equity markets than are previous generations. If economies continue down the road they currently follow, the job-creation cycle illustrated in figure 2 will not flourish and in the long term, governments are likely to face increased civil unrest.

Crowdfund investing overcomes the “trust problem” that keeps capital out of the productive

“The problem is the lack of trust in existing financial systems.”

11 See the Chicago Booth/Kellogg School, Financial Trust Index from May 2, 2012, Wave 14. These findings based on a survey conducted in March 2012. Accessible online at http://financialtrustindex.org/.

Additionally, we believe that it is fair to question the allocative efficiency of large quantities of investment capital resting in long-term government bonds rather than with innovative entrepreneurs and small businesses. Without crowdfund investing, there are few investment alternatives available for regular citizens who might prefer to invest in small businesses and startup companies and cannot do so.

14 2012 Investment Company Fact Book, Figures 2.5 and 2.6.
economy by creating a new asset class that naturally overcomes the problem. It’s helpful to think of crowdfund investing opportunities as “engaged investment opportunities.” That is, the asset class created by crowdfund investing is one that investors can easily participate in and monitor easily online, often via social networks. The crowdfund investment asset class offers investors an opportunity to buy securities in projects they believe in or the businesses of people they know personally. These features of the crowdfund investment asset class help investors overcome the trust problem. Ultimately, this means that much of the staggering amounts of capital that is currently invested in unproductive areas of the economy (like zero-yield savings accounts) will be drawn back in to the productive economy, and because crowdfund investing funds small businesses and startups, the capital will be re-allocated to businesses that naturally create the most jobs.

Job-Creator #2: Funding Entrepreneurs Everywhere

Not all great ideas reside in major metropolitan areas. The implementation of crowdfund investing frameworks by governments invites those who live outside of major financial or technical hubs to access growth capital, increasing the allocative efficiency of capital through its democratization. This creates additional new jobs, helps grow national gross domestic product (GDP), and takes pressure off of urban infrastructures that are expected to become increasingly over-stressed in the coming decades. The economic problem crowdfund investing helps solve is related to productivity: an increasing number of productive people want to work remotely, and growth capital (apart from friends and family networks)

Figure 3

A paltry 15.5% of Americans surveyed report that they “trust” the stock market and large corporations.
Crowdfund investing frameworks make it possible for smart, ambitious people to live and to be productive outside of major urban centers, helping governments solve problems related to rapid urbanization.
for businesses outside of major financial and technical hubs is generally unavailable.

Researchers at the Cornell Center for Advanced Human Resource Studies and from Northeastern University have successfully demonstrated that remote work is often more productive than work in an office, and more companies are discovering the benefits of employing a more robust remote workforce, so workers are increasingly choosing to live outside of major urban centers. But herein lies the problem: without crowdfund investing, venture capital is virtually unavailable to these remote workers. Researchers at the University of California at Davis have shown that venture capital firms overwhelmingly operate from financial centers and technology hubs like the Silicon Valley, and Chen et. al. at Harvard Business School have shown that a VC firm’s proximity to a startup is extremely influential in the venture firm’s funding decision. So, it’s clear that as more productive workers choose to work remotely, often outside of major urban hubs, they move away from the traditional sources of capital for starting businesses, which lowers the probability that they can start a business (and hire workers). Should remote workers be punished economically for choosing to live outside urban centers if it can be avoided?

Governments can help solve this problem by introducing crowdfund investing frameworks, because this decentralizes a nation’s funding network. Because crowdfund investing is done via the Internet, crowdfund investors from anywhere inside the nation’s borders can participate in a funding network.

“The economic problem crowdfund investing helps solve is related to productivity: an increasing number of productive people want to work remotely, and growth capital (apart from friends and family networks) for businesses outside of major financial and technical hubs is generally unavailable.”


issuance. So, crowdfund investing helps solve this productivity problem and makes capital available to productive workers regardless of their proximity to an urban center. This economic efficiency leads to job creation, to higher GDP, and it will ultimately reduce the strain on infrastructures in large cities.

