THE WAY TO REVIVE CROWDFUNDING IN CHINA: BASED ON THE RULES AND PRACTICES IN THE U.S.

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ABSTRACT

Crowdfunding is an increasingly popular way for startup founders to raise capital from a large number of people through the internet. In the United States, the JOBS Act exempts crowdfunding offerings from registering with the SEC. To implement this exemption, the SEC issued Regulation Crowdfunding (Regulation CF) in 2015, which was amended in 2020. Regulation CF imposes certain obligations on issuers, investors, and funding portals, but also allows for flexibility.

In the U.S., offerings under Regulation CF have become widespread. This article surveys the market practices of Regulation CF offerings in the U.S., especially on three funding portals which account for a majority of securities offerings under Regulation CF. This article finds, different from seed and venture capital financing, the most common types of securities issued in these offerings are common stock, debt, and Simple Agreement for Future Equity (SAFE). The SAFE is derived from the convertible note but omits its characteristics as a debt instrument. As a convertible security, the SAFE can be converted into equity securities, typically preferred stock, subject to a valuation cap and other conditions set forth in the agreed-upon SAFE contract.

This article expounds on how SAFE works. In addition to the standard Y Combinator template, the SAFE has two variations alleged to avoid complicated cap tables and make offerings simpler. However, these variations have raised safety concerns for investors and have been criticized by academics and the SEC. Despite these concerns, the SEC did not ban the use of the SAFE in crowdfunding offerings in the amended Regulation CF due to strong opposition from industry representatives. This article finds that the attacks against the safety of the SAFE lack conclusively robust evidence, and that in the real world, the SAFE is particularly favored in the offerings reaching or approximating the $5m raising limit.

In contrast, the crowdfunding industry in China used to be thriving but has almost vanished due to regulatory crackdowns. To revive the industry, two legal loopholes in the China Securities Law (CSL) need to be addressed. The first is that

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only a limited number of securities are covered by the CSL, with notes and SAFEs being outside of its scope. The second is that the CSL's numeric benchmark for a public offering is neither scientific nor reasonable. Above all, the top priority is to provide a statutory exemption for crowdfunding offerings in China.

The article looks at the rules of law in the U.S. to address the above loopholes. The Supreme Court of the U.S. in its famous Howey decision clarified the elements for an investment contract to be treated as a security, thus allowing the SEC to exercise regulatory powers over offerings issuing SAFE and other convertibles. In addition, in Ralston Purina, the Supreme Court enacted the "sophistication and information" test to determine a public offering. Meanwhile, Regulation CF's tiered disclosure obligations on issuers and differentiation for accredited and non-accredited investors are worth being studied by regulators in China.

In sum, Regulation CF, and a wealth of Howey- and Ralston Purina-line of cases in the U.S. could be useful for China's rulemaking efforts in the field of crowdfunding, especially in terms of designing a balanced exemption and its implementing rules, expanding the CSL's reach to more types of securities, while broadening investors' access to the exempted crowdfunding offerings

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I. INTRODUCTION

Crowdfunding, a new and evolving financing method for startups and small businesses to raise money using the Internet, is now a worldwide phenomenon. The basic idea of crowdfunding is to raise money through relatively small contributions from a large number of people,[1] i.e., a crowd, who may not be experienced investment experts. In light of current practices, the existing modes of crowdfunding can be categorized into five modes on the basis of what is promised in return for a contribution.[2] These five modes are donation mode, reward mode, pre-sale mode, lending mode and equity mode.[3] They are to be sketched in the following, with the complexity of transaction structure of each mode ascending:

Donation Mode: In this mode, the funders invest in the crowdfunding projects for gratuitous purposes and receive nothing in return.

Reward Mode and Pre-sale mode: These two modes are similar. In the former, the funders will receive a small reward, which could be a T-shirt or hallmarking the funder's name on the credits of the movie funded. In the latter, funders will receive the product that the fundraiser is developing after the product is launched. In such a case, a contribution to the fundraiser resembles pre-ordering a product.

Lending Mode: The lending mode of crowdfunding is also termed Peer-to-Peer (P2P) lending,[4] for its bypassing the functioning of banks in the course of lending. In some cases, investors receive interest on the funds they loan. In other cases, In other cases, they bear risks and share revenues with debtors, and get contingent paybacks.[5] A study suggests that no platform allows lenders to lend

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[1] *See* PAUL BELLEFLAMME, THOMAS LAMBERT & ARMIN SCHWIENBACHER, CROWDFUNDING: TAPPING THE RIGHT CROWD, 11, 13 (International Conference of the French Finance Association (AFFI) 2011).

[2] *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 10, 18 (2012).

[3] *See* Joachim Hemer, *A snapshot on crowdfunding*, ARBEITSPAPIERE UNTERNEHMEN UND REGION, No. R2/2011, at 1, 9.

[4] *See What is Crowdfunding,* UK CROWDFUNDING ASSOCIATION, http://www.ukcfa.org.uk/what-is-crowdfunding. (UKCFA was formed in 2012 by fourteen crowdfunding businesses).

[5] Hemer, *supra* note 3, at 14 ("He does not get interest but receives, at the defined end of the

directly to borrowers. In fact, P2P lending platforms either: (1) broker loan reimbursements through interest-free investments; (2) broker sale of issuer-backed securities by third parties; or (3) facilitate the origination of loans which are sold as securities to P2P investors who act as lenders.[6] The P2P lending sites can be either for-profit or non-profit.[7]

Equity Mode: Equity-based crowdfunding is the most complicated form in the family of crowdfunding. Crowdfunding investors purchase equity securities in this mode. Their returns could be a combination of the following: shares of the venture, dividends, and voting rights.[8]

Both the lending mode and the equity mode may involve issuances of securities.[9] The distinction is that securities issued in lending mode are debt instruments with fixed returns, while equity securities, such as common stock or preferred stock, are issued in the equity mode. Returns in the equity mode is contingent on the operation of fundraisers' firms or projects,[10] and the funders in equity mode can exercise control over their invested projects if the securities they purchased are attached voting rights.

As indicated by an industry report, equity crowdfunding raises the largest amount of funds per project among all crowdfunding modes. 21% of equity crowdfunding projects raise over $250,000, which significantly outnumbers the average amount raised by other types of crowdfunding, whose fundraising amount on average is less than $10,000.[11] Meanwhile, the report also stated that equity crowdfunding, growing at an 114% compound annual growth rate in 2011, is the fastest-growing type of all crowdfunding categories.

