Declaration of Crowdfunding Independence
Finance of the People, by the People, and for the People

By John Berlau*

When John W. Anderson, a young attorney, learned of the crowdfunding project, he could not wait to tell his father about it. An acquaintance of Anderson’s, whom Anderson described to his father as “one of the best automobile mechanical experts in the U.S.,” was prospecting for funds to “place on the market an automobile that is far and away ahead of anything that has yet come out.”

To bring this disruptive technology to the market, the engineer wanted to bypass financing from what Anderson called “big capital.” Instead, he sought initial funding for the car from “friends and business associates.” Anderson was long on enthusiasm but short on cash. Convinced that the engineer’s project would be the next big thing, he asked his father to front him $5,000 to invest in it.

The venture was risky, but even though “not a machine has been put on the market,” Anderson argued to his father, “orders have begun to come in every day, so there is not the slightest doubt as to the market or the demand.” Anderson called this new company “one of the very most promising and surest industrial investments that could be made.”

What John W. Anderson described to his father sounds like one of those wild-eyed projects on crowdfunding platforms like Kickstarter and IndieGogo—business plans that stir the passions of young enthusiasts like Anderson, while they leave skeptics shaking their heads. Looking at Anderson’s description, these skeptics may ask, “Just who does this auto engineer think he is? Henry Ford?”

Actually, yes! Ford was the “inventive and mechanical genius” Anderson described in a lengthy letter to his father in 1903.1 Anderson was right about this being a “promising industrial investment.” The $5,000 Anderson invested turned into $12.5 million when he sold his shares back to the firm’s founding family 16 years later.2

Welcome to the long and proud American tradition of crowdfunding—a tradition that predates the smartphone app, the computer, and even the telephone. It has built cars, railroads, and financial institutions that exist to this day.

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By 1903, the 36-year-old Ford already had an impressive resume as chief engineer for Thomas Edison’s electricity company and designer of the car that became the Cadillac, and could have attracted financing from Wall Street. But instead, Ford tapped his own physical “social network.” Among the dozen original Ford funders were a bookkeeper, a clerk, and a building contractor.

However, about 30 years after Ford raised funds from Anderson and other acquaintances to launch the company that first made the automobile affordable to the masses, Washington put up regulatory roadblocks in the way of crowdfunding that remain in place to this day.

In the name of “protecting” the public from dangerous investments, the U.S. government has made it nearly impossible for individuals to invest in the businesses of their friends and neighbors. While Ford today could still go to Anderson, the clerk, the bookkeeper, and probably an even larger network to fund his venture, he likely could not offer them the tangible financial rewards he offered in 1903 to get his company moving.

Anderson, like today’s crowdfunding donors, was driven by belief in the project, but he was not about to bother his father for funds just to get a t-shirt or even a valuable item like one of Ford’s first cars. Anderson made the case to his father, and Ford made the case to Anderson and other investors, by offering ownership interests—shares of stock—in the company.

Today, Ford would not be able to offer friends, family members, or acquaintances a return on such an initial investment, unless they met a strict definition of “preexisting” business relationships under federal and state securities laws or had substantial wealth to meet requirements of the Securities and Exchange Commission for more lightly regulated investment. Were an innovator on a crowdfunding platform to offer a share of profits in the project, that would be considered a “security” under federal law, and he or she would have to wade through much of the same red tape as a Fortune 500 company listed on the New York Stock Exchange.

Technology did not create crowdfunding, but it has widely broadened the size of the crowds and increased the potential of both charitable and entrepreneurial ventures to find funding. But capital raising in the age of the app is being stalled by rules that came into place before most people had a telephone in their home. As a result, crowdfunding’s potential of creating jobs and increasing income mobility is being held back as the Henry Fords of today struggle with mounds of red tape from securities laws.

**Crowdfunding’s Wealth- and Job-Creating Potential.** Crowdfunding has positive effects on job growth, revenue for entrepreneurs, and follow-on interest from institutional investors, according to a study of crowdfunding by Crowdfund Capital Advisors, an economic consulting firm that works closely with the University of California-Berkeley Center for Entrepreneurship and Technology. The study found that, “the average crowdfunding campaign returns $813 for every hour invested,” and that many of these firms use these returns, among other things, to hire new employees.