**Job-Creator #3: Capital No Longer for the Chosen Few**

It is widely accepted in economic development literature that traditional sources of funding tend to favor the rich, especially in developing economies. In their overview of this subject, Ghosh et. al. conclude that “access to credit is especially restricted for the poor, owing to their inability to provide collateral...existing poverty and wealth inequalities may therefore tend to be perpetuated.” So, the problem for many entrepreneurs in emerging economies is their lack of collateral. Should the poor be prevented from having the chance to start a business? In many economies, without collateral, getting funding for a business will often prove impossible. Therein lies the problem: how many small job-creating small businesses never see the light of day because the entrepreneurs lack collateral?

Crowdfund investing helps solve this problem. Crowdfund investing is available to anybody who can activate a social network and can execute compelling business ideas. Then, by implication, the possession of personal assets as is not a pre-requisite for raising funds with a crowdfund investment strategy. Conversely, the many of the alternative methods of raising funds, such as issuances of debt instruments to banks, do usually require that the fundraiser have personal assets that can be used as collateral. So, when access to capital is democratized with the implimentation of crowdfund investment strategies, businesses can find the funding they need to start, to grow, and to hire regardless of the entrepreneur’s net worth prior to the fundraising effort. This means that educated individuals who don’t have collateral are able build businesses and livelihoods. This helps to create more competitive marketplaces, encourages innovation and entrepreneurship, and lowers the chances that members of society will feel alienated from a nation’s economic system. All of these benefits to crowdfund investing have the long-term impacts of driveing GDP growth and creating employment opportunities for citizens.

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Crowdfund investing frameworks help an economy become more productive.
HOW CROWDFUND INVESTING GROWS GDP

Productivity Creator #1: Reduction in the Failure Rate of Small Businesses

According to the US Small Business Administration, 25% of small businesses fail within twelve months of launching. After the first year, the failure rate starts to drop sharply over time. For policymakers looking to support small businesses and job creation, promoting the adoption of crowdfund investing frameworks is one way to do so because small businesses funded with crowdfund investing strategies have a built-in group of hundreds or thousands of advocates and supporters—their investors. Next, we’ll tell readers how a creating a new kind of investor causes more good businesses to survive and prevents more bad businesses from beginning, creating a better environment for small business and innovation.

One famous mantra in entrepreneurship studies is “find 1000 true fans for your business and you will survive.”19 According to the business journal Social Media Weekly, when businesses raise growth capital with crowdfund investing strategies, they are likely to convert their investors “into advocates and ambassadors.”20 That’s because an investor who commits capital to a crowdfunded security will usually be closely connected to the company via social networking sites, will be an early customer of the business, will actively promote the company to increase their chances of earning a profit, and will be part of a network that can help the company solve common business problems cheaply and efficiently.

See “Case Study: An Example of Support from the Crowd” on the following page for an example of how a small company might use a group of crowdfund investors to solve a business problem.

Now consider the opposite scenario—a failed attempt at using crowdfund investing to raise growth capital. Most people would agree that when funds are invested into products or services that the market does not value, the overall impact on the economy is negative because the funds have been allocated to an unproductive use. Inefficiencies like this happen in economies due to poorly-made decisions about which projects receive funding and which do not. While no policymaker can prevent a wealthy person from financing a bad business, implementing a crowdfund investing framework does

introduce a new kind of filter for small business funding rounds—the crowd. Just as some businesses are able to successfully get funding to grow, others will not, and fewer bad business ideas will get funded. So crowdfund investing opens a sort of economic forum in which business ideas can be market tested, lowering the number of ill-fated small business launches.