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lending period, an amount including an agreed share of the earnings of the venture, which could be a multiple of the original loan but could – in the case of bad performance – also be nothing.")

6 *See* Ian Galloway, *Peer-to-Peer Lending and Community Development Finance* 19 (Federal Reserve Bank of San Francisco Working Paper No. 2009-06), https://www.frbsf.org/community-development/wp-content/uploads/sites/3/galloway_ian.pdf.

7 *See generally* LENDING CLUB, https://www.lendingclub.com/; *About Us*, KIVA, https://www.kiva.org/about (For instance, Lending Club and Prosper typify the for-profit lending sites, and Kiva is the leading non-profit lending site).

8 *Supra* note 4.

9 The definition of securities provided by the Securities Act is very broad, including without limitation, "notes", "bonds", "debentures", and "evidence of indebtedness." *See* Securities Act § 2(a)(1). The scope of this definition is predicated on federal securities law, in particular, SEC v. W. J. Howey Co., 328 U.S. 293, 297 (1946).

10 Joseph Feller, Rob Gleasure & Stephen Treacy, *Crowdfunding: Past Research, Future Directions*, DEP'T OF ACCT. FIN. AND INFO. SYS. (Jun. 6, 2013), http://openresear.ch/wp-content/uploads/2013_ECIS_Crowdfunding_Seminar_Report.pdf.

11 *See* Massolution, *Crowdfunding Industry Report: Market Trends, Composition and Crowdfunding Platforms*, CROWD SOURCING 1, 20 (May 2012), https://www.crowdfunding.nl/wp-content/uploads/2012/05/92834651-Massolution-abridged-Crowd-Funding-Industry-Report1.pdf.

As more and more investors and entrepreneurs become interested in investing and financing through equity crowdfunding, platforms have come forward to intermediate transactions between interested investors and fundraisers. For instance, Wefunder, a leading crowdfunding platform, lobbied U.S. congress to provide an exemption for crowdfunding transactions from registration with the SEC in 2012. Some online funding platforms engaging in private placements of securities were also paying attention to the burgeoning crowdfunding market.[12]

In response to this trend, the U.S. Congress passed the Jumpstart Our Business Startups Act (JOBS Act). Title III of the JOBS Act adds a new section 4(a)(6) to the Securities Act of 1933. This section exempts the crowdfunding offering with an offering amount no more than $1 million from registering with the SEC and mandates the SEC to make rules implementing the crowdfunding exemption.

In 2013, the SEC promulgated its proposed rules on crowdfunding exemption. And two years later, in October 2015, the SEC eventually issued its long-awaited final rules of Regulation Crowdfunding ("Regulation CF"), effective on May 16, 2016. Regulation CF does not limit the type of securities issued using the crowdfunding exemption to equity securities. Under Regulation CF, equity, debt, and convertible securities are all allowed to be offered by issuers. Hence, Regulation CF transcends the bounds of equity crowdfunding, and makes the broader securities-based crowdfunding offerings possible.

Since the effective date of the Regulation CF, offerings using the crowdfunding exemption are prolific. In 2022 alone, at least $494.0 million was raised from approximate 1,558 offerings under the Regulation CF.[13]

In March 2020, the SEC proposed an overhaul to private placement exemptions in the U.S., including various amendments to Regulation CF. In November 2020, the SEC issued the final rule,[14] which took effect on 15 March, 2021. Under the amended Regulation CF, the offering limit within a 12-month period is now $5 million, 5 times the original $1 million limit. As such, issuers can use offerings under Regulation CF to raise much more capital. It is reasonably foreseeable that the burgeoning crowdfunding industry would be further fueled by this increase in offering limit.

This article examines and compares legal frameworks and practices of crowdfunding in the U.S. and China. The rest of this article has four sections.

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[12] For instance, Republic, another leading crowdfunding platform, is a spin-off of AngelList, a funding platform engaging in private placements of securities.

[13] *See* Brian, *2022 Equity Crowdfunding Stats and Top Platforms*, CROWDWISE (Jan. 16, 2023), https://crowdwise.org/funding-portals/2022-equity-crowdfunding-stats-and-top-platforms/.

[14] *See* SEC Harmonizes and Improves "Patchwork" Exempt Offering Framework, SEC(Nov. 2, 2020), https://www.sec.gov/news/press-release/2020-273.

The first section summarizes the legal framework in the U.S. Prior to the addition of section 4(a)(6), i.e., the crowdfunding exemption, to the Securities Act, private issuers rely on exemptions such as Regulation D, especially Rule 506 to sell securities. Various requirements imposed by Regulation CF on issuers, investors and funding platforms, and significant amendments to Regulation CF in November 2020 are to be discussed in this section.

The second section examines practices of offerings under Regulation CF in the U.S. First the percentage of each type of security offered in Regulation CF offerings is calculated. The finding is that common stock, debt, and Simple Agreement for Future Equity ("SAFE") are consistently the most-issued types of securities. Then contractual terms of stock, debts, convertible notes, and SAFEs are explored. The focus is in particular on provisions in relation to voting rights and economic interests of each type of security. Further, the risks posed by SAFE to investors are discussed.

The third section first discusses the legal framework and rulemaking effort regarding equity crowdfunding in China. Then this section surveys how crowdfunding portals in China used to operate. Subsequently, the section goes to discuss how regulatory action taken by the CSRC led to the demise of equity crowdfunding in China.

The fourth Section proposes a legal framework to revive China's dying crowdfunding industry. Two loopholes of the China Securities Law ("CSL") should be resolved. The first is that only a small group of securities are governed by the CSL. Promissory Notes, convertible notes, and SAFEs are securities frequently issued in crowdfunding offerings in the U.S. However, the issuances of all of them are not governed by the CSL. This loophole will preclude investors of these securities from the protections provided by the CSL. This article suggests that the crowdfunding offerings in China should extend from equity securities to equities, debts, and convertibles. To serve this end, an encompassing range of securities should be governed by the CSL. Second, the arbitrary numeric cutoff to determine a public offering in the CSL is unreasonable. By looking at the definition of securities and public offering in the U.S., this article proposes amending these two loopholes in the CSL. But above all, the section comes up with a framework of a crowdfunding exemption in the CSL and proposes the principles of its implementing rules.