Firms that met their goals in crowdfunding campaigns hired, on average, two new employees by the end of the campaign. This is all the more remarkable considering that the firms had, on average, only one or two employees before the crowdfunding campaigns began. This represents a post-crowdfunding doubling in the number of employees at many firms. As the study concludes, currently “crowdfunding campaigns are used by smaller entities but represent job potential.”
The most potential comes from equity- and debt-based crowdfunding, both of which are either banned or heavily restricted in the United States due to arcane securities laws. Debt-based crowdfunding offers funders a specific rate of return, while equity-based crowdfunding offers an ownership interest—similar to a share of stock—and a share of the crowdfunding firm’s potential profits. In reviewing foreign debt- and equity-based crowdfunding campaigns, the Crowdfund Capital Advisors study found that these were the most likely to create jobs. According to the study, “87 percent of firms either had or intended to hire new employees as a direct result of having raised equity or debt financing via crowdfunding.”

The greater potential for job creation from equity- and debt-based crowdfunding stems from the greater revenue growth this type of crowdfunding generates compared to the donation-based kind. “While pledge or donation crowdfunding lead to an increase of 24 percent in revenues, equity-based crowdfunding resulted in a quarterly increase of 351 percent not including funds raised via the equity round,” the study found.

However, outdated securities laws have effectively locked Americans out of the wealth-creating potential of debt and equity-based crowdfunding. While the U.S. leads the world in crowdfunding campaigns on popular sites like Kickstarter and IndieGogo, these campaigns are overwhelmingly donations- and rewards-based. The donors get nothing more than recognition, souvenirs like t-shirts, or a sample of the product produced. This is a sad irony given that what we now call equity and debt-based crowdfunding was once instrumental in fueling this country’s growth and prosperity.

**America’s Crowdfunding Heritage.** Crowdfunding essentially involves raising money from a crowd of ordinary people without going through a “middleman,” like a major stock exchange or financial institution. Under this definition, Henry Ford was far from the first American crowdfunding pioneer to revolutionize a product or service and make himself and others wealthy by doing so. In 1752, Benjamin Franklin led a crowdfunding campaign to provide home fire insurance in Philadelphia. Franklin and members of his Union Fire Company, Philadelphia’s first volunteer fire department, met with the member of the city’s other fire brigades to form the Philadelphia Contributionship. This mutual insurance company, now the oldest continuous insurer in the U.S., engaged in equity crowdfunding as well as the “reward” of protecting one’s house against it burning down. Its charter allowed its owners “to be and continue to be Contributors unto and equal Sharers in the losses as well as the gains.”

Similarly, in the 1860s civil war veterans and German immigrant fraternal societies formed the Metropolitan Life Insurance Company, today known as MetLife, to provide life and disability insurance policies to veterans and workers. Originally formed with investors and shares of stock—and with policyholders given the promise of a substantial share of any profits—MetLife became a mutually owned company owned by its policyholders in 1915. It was not traded on a major stock exchange until 2000, after it launched an initial public offering on the New York Stock Exchange upon demutualization.

The nation’s first major railroad, powered by the then-experimental steam engine, was crowdfunded among the citizens of Baltimore in 1828. “The Baltimore and Ohio Railroad was an equivalent of a modern day high-tech, start-up company,” write accounting professors William D. Samson and Gary John Previts of the University of Alabama and Case Western Reserve University, respectively.
Baltimore business leaders wanted a transportation alternative to shipping through canals. They persuaded everyday citizens to back them. The B&O was initially capitalized in 1827 with a $3 million stock issue. Crowds literally stood in line to buy shares at banks across Maryland, where they were offered. According to railroad historian James D Dilts, “There were rumors that the entire 15,000 shares reserved for individuals would be sold the first day, and they almost were: 13,586 went in four hours.”

Over the next few years, “virtually every citizen of Baltimore owned a share,” Samson and Previts write. The company went on to pioneer accounting and disclosure methods in annual reports to shareholders that today are requirements of the government and stock exchanges.

In the early 20th century, as people moved towns and cities (aided in part by the trains and cars that had their origins in crowdfunding), they crowdfunded retail cooperatives through the coordination of buyer groups to purchase goods from a cooperatively owned wholesaler. In 1920, there were 2,600 consumer co-ops in the U.S., including many of the general stores we look fondly on with nostalgia.

**Banks Strike Back: “Blue Sky” Laws and SEC.** As crowdfunding grew by leaps and bounds, securities laws pushed by progressive reformers and the banking industry, supposedly to combat fraud, came along to stunt this growth.

Both self-styled reformers and entrenched interests (which often overlapped), stoked fears about strangers offering investment opportunities backed by nothing but “blue skies.” So beginning with Kansas in 1911, state legislatures enacted “blue sky” laws to give state authorities the power to ban investments deemed injurious to state residents. Today, nearly all states have such laws, with some being more stringent than others.