**Case Study: An Example of Support from the Crowd**

Imagine a future where a group of individuals have committed some capital, via a crowdfund investing website, to a startup fashion line based in LA. Now imagine that most of these investors have opted to join a private group on LinkedIn to network with other investors in the fashion line and to communicate with the senior people at this infant fashion enterprise. Scenarios like this are sure to happen. So, how will this situation help reduce the failure rate of small businesses?

First, the wider knowledge base and human network is an obvious advantage for the young startup. Imagine that the clothing company wants to get attention from the news media to raise awareness for the company’s launch party. Instead of hiring a publicist, the savvy entrepreneurs will ask their LinkedIn investor group something like “does anyone know anybody in the media who might write about our launch party?” Likely, some (or even a few) investors will know someone in the media who can help. Because they’re incentivized to act on the startup’s behalf, these investors are likely call on their relationships to get help for the new fashion company’s launch party. So, the company will have saved money and will have achieved their objectives by activating their robust investor knowledge network.

The second way the investors will help this business survive is with their advocacy and patronage. Clearly, many of the investors in a crowdfunded investment will be genuinely interested in the products or services that they are helping to launch. Also, the incentive to promote a startup that one has invested in is clear. So, these investors will be almost effortlessly converted into vocal customers, helping to spread the word about the exciting new venture they’ve helped launch. This will assure the young venture of a revenue base and significant word-of-mouth promotion.

**Productivity Creator #2: “Crowd Monitoring” Reduces Agency Costs**

Stopping corporate fraud and protecting investors are paramount concerns for securities regulators like those at the Securities and Exchange Commission (SEC) in the US. In their landmark paper
published in the *American Economic Review* in 2000, Simon Johnson et. al. describe “tunneling” as “the transfer of assets and profits out of firms for the benefit of their controlling shareholders.” Not only is tunneling wrong, it’s costly in terms of the health of capital markets. While tunneling has been proven to be widely observed in traditional stock markets by larger corporations, it is not likely to be seen in crowdfund investment financial systems.

It is extremely difficult to defraud a crowd of engaged people, primarily because the vetting process for a crowdfunded securities issuance is comprehensive and involves people from many different backgrounds and perspectives, and because monitoring is so easy. For the entrepreneurial team, crowdfunded issuances involve gathering references and testimonials from individuals who stake their reputation on the trustworthiness of the entrepreneurial team, which limits the chance that false statements will be made to investors. Though many skeptics believe that fraud will be a big problem in crowdfunded investments, the research suggests that cases of fraud will actually decrease as “crowd monitoring” is born with crowdfund investing frameworks. So, the rigorous vetting process and the easy monitoring of investments is likely to drastically reduce cases of tunneling by corporate leaders.

For an idea of how a crowdfund investing issuance will operate, imagine something like a penny stock board with hundreds or thousands of people asking and answering questions, doing research and posting results in a “deal room” as a crowdfunded security issuance occurs. Because the people who typically invest the first crowdfund dollars in a security tend to be friends and family of the issuers, new potential funders will be asking questions of these people and using them to verify information that has been disclosed by the issuing company’s directors. Crowdfund investing (CFI) platforms “will include social media tools that will allow potential investors to see what parts of the entrepreneur’s social network are engaged in his funding. Are there more first-degree connections that third-degree connections? How many investors are there that have no social media connection to the entrepreneur? Because both investor and entrepreneur create accounts with their real LinkedIn and Facebook accounts, a new level of transparency in early stage funding is created. We expect these CFI platforms to create online reputation systems (much like eBay, Amazon or Klout) that will allow individuals to
create relationships of trust based on crowd experience,” describes CCA Principal, Jason Best. So, with
crowdfund investing, a dramatic increase in the level of transparency involved in a funding issuance is
introduced into an economy’s financial system, reducing the chances of fraud.