II. THE REGULATORY FRAMEWORK OF CROWDFUNDING IN THE U.S.

The Securities Act of 1933 ("Securities Act" or the "1933 Act") and Securities Exchange Act ("Exchange Act or 34 Act") are two pillars of the U.S. securities regulation regime. The Securities Act regulates offerings and sales of securities in the primary market, while the Exchange Act regulates transactions of securities in the secondary market.[15] The core idea of securities regulation in the U.S. is mandatory information disclosure[16] and restrictions on fraud, manipulation, and insider trading.[17]

A. Pre-JOBS Regulation

In the U.S., an issuer intending to offer to sell or sell securities in the public market should file a registration statement with the SEC[18] or find an exemption from the registration requirement.[19] The cost of preparing for and filling a registration statement, including legal fees, accounting fees, and registration and printing fees, could be very high.[20] The costly registration process prevents small businesses from selling their securities in the public market, forcing them to look for affordable exemptions under which they can issue securities at lower costs.

The Securities Act provides some exemptions for issuers to make offerings without registering with the SEC. These exemptions include[21] Section 4(a)(2) of

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[15] A primary is a market where new securities are issued. A secondary market is where securities already issued are traded. For a good general survey of the U.S. federal securities regulation. *See* JOHN C. COFFEE JR., HILLARY A. SALE, AND M. TODD HENDERSON, SECURITIES REGULATION: CASES AND MATERIALS 56-69, (West Academic, 13th ed. 2015).

[16] *See* e.g., Donald C. Langevoort, *Primary Markets and the Securities Law: Capital-Raising and Secondary Trading*, 6 (May 19, 2017) https://capital-markets.law.columbia.edu /sites/default/files/content/docs/donald_langevoort-_final_draft.pdf. (This article argues securities offerings pose a classic "lemon problem"- investors shop for investable securities while promoters possess private information about the quality of their ventures. In response, the Securities Act tries to solve this problem by requiring mandatory, credible disclosure of information.)

[17] *See* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 733 (2006) (arguing securities law "by adopting the restriction on insider trading, entrusts information traders with the role of providing efficient and liquid markets. As a result, securities regulation, through disclosure duties and restriction on fraud and manipulation, minimizes the costs and risks that information traders bear").

[18] Section 5(c) of Securities Act bars an issuer from offering to sell or selling a security until a registration statement has been filed with the SEC. 15 U.S.C. § 77e(c). Section 5(a)(1) of the Act prohibits sales of a security until the registration statement of that security has become effective. 15 U.S.C. § 77e(a)(1).

[19] 15 U.S.C. § 77d(a)(4) of the Securities Act provides exemptions from the registration requirement in Section 5.

[20] *See* PWC, https://www.pwc.com/us/en/services/deals/library/cost-of-an-ipo.html (noting that a deal value between $25m to $99m, the total of legal fees, accounting fee, registration fee, printing fee can be as high as over $7.4m).

[21] Bradford, *supra* note 2, at 44-49 (naming Section 4(a)(2), Section 4(a)(5), Rule 504, Rule 505, Rule 506 as possible alternatives for small businesses to issue securities).

Securities Act, which provides an exemption for private offerings;[22] Regulation D under Securities Act,[23] including Rule 504 to Rule 506; and Regulation A.[24]

However, all the exemptions are to some extent inapplicable to startups and small businesses for their exacting requirements on the qualification of issuers and fundraisers, and significant compliance costs. For instance, Section 4(a)(2) only exempts offerings not involving any public offering. The exact meaning of a "public offering" is not defined in the statute, but was decided by a Supreme Court case, which will be discussed later. If a startup intends to raise capital from a large group of investors, Section 4(a)(2) may not apply. Regulation A requires issuers to file Form 1-A with the SEC. The burden and cost for preparing and filling for an offering under Regulation A is substantial,[25] which could discourage startups from using this exemption. Hence, startups and small businesses faced difficulties finding a viable means to raise capital.

Among all the Pre-JOBS available exemptions, the most important one is Rule 506 of Regulation D.[26] It imposes no limitation on the maximum aggregate offering amount using this exemption. Under Rule 506(b),[27] an issuer can offer securities to an unlimited number of accredited investors[28] and up to 35 non-accredited investors. These non-accredited investors should be sophisticated-that is, they should have sufficient knowledge and expertise in financial and business matters to make informed decisions. However, under Rule 506(b), an issuer is

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22 15 U.S. C. § 77d(a)(2).

23 17 CFR §§ 230.500 - 230.508 (2021).

24 17 CFR §§ 230.251-230.263 (2021).

25 *See* Rutherford B. Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital",* 31 DEL. J. CORP. L. 77, 104–106 (2006) (noting the disclosure requirements of Form 1-A are burdensome for small businesses), *see* also *Regulation A+: What Entrepreneurs Need to Know,* STARTENGINE (April 9, 2021), https://www.startengine.com/blog/regulation-a-what-entrepreneurs-need-to-know/ (stating "The cost for (a Regulation A offering) varies, but the short answer is it costs a good deal more than Regulation Crowdfunding. Companies can expect to pay anywhere between $50,000-$100,000 before their offering is qualified and they can begin raising capital.").

26 *Accredited Investor Definition,* U.S. SEC, (2020), https://www.sec.gov/rules/final/2020/33-10824.pdf (noting the SEC estimated offerings under Rule 506(b) in 2019 amounted to $1,492 billion, under Rule 506(c) $66 billion, by contrast, under Rule 504 only $0.228b, under Reg A: tier 1 $0.044 billion and Reg A: tier 2 $0.998 billion).

27 17 CFR. § 230.506(b) (2021).

28 17 CFR. § 230.501 (2021). (Rule 501(a) of Regulation D's definition of "accredited investors" includes: (1) affluent natural people, such as a natural person with income exceeding $200,000 or joint income with a spouse exceeding $300,000 for a certain period; a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million with some conditions; (2) institutional investors, such as a charitable organization, corporation or partnership; a bank, insurance company, registered investment company, business development company or small business investment company).

unable to make general solicitation or general advertising,[29] and should provide non-accredited investors with information that is generally the same as that disclosed in a registration statement, including financial statements.[30]

Under Rule 506(c),[31] if all investors participating in a Rule 506 offering are accredited investors, the limitation on the number of purchasers, the requirement of disclosures and sophistication are excused. Rule 506(c) further unfetters Rule 506(b)'s prohibition on general solicitation or general advertising, provided all the purchasers are accredited investors, or the issuer takes steps to verify the purchasers' status as accredited investors. But the issuers under Rule 506 are still required to file Form D with the SEC, which incurs costs on issuers.