While entrepreneurs’ greater ability to travel to find investors for various ventures did increase the potential for fraudulent dealings, it is unclear how widespread fraud was. As University of Virginia law professor Paul Mahoney explains, claims of fraud in these offerings by “reform-minded” politicians do not match court records and other contemporary evidence. “The evidence offered in support of the existence of widespread fraud in the early 20th century securities markets … is extremely thin,” he writes.

Rather, Mahoney and other scholars point to lobbying by local banks as the primary reason states adopted “blue sky” laws that outlawed many crowdfunded investment opportunities before they were even proven to be fraudulent.

Mahoney writes, “A bank wishing to suppress competition would favor a statute giving the administering official (often a bank commissioner, who might be sympathetic to the bank’s point of view) maximum authority to prevent securities offerings.” For example, Kansas Bank Commissioner J.N. Dolley, who pushed through that state legislature the nation’s first “blue sky” law, was a former bank executive who worried openly about deposits being withdrawn for stock offerings. He complained, “The banks hear of such cases because usually the victim draws money out of a bank to buy his wildcat mining shares or his stock in a lunar oil company, or whatever it may be.”

Meanwhile, some ideological reformers considered certain forms of innovative finance sinful, and established financial firms were only too happy to join efforts to hobble potential competitors, leaving consumers with virtually no choice but to let the old firms handle their savings.
The enactment of state “blue sky” laws was a prelude to federal securities laws enacted in the 1930s, primarily the Securities Act of 1933 and the Securities Exchange Act of 1934, intended to tame the supposed excesses of the New York Stock Exchange in the 1920s. The Securities Exchange Act of 1934 created the U.S. Securities and Exchange Commission (SEC). Once again, established financial firms came out on top. It became very difficult for an entrepreneur to make an offering to investors without going through a stock or securities exchange (including the newly formed National Association of Securities Dealers, which would later develop the NASDAQ stock market). Laws fighting so-called market excesses ended up enabling Wall Street to corner the market for investors.

The amount of paperwork required by the SEC has multiplied massively since then. The Sarbanes-Oxley Act of 2002 quadrupled auditing costs for most public companies by forcing auditors and executives to sign off not just on a company’s numbers, but on dozens of “internal controls.” This created a large disincentive for companies to go public on U.S. exchanges. Home Depot co-founder Bernie Marcus has said that he could not have taken the firm public and financed its growth had Sarbanes-Oxley been in place in 1981, when Home Depot launched its first stock offering with just four stores in Georgia.

Then the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 imposed on public companies burdensome reporting requirements that are not even tangentially related to preventing financial fraud, and instead are designed to advance certain social or political agendas. For example, Dodd-Frank’s “conflict minerals” provision (Section 1502) requires public companies to disclose if any gold, tin, or tungsten used in their products may have come from war-torn regions of the Congo. Under the “foreign payments” provision (Section 1504), publicly-traded energy firms must disclose payments they make to foreign governments to further their development activities. Each of these provisions will make companies pay more than $1 billion in initial costs, followed by annual costs in the hundreds of millions, according to SEC estimates. This is yet another deterrent to firms going public.

**What Is a Security? The Million-Dollar Question.** Entrepreneurs are often vexed by SEC rules and state “blue sky” laws even when pursuing modest investments from a few new investors. While there is an exemption in the Securities Act of 1933 for “preexisting” business relationships, there is no consistent definition of “preexisting,” and many securities lawyers now say even investments from friends and family can put an entrepreneur at risk of not complying with some laws.

As a result, there is frequently a de facto “millionaires only” rule for investment in new business that limits entrepreneurs’ capital-raising ability and deprives average investors of the opportunity to grow wealthy through early-stage investment in a company. In 1982, the SEC implemented Regulation D, which allowed entrepreneurs to raise capital free of much of the red tape of the Securities Act of 1933 and Securities Exchange Act of 1934—and subsequent changes to those laws by Sarbanes-Oxley and Dodd-Frank—so long as the securities were sold only to “accredited investors.”

The SEC currently defines “accredited investor” as having a net worth of at least $1 million, excluding the value of a principal residence, or an income of at least $200,000 a year or $300,000 with a spouse. Although the Jumpstart Our Business Startups (JOBS) Act now allows advertising of these offerings to the general public, still only millionaires may invest. And the SEC’s Investor Advisory Committee pushed in October 2014 for raising this threshold under the questionable rationale that “poor millionaires” need more protection.
So while at the turn of the century ordinary folks were crowdfunding general stores, the American people today may not be able to invest in neighborhood restaurants. For example, a May 2014 Washington City Paper cover story observed:

[W]hile you don’t have to be [AOL co-founder and venture capitalist] Steve Case to invest in restaurants, you do have to be pretty rich. Almost all restaurants require backers to meet the Securities and Exchange Commission’s definition of “accredited investors.” That means they need a net worth of at least $1 million (which can include assets owned jointly with a spouse, but excludes the value of their primary home), or an income of at least $200,000 for the past two years (or $300,000 with a spouse). The idea is to protect people from getting in over their heads if they can’t afford to lose whatever they’re putting up.”