Also, we haven’t seen any evidence of fraud yet. As of April 2012, hundreds of millions of dollars
worth of capital have been raised using crowdfunding methodologies (both “token” and crowdfund
investing outside the US) and there has yet to be a single reported case of fraud (see Figure 4).22 Also,
because of the online nature of these crowdfunding securities issuances, fraudulent business people
have very few places to hide. Crowdfund investing frameworks give engaged investors the means
to mobilize and to act to combat fraudulent activities very quickly because of the online nature of
crowdfund investing. The attenuation of corporate fraud and tunneling practices will, according to vast
financial economics research, have the long-run effect of stimulating GDP growth by fostering more
efficient capital markets.23

![Crowdfunding Fraud Chart](image)

Figure 4


Case Study: Reduction of Agency Costs with “Crowd Monitoring”
Imagine that 1500 people funded XYZ Corp. with a total commitment of $350,000. Now imagine that all of these investors were members of a Facebook group that concerned the activities of XYZ Corp. and that one investor learned that XYZ Corp.’s CEO was paying her brother above market prices for office space. This investor would instantly blow the whistle on these sorts of activities in the Facebook group and the group would start to mobilize to take action. Individuals who invest in crowdfunded securities have a lot of information about the company and the key players at these companies because they will likely have access to references, LinkedIn profiles, Twitter accounts, and other channels of influence that can shape key players’ online reputations and thus, their access to future capital.

“There are three types of leaders... Those who see change as a must and want to lead and manage it; those who accept the need for change but who are following rather than leading in the hope of gaining time; and those who are resisting change. The third category will disappear, the second can get by for a time, but only the first category will survive.” - Turkish Foreign Minister Ahmet Davutoglu

A CALL FOR GLOBAL POLITICAL ACTION

Jobs are a Global Issue

When crowdfund investing comes online in the United States in 2013, a new wave of capital becomes available for innovative and job-creating American entrepreneurs. So where do other economies fit in? Sherwood Neiss, Principal at Crowdfund Capital Advisors recently told a group in Turkey that “unemployment is not just an American epidemic—it is a global problem.” Still, currently less than 1% of the crowdfunding activity worldwide occurs outside of North America and Europe (see Figures 5 and 6). Apart from the United States and some Western European countries, crowdfund investing policy frameworks are yet to be widely developed. The time is now for countries outside of

24 In a speech on March 28, 2012 at a conference in Istanbul, Turkey.
Number of Crowdfunding Campaigns in 2011

Figure 5

Funding Portals as of April 2012

Figure 6

Source: Based on Crowdsourcing.org Directory of Sites as of April 2012
North America and Western Europe to build crowdfund investing frameworks so that their societies can reduce the costs of social programs, promote growth outside of urban hubs, democratize access to capital, create jobs, and be more productive.

**Why it is Time to Update Financial Services Regulations**

*Technology is Changing the Way People Relate and Produce*

We all agree that governments play a very important role in an economy. They facilitate business via the rule of law, they support it with infrastructure, and they ensure the peace and protection of citizens so that energy can be spent on economic activity rather than on concerns about one’s safety. Still, there exists a widely-adopted social mythology that the role of government has nothing to do with business. Should this “black or white” idea be brought in to question? Considering the facts, the reality is that policy regimes create the conditions under which businesses either thrive or perish, so people working in government have the responsibility of creating policy regimes that work in the modern world, with modern technology.

Policy regimes often last for a long time. For example, many US securities laws that were created after the Great Depression still frame the operation of financial markets in the US, but in the aftermath of the 2008 financial crisis, we saw why governments need to update the financial regulations regimes: across the world, small businesses became starved of capital (see Figure 7). In the UK, the US, France, and around the world, many honest, well-meaning, job-creating small businesses were forced out of business when traditional financial markets began to fail. Well-meaning nations across the globe have old rules on the books that prohibit small business communities from using their own personal networks for financing their growth or conception, even though technology has changed dramatically. The time is now to update the laws.
It’s Difficult to Paddle Against the Current