Some Internet funding portals, such as AngelList and FundersClub, make use of the Rule 506 exemption to channel offerings initiated by startups to accredited investors. For instance, AngelList expressly states that all investors on AngelList should be accredited investors,[32] Fundersclub also requires interested investors to verify their status as accredited investors when signing up.[33]

To verify an investor's status as accredited, AngelList pre-screens investors by asking their annual income, assets, and investment sophistication.[34] Meanwhile, they also pre-screen fundraisers by asking about their financial healthiness and quality of projects. This pre-screening process precludes participation of small startups and investors. In addition, it is difficult for startups and small businesses to make attractive pitches to accredited investors, to verify all their securities' purchasers as accredited investors, or to pay the costs incurred by the filing of Form D and charged by the portals.

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[29] *Id.* § 230.502(c) (2021).

[30] *Id.* § 230.502(b) (2021).

[31] *Id.* § 230.506(c) (2021).

[32] ANGELLIST, https://www.angellist.com/syndicates (last visited February 2023) (stating "All investors on AngelList should be accredited investors" under the bold words "Apply to become an investor").

[33] *See* FUNDERSCLUB, https://fundersclub.com/how-it-works/ (last visited February 2023) ("In compliance with SEC regulations, you will need to verify that you are an accredited investor in order to invest on our platform.").

[34] *See Accreditation Overview,* ANGELLIST, https://help.angellist.com/hc/en-us/articles/360057863351-Accreditation-Overview (last visited February 2023) (AngelList asks investors to complete a "accredited investor questionnaire" before they can purchase securities offered on this site under Rule 506. The questionnaire requires individual investors to satisfy the minimum requirement of a natural person accredited investor with respect to net assets, annual income, or amount in investments, and upload evidence to verify their status as accredited investors).

B. Post-JOBS Regulation

1 Section 4(a)(6) of 1933 Act and Regulation Crowdfunding

The JOBS Act is monumental for the development of the crowdfunding industry in the U.S. To facilitate the financing for startups and small businesses of the U.S. Title III of the JOBS Act provides crowdfunding transactions with an exemption from registering with the SEC by adding Section 4(a)(6) to the Securities Act. This section provides that an offering of securities is exempted from registration if the offering meets the following requirements: (1) the amount of the offering raised must not exceed $1 million within a 12-month period;[35] (2) individual investments within this period are limited to: (a) the greater of $2,000 or 5 percent of the investor's annual income, if annual income of the investor is less than $100,000; and (b) 10 percent of annual income (not to exceed $100,000), if the investor's annual income is $100,000 or more; and (3) transactions must be conducted through an intermediary that either is registered as a broker or is registered as a new type of entity called a "funding portal."[36] Congress further mandated the SEC to lay down detailed implementing rules.

In implementing this Congressional mandate, the SEC promulgated its proposed rules in October 2013. The proposed rules addressed the regulatory framework by imposing disclosure duty on issuers, certain duties on the platforms and funding portals such as duty against fraud, and the upper limit of investments on investors.

In October 2015, two years after the publishing of the proposed rule, the SEC issued its long-awaited final rule to regulate all issuances of securities under the crowdfunding exemption, including issuances of both equity and non-equity securities, which took effect on May 16, 2016. The final rule, also known as Regulation Crowdfunding,[37] imposes various duties on companies and platforms, and an upper limit of investment on investors.[38]

Limits on Investors' investment amount

Regulation CF put limits on how much each investor can invest in crowdfunding offerings on his/her annual income or net worth. If either the investor's annual income or net worth is less than $107,000, the limit equals the greater of $2,200 or 5% of the lesser of his/her annual income or net worth. If both the investor's annual income and net worth are at least $107,000, then the limit

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[35] 17 C.F.R. § 227.100(a)(1) (2021) (On March 31, 2017, the SEC increased the upper limit of offerings to $1.07 million to account for inflation as required by the JOBS Act).

[36] 15 U.S.C. § 77d 4(a)(6)(C) (2015).

[37] 17 C.F.R. §§ 227.100-503 (2021).

[38] *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers,* U.S. SEC (April 5, 2017), https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316#6.

equals 10% of the lesser of his/her annual income or net worth, up to a maximum of $107,000.[39]

Eligibility of Issuers

Certain companies are not eligible to issue securities under Regulation CF. These ineligible companies include:[40] non-U.S. companies; companies subject to reporting obligations under Section 13 or Section 15(d) of the Securities Exchange Act;[41] some investment companies; companies that are disqualified under Regulation CF's disqualifiers;[42] companies that have failed to conform to the annual reporting requirements under Regulation CF during the two years immediately prior to the filing of an initial offering statement (Form C); and companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies.

Restrictions on Resale of Securities Issued

Securities purchased by investors Regulation CF offerings generally cannot be resold for one year, unless the securities are transferred: (1) to the issuer of the securities; (2) to an accredited investor defined in Rule 501(a); (3) as part of an offering registered with SEC; or (4) to family member of the purchaser, to a trust controlled by the purchaser or created for the benefits of a family member of the purchaser.[43]

Disclosure by Issuers

Every issuer using Regulation CF is required to file Form C, the initial offering statement for crowdfunding offerings, with SEC. Form C contains various items that require issuers to disclose. Some important items are: information about officers, directors, and owners of 20 percent or more of the issuer; a description of the issuer's business and the use of proceeds from the offering; the price to the public of the securities or the method for determining the price, the target offering amount and the deadline to reach the target offering amount, whether the issuer will accept investments in excess of the target offering amount; a discussion of the issuer's financial condition and financial statements.[44]

The extent of disclosing financial statements of the issuers is based on the aggregate amounts of securities sold and target offering amounts under Regulation CF within the preceding 12-month period:[45]

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[39] 17 C.F.R. § 227.100(a) (2018).
[40] *Id.* § 227.100(b) (2018).
[41] 15 U.S.C. §§ 78m-78o(d) (these sections require publicly listed companies and some companies with numerous public shareholders file periodical reporting forms and forms regarding material change or action of such companies with the SEC).
[42] 17 C.F.R. § 227.503(a) (2021) ("Disqualification provisions").
[43] *Id.* § 227.501 (2016).
[44] *Id.* § 227.201 (2022).
[45] *Id.* § 227.201(t) (2022).