But is offering a partnership in a restaurant to a friend or patron really the same as an initial public offering? To the SEC or a state securities regulator, it may be, under the ever-expanding definition of “security” as any type of ownership interest.

The SEC and courts enjoy broad discretion to define “securities” for the purposes of federal securities laws, as Supreme Court Justice Lewis Powell explained in a 1975 ruling narrowly overturning a lower court decision that found that some condominiums were securities:

Congress did not attempt to articulate the relevant economic criteria for distinguishing “securities” from “non-securities.” Rather, it sought to define the term “security” in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security. … The task has fallen to the Securities and Exchange Commission (SEC), the body charged with administering the Securities Acts, and ultimately to the federal courts to decide which of the myriad financial transactions in our society come within the coverage of these statutes.

Then in 1990, the Supreme Court ruled 5-4 in Reves v. Ernst & Young that short-term promissory notes issued by an agricultural cooperative were “securities” subject to SEC regulation, even though the Securities Acts specifically exempted “notes” with durations of less than nine months and agricultural cooperatives had a specific exemption under the law. Twenty-five years later, the SEC is relying on this case to regulate “notes” offered through peer-to-peer online lending operations like Prosper and Lending Club, by requiring a separate prospectus or securities filing on every loan made on peer-to-peer websites.

**JOBS Act Only the Beginning for the Future of Crowdfunding.** The hindrances that securities laws place on entrepreneurs have led to a consensus forming in favor of reforming these laws to allow small crowdfunding campaigns to offer to share profits around without making a securities offering. The Jumpstart Our Business Startups Act of 2012 is a good start. The JOBS Act was supported by everyone from venture capitalists to avant garde artists interested in getting new capital for their films and music. It reduced regulatory barriers for smaller and midsize public companies (Title I), lifted the advertising ban for entrepreneurs soliciting wealthy “accredited investors,” (Title II) and created an exemption from most securities laws for crowdfunding offerings of up to $1 million (Title III).

In signing the JOBS Act into law, President Barack Obama declared:
For start-ups and small businesses, this bill is a potential game changer. Right now, you can only turn to a limited group of investors—including banks and wealthy individuals—to get funding. Laws that are nearly eight decades old make it impossible for others to invest. But a lot has changed in 80 years, and it’s time our laws did as well. Because of this bill, startups and small business will now have access to a big, new pool of potential investors—namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.\(^{31}\)

Yet more than two years after Obama signed the JOBS Act, the SEC has yet to implement provisions from Title III to allow crowdfunding offers of $1 million or less.

Perhaps one day we’ll be able to go “back to the future” and undo the securities laws that have created so many barriers for crowdfunding. Short of that, Congress and the president should expand the JOBS Act by creating an upper limit for crowdfunding exemptions from securities laws of $10 million, as proposed for streamlined securities offerings by Rep. Patrick McHenry’s (R-N.C.) Startup Capital Modernization Act (H.R. 4565), which passed the House Financial Services Committee in 2014. They should also decrease the “accredited investor” net worth exemption from $1 million down to $500,000, or preferably lower. These reforms can help pull out by root and branch the deadwood blocking the seeds of entrepreneurship from growing, crowdfunded by everyday investors.

**Notes**

2. Ibid., p. 179.
4. Ibid., p. 7.
5. Ibid., p. 8.
6. Ibid.
7. Ibid., p. 7.
15. Author’s interview with David Burton, Senior Fellow in Economic Policy at Heritage Foundation, November 10, 2014.

Mahoney employed public choice analysis, a field of economics that approaches public policy with the acknowledgment that political actors are motivated by self-interest in the same way as market actors. The reputation of public choice was cemented firmly in 1986, when one of its founders, James Buchanan, was awarded the Nobel Prize in economics. Brian Doherty, “Nobel Prize Winning Economist James Buchanan, RIP,” Reason, January 9, 2013, http://reason.com/blog/2013/01/09/nobel-prize-winning-economist-james-buch.

18 Mahoney, p. 25.


28 494 U.S. 56 (1990),

29 Author’s interview with Prosper President Ron Suber, September 17, 2014.

30 For more details about changes made by the JOBS Act, see the crowdfunding “cheat sheet” put together by Mark Roderick, head of the crowdfunding practice at the Flaster/Greenberg law firm. http://crowdfundattny.com/2014/01/29/crowdfunding-cheat-sheet-3/