Globally, both investors and entrepreneurs are demanding the ability to form the kind of investment relationships that crowdfund investing frameworks enable. So, they are searching for ways to promote the adoption of crowdfund investing frameworks similar to the one that has been created in the US. For example, in June of 2012, CCA Principals, Jason Best and Sherwood Neiss were asked to join the board of advisors for the European Crowdfunding Network (ECN) to help lobby for the adoption of crowdfunding frameworks in European nations. The goal of the ECN is to increase prosperity and job creation by encouraging the adoption of crowdfund investing throughout Europe. Messrs. Best and Neiss are also serving in an advisory role for iCanCrowdfund, the Canadian Crowdfunding Network. For the remainder of 2012, in addition to North America, CCA will be speaking with and working with groups in South America, in the Middle East, in South Africa, in Asia, and in Europe. It is clear that investors and entrepreneurs across the world are aware of the power of crowdfund investing and want to see legislation evolve to permit crowdfund investing.

CONCLUSION

The forces driving crowdfund investing’s adoption, social media, the trend towards remote work, and the existence of funding systems that exclude people outside of major urban centers, are not going away. These trends will only accelerate. In this paper, we have demonstrated how the implementation of crowdfund investing policy frameworks creates jobs, increases national GDP by building better companies and eliminating fraud, and raises wages outside of the major urban centers and thus, reduces migration to them, lowering strain on already-stressed urban infrastructures.

In a speech on May 2, 1935 future UK Prime Minister Winston Churchill said the following: “Want of foresight, unwillingness to act when action would be simple and effective, lack of clear thinking,

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27 This thinking is based on the widely accepted Harris-Todaro economic model, which asserts that migration decisions are largely based on wage expectations. For an overview of this economic model, see Field, Gary (2007). “The Harris-Todaro Model.” Cornell University IRL School, August 1, 2007. Available online at http://bit.ly/LvJowh.
confusion of counsel until the emergency comes, until self-preservation strikes its jarring gong–these are the features which constitute the endless repetition of history.” Perhaps initiatives by governments designed to build understanding about the power of crowdfund investing is one of the steps we can take today to build a better future tomorrow. Ted Forstmann hit the nail on the head when he said, “the entrepreneur, as a creator of the new and a destroyer of the old, is constantly in conflict with convention. He inhabits a world where the belief precedes results, and where the best possibilities are usually invisible to others. His world is dominated by denial, rejection, difficulty, and doubt. And although he is an innovator, he is unceasingly imitated when successful, but always remains an outsider to ‘the establishment.’”

The subject of crowdfund investing is complex. Crowdfund investing frameworks must be tailored to each government’s securities regulation frameworks. Also, research shows that cultural factors play a major role in the economic integration of crowdfund investing. The design of disclosure standards and reporting standards are also issues, as are the term sheets that are most likely to foster successful funding relationships. Beyond these specific challenges, we look forward to a future where crowdfund investing plays a role in improving the standards of living in economies across the world. Countries around the world are watching as the US takes century-old securities laws and updates them to allow Americans to use crowdfund investing to create a brighter future. 2013 will be the year of the small business and the entrepreneur in the US. What does it mean for the rest of the world? What steps will the leaders of other nations take to harness the power and wisdom of their citizens? What does this mean for our globally connected world?


29 Recent research from Xavier University has shown that cultural background has a lot to do with one's attitude towards crowdfunding. See Klein, Candice. “Who is Likely to be the First Crowdfunding Investor Demographic?” SoMoLend.com, April 12, 2012. Accessed online at http://bit.ly/HAna9B on July 5, 2012.
To request a copy of the next installment of this white paper - *Ten Steps to Implementing a Crowdfunding Framework* or to sign up for our upcoming educational series for government leadership:

Democratizing Access to Capital, please contact us at info@theccagroup.com.