For issuers offering no more than $107,000: Financial statements of the issuer and certain information from the issuer's federal income tax returns, both certified by the principal executive officer;

Issuers offering more than $107,000 but not more than $535,000: Financial statements reviewed by a public accountant that is independent of the issuer;

Issuers offering more than $535,000:

For first-time Regulation CF issuers: Financial statements reviewed by a public accountant that is independent of the issuer, unless financial statements of the issuer are available that have been audited by an independent auditor;

For issuers that have previously sold securities in reliance on Regulation CF: Financial statements audited by a public accountant that is independent of the issuer.

In addition to filing Form C, the issuer is required to file Form C/A to report material changes of the offering[46] and Form C-U within 5 days of an offering reaching its target offering amount. Meanwhile, issuers that have sold securities under Regulation CF are also required to file an annual report on Form C-AR no later than 120 days after the end of its fiscal year.[47]

Requirements on Platforms

Every offering under Regulation CF must be exclusively conducted through one online platform. The intermediary operating the platform must be a broker-dealer or a funding portal that is registered with the SEC and the FINRA.[48]

Regulation CF requires these intermediaries to provide investors with a broad range of educational materials, including the process of the offering, types of securities offered on the platform and accompanying risk of each type of security, restrictions on the resale of securities issued under Regulation CF.[49] In addition, Regulation CF dictates intermediaries to take measures to reduce the risk of fraud[50] and to make information about the issuer and the offering publicly available to the SEC and investors.[51] Further, intermediaries should also provide communication channels on their platforms by which investors can communicate with each other and with representatives of the issuer about offerings on the platform.[52]

Regulation CF requires funding portals facilitating crowdfunding offerings in reliance on the exemption should not offer investment advice or recommendations; solicit purchases, sales, or offers to buy the securities offered on its platform; compensate employees, agents, or others for such solicitation or based

46 *Id.* § 227.203(a)(2).
47 *Id.* § 227.202; § 227.203(b)(1).
48 *Id.* §227.100(a)(3).
49 *Id.* § 227.302(b).
50 *Id.* § 227.301.
51 *Id.* § 227.303(a).
52 *Id.* § 227.303(c).

on the sale of securities displayed or referenced on its platform or portal; hold, manage, possess, or handle investor funds or securities.[53]

2. Amendments to Regulation CF

As Regulation CF enacted various requirements on the disclosure of information by issuers and services that platforms should provide, the cost of compliance could be substantial.[54] Thus, the SEC's rulemaking responsibility for crowdfunding is far from over.

In March 2020, the SEC proposed substantial amendments to Regulation CF seeking to "address the gaps and complexities in the offering framework that may impede access to capital for issuers."[55] In November 2020, the SEC issued the final rule on Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets,[56] which became effective in March 2021.

This set of rules makes various amendments to Regulation CF, Regulation A and Regulation D. Amendments to Regulation CF are particularly substantial.

First, the final rule raises the offering limit from $1.07 million to 5 million[57] within 12 months. As $5 million surpasses the authorization of Section 4(a)(6) of the Securities Act, the SEC uses its general exemptive authority under Section 28 of the Securities Act[58] to justify the raise in the offering limit.

Second, the final rule removes the investment limit on accredited investors.[59] Prior to the amendment, accredited- and non-accredited investors were subject to the same limit on the investments they were allowed to make in crowdfunding offerings. Now under the amended Regulation CF, accredited investors can invest any amount they desire in a crowdfunding offering or a series of such offerings. Meanwhile, the calculation method for investment limits on non-

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53 *Id.* § 227.402(a).

54 *See* C. STEVEN BRADFORD, THE ECONOMICS OF CROWDFUNDING 193 para. 2 (2018).

55 *See* Jay Claton, *Statement on Harmonizing, Simplifying and Improving the Exempt Offering Framework,* U.S SEC(Mar. 4, 2020), https://www.sec.gov/news/public-statement/statement-clayton-harmonization-2020-03-04.

56 17 C.F.R. § 227, 229, 230, 239, 240, 249, 270 & 274.

57 *Id.* § 227.100(a)(1).

58 28 U.S.C. §§ 77z-3. This section provides

> "The Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."

59 *Id.*

accredited investors is revised from "the lesser of annual income or net worth" to the greater of their annual income or net worth.[60]

Third, the final rule adopts Rule 3a-9 of the Investment Company Act to introduce the "crowdfunding vehicles" that act solely as conduits for investors to facilitate investing in issuers seeking to raise capital through a crowdfunding vehicle.[61] The vehicle can beneficially hold the securities issued under Regulation CF, and thus appear on an issuer's cap table as a single line-item entry, avoiding the "messy cap table problem". Meanwhile, a vehicle counts as one investor for the purpose of reporting threshold under Section 12(g) of the Exchange Act. This messy cap table problem and section 12(g) reporting threshold will be discussed later in the subchapter of SAFE.

Meanwhile, the final rule adopts Rule 241 and Rule 206 to allow Regulation CF issuers to test the waters. Under the new Rule 241, issuers can use generic solicitation of interest materials to "test the waters" for an exempt offering prior to the determination of which exemption the issuer will use.[62] Rule 206 is specifically designed to facilitate Regulation CF offerings. The new Rule 206 allows issuers intending to offer securities under Regulation CF to publicly solicit potential investors' interest, orally or in writing, prior to the filing of Form C.

The final rule also adopts Rule 148 which allows demo day communication. Under Rule 148, an issuer can make communication in connection with a seminar or meeting sponsored by a college, university, or other institution of higher education, a state or local government or instrumentality of a state or local government, a nonprofit organization, or an angel investor group, or an incubator, or accelerator.[63]

These amendments could make offering securities under Regulation CF more appealing. More companies would choose Regulation CF as an exemption to offer securities if their needs for capital are below $5 million. Meanwhile, as some types of general solicitations by issuers are allowed prior to the filling of Form C and issuers can attend meetings and seminars sponsored by angel investor groups, incubators, and accelerators can introduce themselves and their businesses to attendees comprised of experienced investors, meaning the possibility of raising more capital is very likely to increase.