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**About the Authors:**
Crowdfund Capital Advisors’ mission is to create a global crowdfunding industry that unlocks innovation, jobs and enhances political stability. Crowdfunding increases access to capital and is a dynamic new asset class in the private capital markets. CCA provides strategy and technology advisory services to governments, NGOs, investors, crowdfunding platforms, and the entrepreneurial community. CCA’s founders, Sherwood Neiss and Jason W. Best, authored the Startup Exemption Regulatory Framework and championed the crowdfunding legislation in the 2012 JOBS Act. In addition to their advisory work, they co-founded and co-chair the Crowdfunding Professionals Association (CfPA) and are co-founding board members of the Crowdfunding Intermediary Regulatory Advocates (CFIRA). They are also on the board of the European Crowdfunding Network and the Canadian Technology Alliance. They keynote conferences and advise globally. Jason and Sherwood are regular contributors to Venture Beat and Tech Crunch and have been covered in many publications including Wall Street Journal, New York Times, Fast Company, INC. Magazine, Bloomberg News, MSNBC and Fox Business News. Davis Jones, MBA, is a Crowdfund Investment Analyst at Crowdfund Capital Advisors. For his graduate research, he worked with professors from the US, from Mexico, and from Israel to develop a crowdfund investing systems map by interviewing dozens of thought leaders, investors, businesspeople, and government regulators who are involved in the development of crowdfund investing in the United States.
CLIENT ALERT

Introduction

On April 5, 2012, President Obama signed the Jumpstart Our Business Startups Act (the “Act”) into law. The Act introduces several historic reforms to facilitate capital formation, including the creation of a new exception under Section 4 of the Securities Act of 1933 (the “Securities Act”) permitting crowdfunding transactions. Crowdfunding is the offering of unregistered securities through a registered internet intermediary website or broker to raise small amounts of money (up to $1,000,000) from a large pool of investors. Prior to enactment, entrepreneurs, new ventures and charities had proven with great success that the internet and social media can be used to raise money from hundreds or thousands of contributors in exchange for either rewards, a gift or the completed product once manufactured. The reforms will now allow securities to be sold so that contributors may become shareholders.

Crowdfunding Intermediaries:
Funding Portals & Brokers

Crowdfunding transactions may only be conducted through either a broker or funding portal registered with the Securities & Exchange Commission (“SEC”) and probably the Financial Industry Regulatory Authority as well. A funding portal is a new form of registered entity whose rules and regulations are currently being drafted. As a law firm, we are cooperating and participating in the process. Unlike a broker, a funding portal is restricted from offering investment advice or recommendations to investors. Its members may not solicit purchases, sales or offer to buy securities offered by the portal. Funding portals are strictly prohibited from paying its agents or employees any compensation based on the sale of securities offered on its portal or website. The SEC is currently drafting the new rules and regulations that will define the registration process, legal obligations and liabilities of a funding portal.

The crowdfunding intermediaries will have certain obligations to protect investors. For example, the Act requires a crowdfunding intermediary to:

- Ensure that investors review certain educational material and acknowledge that the investor both understand the risks inherent in a crowdfunding investment and can sustain the risks of loss;
- Ensure that investors demonstrate an understanding of the risks associated with investing in new ventures and small business;
- Implement measures to reduce the risks of fraud;
- Implement measure to ensure that the proceeds of an offering are only released to the issuer when the target offering amount is reached or exceeded;
- Comply with applicable privacy rights and protections of information requirements;
- Ensure that investors do not purchase an amount of crowdfunding securities during a 12 month period in excess of the statutory limit; and
- Prohibit its directors, officers or partners from participating in a crowdfunding offering or having any financial interest in a company that uses its services.

**Offerings Limitations & Requirements**

The Act limits both the aggregate value of securities that an issuer may offer through a crowdfunding intermediary and the amount that an individual can invest. An issuer may sell up to an aggregate of $1,000,000 of its securities during any 12 month period. Investors with an annual income or net worth of less than $100,000 will only be permitted to invest the greater of $2,000 or 5% of their annual income or net worth in any 12 month period. Investors with an annual income or net worth greater than $100,000 will be permitted to invest the greater of $100,000 or 10% of their annual income or net worth. Investors are limited to investing $100,000 in crowdfunding issues in a 12 month period.

Investors who purchase securities in a crowdfunding transaction are restricted from transferring those securities for a period of one year. This restriction is subject to certain exceptions, including transfers: (i) to the issuer; (ii) to an accredited investor; (iii) pursuant to an offering registered with the SEC; (iv) or to the investor’s family members.

The option of raising capital through a crowdfunding offering is only available to domestic issuers that are neither reporting companies under the Securities Exchange Act of 1934 nor investment companies. The SEC will further provide rules disqualifying certain “bad actor” from participating, including persons with criminal convictions or court injunction in connection with the purchase or sale securities.

**Issuer Responsibilities**

Equal access to and disclosure of material information is a core principal of federal and state securities regulations. It is essential for investors to have the necessary information to appreciate the potential risks and rewards of an investment. The Act requires issuers to provide investors with a description of the following:

- **Company**: the issuer and its members, including the name, legal status, physical address, the names of the directors and officers holding more than 20 percent of the shares of the issuer.
- **Offering**: the anticipated business plan of the issuer, the target offering amount, the deadline to reach the target offering amount and the price to the public of the securities.
- **Structure**: the ownership and capital structure of the issuer, including terms of the securities of the issuer being offered.
- **Valuation**: how the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions; and
- **Risks**: the risks to purchasers of the securities relating to minority ownership in the issuer, the risks associated with corporate actions, including additional issuances of shares, a sale of the issuer or of assets of the issuer, or transactions with related parties.
The intermediary crowdfunding portals are also required to make available to the SEC and to potential investors any information provided by the issuer no later than 21 days prior to the first day on which securities are sold to any investor.

The extent to which an issuer must disclose its financial statements varies depending on the aggregate amount offered, including any prior offerings in the preceding 12 months period. For crowdfunding offerings with an aggregate offering amount up to $100,000, the issuer must disclosure its most recently filed income tax returns and its financial statements certified by the issuer’s principal executive officer. For offerings that exceed $100,000 during the 12 month period but are less than $500,000, the issuer must provide financial statements reviewed by an independent public accountant. If an aggregate offering amount exceeding $500,000, the issuer must provide audited financial statements.

Crowdfunding Rules & Regulations

The Act requires the SEC to draft the rules regulating crowdfunding within 270 days from the date of its enactment, namely January 1, 2013. The rules will further define the role of intermediaries in crowdfunding transactions, obligations of issuers and the rights of investors. On April 21, 2012, EG&S was privileged to be the only law firm to participate in a formative meeting with the SEC along with several leading intermediary sites to discuss the substance of the new regulations. The SEC is currently accepting comments from members of the public in advance of its publication of the draft regulations.

Ellenoff Grossman & Schole LLP

Ellenoff Grossman & Schole LLP was the premier sponsor at Deal Flow Media's Crowdfunding Conference on April 19th, in New York City. Douglas S. Ellenoff, a member of the Firm, opened the conference with his keynote address focusing on the outlook of the crowdfunding market. Sarah E. Williams, also a member of the Firm, moderated the panel: Understanding Policy Issues vs. Securities Rules if you're in the Crowdfunding Business.

The Firm is actively engaged with clients in fashioning what level of regulatory review and monitoring is appropriate by the SEC and FINRA in balancing the interests of the program with investor protection. EG&S has established a Crowdfunding Group comprised of the following members:

Douglas S. Ellenoff       Joan Adler
Barry I. Grossman        George Georgiades
Adam Mimeles             Svetlana Lebedev
David Selengut           Matthew Bernstein
Sarah Williams

To learn more about crowdfunding and the recent reforms in capital formation, we invite you to join our Resource Center or contact our members.
Appendix: Legal Information about Crowdfunding Investing from Ellenoff Grossman & Schole LLP

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