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[60] 17 C.F.R § 155.

[61] *Id.* § 270.3a-9.

[62] *See* Asher J. Friend, *SEC Adopts Final Rules Improving and Harmonizing the Exempt Offering Framework*, NAT'L L. REV., https://www.natlawreview.com/article/sec-adopts-final-rules-improving-and-harmonizing-exempt-offering-framework (Nov. 19, 2020).

[63] *Supra* note 56, at § 230.148.

III. CURRENT PRACTICES OF CROWDFUNDING OFFERINGS IN THE U.S.

After Regulation CF took effect in May 2016, small businesses and startups have been eager to utilize this new exemption. On June 30, 2019, only two months after the effective date of Regulation CF, there were 50 issuers filling a Form C with the SEC.[64] As of the third quarter of 2020, offerings under Regulation CF raised $410.5 million in total, and the amount raised through such offerings in that quarter was the largest ever among all quarters since 2016.[65] Wefunder, one of the largest crowdfunding portals, alone has helped 435 startups raise more than $130 million through Regulation CF offerings to date.[66]

In this part, first, the types of securities offered in offerings under Regulation CF are to be discussed. Then, the essential terms of contracts accompanying the issuance of each type of security, especially terms with respect to voting rights and economic interests for investors, will be explored. Finally, the risks of SAFE - a special convertible security, will be discussed as the SEC attempted to ban its issuance in Regulation CF offerings when the Commission was amending Regulation CF.

A. Types of Securities Offered and Amount Raised

In June 2019, the SEC issued its official report on offerings under Regulation CF. This report surveyed offerings under Regulation CF during the period from May 2016 to December 2018,[67] and produced valuable observations and results.

The SEC estimated that during the considered period, there were 1,351 offerings launched, 519 of which were completed. These 519 completed offerings raised $108.2 million in total, with the average amount being $208,400 and median amount being $107,763.[68]

The SEC estimation was lower than some industrial statistics. For instance, Crowdfund Capital Advisors estimated that $194 million was raised during the

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64 Marc A. Leaf, Robert T. Esposito & Abigail Luhn, *Leading the Crowd: An Analysis of the First 50 Crowdfunding Offerings,* FAEGRE DRINKER (July 14, 2016), https://1npdf11.onenorth.com/pdfrenderer.svc/v1/abcpdf11/GetRenderedPdfByUrl/Leading-the-Crowd-An-Analysis-of-the-First-50-Crowdfunding-Offerings.pdf/?url=https%3a%2f%2fwww.faegredrinker.com%2fen%2finsights%2fpublications%2f2016%2f7%2fleading-the-crowd-an-analysis-of-the-first-50-crowdfunding-offerings%3fformat%3dpdf&attachment=false.

65 *See* The StartEngine Team, *Equity Crowdfunding Q3 2020 Review*, START ENGINE (Nov. 5, 2020), https://www.startengine.com/blog/equity-crowdfunding-q3-2020-review/.

66 *See* WEFUNDER, https://wefunder.com/results, (last visited Oct. 2020).

67 *See* U.S SEC, REGULATION CROWDFUNDING REPORT 2019, at 13-14,https://www.sec.gov/smallbusiness/exemptofferings/regcrowdfunding/2019Report.

68 *Id.* at 15.

same period as that of the SEC's report.[69] Another industrial report provided by StartEngine, a leading crowdfunding platform, estimated that as of December 2018, offerings under Regulation CF raised $161.5 million in total, $75.8 million of which was raised in 2018.[70]

The differences in estimation between the SEC and industry reports could be attributed to different data sources they used.[71] But all these reports reflected the growing use and popularity of Regulation CF offerings.

The SEC further examined the types of securities issued in Regulation CF offerings. In terms of the number of offerings, 48% of the offerings issued equity securities, 27% issued debts, 21% issued SAFEs, and 4% issued other offerings. In terms of target amount sought, 42% of all the target amounts were to be raised by equity, 30% by debts, 25% by SAFEs, and 3% by others types of securities.[72]

For corporations, equity securities are primarily common stocks and preferred stocks. For limited liability companies and limited partnerships, equity securities refer to membership units and limited partnership interests. Debts include straight debts and convertible debts that can convert into equity securities. The SEC did not provide a breakdown of percentages for each subtype of securities in its report. To delve into the percentages of subcategories of each security further, we collect and analyze the data sourced from SEC filings and provided by crowdfunding platforms.

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69 *See* JD Alois, *There are 46 FINRA Regulated Reg CF Portals. In 2018 $109.3 Million was Raised Using this Security Exemption*, CROWDFUND INSIDER, (February 14, 2019, 9:01 pm), https://www.crowdfundinsider.com/2019/02/144537-there-are-47-finra-regulated-reg-cf-portals-in-2018-109-3-million-was-raised-using-this-security-exemption/.

70 *See* The StartEngine Team, Equity Crowdfunding 2018 Review*,* STARTENGINE, (Jan. 14, 2019), https://www.startengine.com/blog/equity-crowdfunding-2018-review/.

71 Numbers of Regulation CF offerings could be collected from Form C filings on the SEC EDGAR system by both the SEC and industry reports. Form C is the initial offering statement. If an issuer intends to amend its original Form C, a Form C/A is required to file. An issuer can file multiple Form C/As. For an offering that has been amended, information should be collected from the latest amendment. Meanwhile, Regulation CF requires an issuer to file a progress update on Form C-U within 5 business days after reaching 100% of its target offering amount. SEC's data on completed offerings should be collected from all Form C-U fillings.

However, relying solely on information contained in Form C fillings on the SEC's database is insufficient. As many offerings in-progress have also raised money but are incomplete, issuers of these offerings will not file Form C-U with the SEC. Meanwhile, as a Form C-U could be filed five days after an offering reaches its target, relying information solely on Form C-U fillings possibly omits the offerings that reached their targets while have not yet filed. Since all offerings under Regulation CF should be made on a funding portal, the data collected and web-crawled from funding portals could be more accurate and timelier than data collected solely from SEC filings.

72 *Supra* note 67, at 19-20.

Table 1: Types of Securities Offered and Amount Raised[73]

Types of Securities offered	2016-2019 Q4	2020 Q1	2020 Q2	2020 Q3
Common Stock	29.70%	28.80%	23.90%	20.90%
Debt	22.50%	28.80%	26.60%	25.30%
SAFE	20.90%	23.90%	26.60%	27.50%
Membership Units	8.20%	3.10%	2.30%	5.40%
Convertible	8.10%	6.70%	7.80%	13.30%

[73] Percentage of each type of security = (Number of offerings of each security / Total number of offerings). The percentages of each security in Q1 and Q3 of 2020 were calculated based on the structured data provided by the SEC, *see Crowdfunding Offerings Data Sets, 2020* Q1 & Q3, U.S. SEC (Dec. 31, 2020), https://www.sec.gov/dera/data/crowdfunding-offerings-data-sets); while the data for the number of offerings and the amount raised were cited from StartEngine; see StartEngine, Equity Crowdfunding Q1 2020 Review (Apr. 18, 2020), https://www.startengine.com/blog/equity-crowdfunding-q1-2020-review/; The StartEngine Team, *Equity Crowdfunding Q3 2020 Review,* STARTENGINE (Nov. 5, 2020), https://www.startengine.com/blog/equity-crowdfunding-q3-2020-review/. All data from 2016 to 2019 Q4 was extracted from StartEngine; see The StartEngine Team, *Equity Crowdfunding Q4 2019 Review,* STARTENGINE (Jan. 29, 2020), https://www.startengine.com/blog/equity-crowdfunding-q4-2019-review/. All data for 2020 Q2 is from StartEngine; see The StartEngine Team*, Equity Crowdfunding Q2 2020 Review,* STARTENGINE (July 17, 2020), https://www.startengine.com/blog/equity-crowdfunding-q2-2020-review/. (The SEC provides structured data containing each item in Form C fillings every quarter and stores these items in six .tsv files. However, SEC datasets mix relevant information from Form C, Form C/A, Form C-U, Form C-AR, Form C-TR (filed when an issuer terminates its annual reporting obligation), and Form C-W (filed when an issuer withdraws from the offering it previously filed using Form C) into a single .tsv file. What is worse, the SEC stores the type of form submitted in FORM_C_SUBMISSION.tsv, while stores other crucial information, such as types of securities offered, target offering amount, net income of issuers, in FORM_C_ISSUER_INFORMATION.tsv. This arrangement of information complicates data wrangling for locating and assorting needed information. For instance, in extracting the data of types of securities offered in 2020 Q1, only information contained in Form C fillings is filtered in, and information contained in other types of forms is disregarded. The SEC data contained 227 Form C fillings in 2020 Q1, 4 more fillings than StartEngine reported. But the SEC data also contains 5 null values, resulting in an effective count equaling 222. Meanwhile, the SEC data characterizes non-voting common stock, Class B common stock as different categories from common stock, crowd SAFE, SAFE and SAFE unit as different, too. The categorization of these securities in the data in question is set aside. All subtypes of common stock, SAFEs and preferred stock are calculated as a single type.).

Note				
Preferred Stock	7.90%	6.80%	8.30%	6%
Revenue Sharing Note	2.10%	0.90%	1.80%	
Other		0.9%	2.80%	1.60%
Amount Raised	$282.6M	$33.3M	$48.2M	$58.9M
Count	2099	223	218	316

Source: SEC, StartEngine

According to the above table, since May 2016, the time when Regulation CF took effect, there have been more than 2,800 Regulation CF offerings launched. Among all these offerings, the most-offered types of securities have been consistent: common stocks, debt, and the SAFE. Interestingly, as opposed to VC financings in which preferred stocks are predominantly favored by investors or IPOs in which merely common stocks are offered to public investors, in Regulation CF offerings, debts and some non-traditional securities are frequently offered.

B. Major Contractual Terms of Each Type of Securities

1. Equity Securities

The major types of equity securities issued in Regulation CF offerings are common stocks and preferred stocks. Remarkably, common stocks are persistently among the most popular securities issued in Regulation CF offerings and outnumber preferred stocks by a landslide. However, to the contrary, in most VC financing, venture capitalists favor preferred stocks far more than common stocks.[74]

Common stocks grant investors the right to receive dividends when declared. In addition to the dividend right, common stocks grant investors voting rights as stated in the issuer's charter and state corporate law, notably the right to vote in the elections of directors, and the right to vote on some fundamental transactions of the issuer, such as a sale of all or substantially all of the issuer's assets, or the issuer being acquired by another corporation. Meanwhile, when preferred stockholders exercise their contractually stipulated rights, the issuer's

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74 *See*, *e.g.*, William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 892 (2002). "Convertible preferred stock is the dominant financial contract in the venture capital market, at least in the United States."

board of directors only owes fiduciary duties to common stockholders, and the board can fulfil its fiduciary duties to the common stockholders irrespective of the best interests of preferred stockholders.[75]

But it seems many investors in common stock offerings under Regulation CF do not care much about their voting rights. In fact, in the third quarter of 2020, there were 20 offerings that issued common stock under Regulation CF, consisting of non-voting common stock and Class B non-voting common stock,[76] accounting for nearly 1/3 of all Regulation CF common stock offerings in this quarter.

In offerings issuing common stock carrying voting rights, there could be some limitations in place on subscribers exercising their voting rights. In fact, terms in many Regulation CF common stock offerings include a "voting proxy" provision. This provision requires subscribers to these common stock offerings to appoint the CEO of the issuer as the subscribers' proxy and attorney. Then the CEO at his/her discretion can vote on subscribers' shares on behalf of them[77]

The inclusion of this provision is ubiquitous in Regulation CF common stock offerings.[78] As a matter of practice, investors purchasing an issuer's common

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[75] *See* In re Trados Inc. S'holder Litig., 73 A.3d 17 (Del. Ch. 2013), (holding "A board does not owe fiduciary duties to preferred stockholders when considering whether or not to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights. Preferred stockholders are owed fiduciary duties only when they do not invoke their special contractual rights and rely on a right shared equally with the common stock.)

[76] The StartEngine Team, *supra* note 65.

[77] A typical voting proxy provision is:

"Voting Proxy. Each Subscriber shall appoint the Chief Executive Officer of the Company (the "CEO"), or his or her successor, as the Subscriber's true and lawful proxy and attorney, with the power to act alone and with full power of substitution, to, consistent with this instrument and on behalf of the Subscriber, (i) vote all Securities, (ii) give and receive notices and communications, (iii) execute any instrument or document that the CEO determines is necessary or appropriate in the exercise of its authority under this instrument, and (iv) take all actions necessary or appropriate in the judgment of the CEO for the accomplishment of the foregoing. The proxy and power granted by the Subscriber pursuant to this Section are coupled with an interest. Such proxy and power will be irrevocable. The proxy and power, so long as the Subscriber is an individual, will survive the death, incompetency, and disability of the Subscriber and, so long as the Subscriber is an entity, will survive the merger or reorganization of the Subscriber or any other entity holding the Securities. However, the Proxy will terminate upon the closing of a firm-commitment underwritten public offering pursuant to an effective registration statement under the Securities Act of 1933 covering the offer and sale of Common Stock or the effectiveness of a registration statement under the Securities Exchange Act of 1934 covering the Common Stock."

This provision is widely used in Regulation CF common stock offerings, especially such offerings on StartEngine. See offering memorandum (Exhibit A to Form C) of Comsero Inc., MF Fire, Inc., Carnot Compression Inc., Hawaiian Ola Brewing Corp. (Form C/A dated 09/30/2020), etc.

[78] In fact, of StartEngine's six in-progress Regulation CF common stock offerings raising $1M or more as of early December of 2020, 2 issues non-voting common stock, 3 voting

stocks in pursuance of offering terms with this voting proxy provision agree to give up their voting rights to the issuer's CEO. Consequently, the issuer's CEO will vote on behalf of the investors. The investors cannot exercise their voting rights until the issuer goes public in the future through an IPO.

Even in common stock offerings without limitations on voting rights, common stockholders collectively invest $5 million - the maximum amount under current Regulation CF an issuer can raise in a corporation valued at $30 million. These common stockholders still own a fraction of the corporation and are minority stockholders. As the minority, these common stockholders still lack the power to decide the outcomes of elections of directors and other material issues requiring the voting of stockholders. Additionally, as a minority, these common stockholders have to rely on the existing corporate leadership to manage the corporation.

As terms of preferred stocks are stipulated through intensely negotiated and tailored contracts, preferred stocks are a contractually created security[79] But most preferred stocks share something in common: they give the holders some preferences over common stockholders. Preferred stockholders have right to receive specified dividends ahead of common stockholders. If a company's board of directors skips declaring and paying dividends, preferred stockholders' claims to unpaid dividends could be cumulative, meaning any unpaid dividend will accumulate. Thus, the corporation should pay preferred stockholders the accumulated amount of these unpaid dividends before paying any dividends to common stockholders.[80]

In addition to this dividend preference, preferred stockholders also enjoy liquidation preferences. Liquidation preferences entitle preferred stockholders to be paid the original investment amount or some multiple of their investments before common stockholders receive any money in liquidation events stated in the preferred stock purchase agreement.[81] The liquidation preferences always significantly exceed preferred stockholders' initial investment amount.[82] The clauses of liquidation preferences always accompany the dividend preferences.

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common stock offerings include the "voting proxy" provision, and only 1 offers common stock without limitations on voting rights.

79 *See*, *e.g.*, In re Appraisal of Metromedia Int'l Grp., Inc., 971 A.2d 893, 899 (Del. Ch. 2009), "A preferred shareholder's rights are defined in either the corporation's certificate of incorporation or in the certificate of designation, which acts as an amendment to a certificate of incorporation. Thus, rights of preferred shareholders are contractual in nature[.]" By contrast, common stockholder's rights are directly provided by state corporate law.

80 *See, e.g.*, William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1825 (2013); Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163, 1171 (2013).

81 *See Glossary: Liquidation Preference <Practical Law>*, THOMSON REUTERS, https://us.practicallaw.thomsonreuters.com/1-384-7000 (last visited February 2023).

82 *See* Korsmo, *supra* note 80, at 1173.

Liquidation multiple is one form of preferred stockholders' liquidation preferences. This preference entitles preferred stockholders to receive an amount equal to their initial investment amount × liquidation multiple before any sale or liquidation proceeds are paid to common stockholders.[83] Though the liquidation multiple can be as high as 3x, the proportion of the liquidation multiple preference in all VC financing contracts is as small as 4% according to a report.[84]

Preferred stockholders can also have participating or non-participating liquidation preferences. The participating preference entitles preferred stockholders to receive a stated liquidation preference in addition to a pro-rata share of any remaining proceeds available to common stockholders on an "as-converted to common stock" basis.[85] By contrast, if the preferred stock is non-participating, then a holder of the preferred stock may choose receiving either the stated liquidation preference or a share of the proceeds in proportion to his or her equity ownership after converting their preferred stocks into common stocks.[86]

A capped liquidation preference will impose a cap on how much a preferred stockholder can receive in liquidation. Under the capped liquidation preference, a preferred stockholder can receive the stated liquidation preference plus a pro-rata share of the remaining proceeds on an as-converted basis. However, there is a cap on the total return the preferred stockholder can receive.

Some scholars argue that investors' willingness to accept common stock in the early-stage financing of startups is due to their lack of sophistication.[87] As concluding a set of preferred stock purchase agreements needs intensive negotiations over some key provisions, such as anti-dilution,[88] liquidation

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[83] Assume preferred stockholders invested $3 million in a startup, the startup is acquired for $15 million, and the liquidation multiple is 2. Then preferred stockholders will receive $6 million out of the $15 million proceeds.

[84] *2020 Venture Capital Report*, WILMERHALE (2020) (https://www.wilmerhale.com/en/insights/publications/2020-venture-capital-report) (WilmerHale, a prestigious law firm, surveyed hundreds of VC financing transactions dated 2014-2019 and found only 4% of VC financing agreements in 2019 included a liquidation multiple.)

[85] I.*e.*, as if the preferred stock had converted to common stock, in short for "as-converted basis".

[86] *See* Aaron Kellner, *What You Need to Know About Liquidation Preferences*, SEEDINVEST (July. 31, 2018), https://www.seedinvest.com/blog/angel-investing/liquidation-preferences.

[87] *See* John F. Coyle and Joseph Green, *Contractual Innovation in Venture Capital*, 66 U.C. HASTINGS L.J. 133, 148 (2014).

[88] A dilution refers to a reduction in equity value per share, earnings per share or relative ownership percentage resulting from subsequent equity issuances by a company. *See Glossary: Dilution <Practical Law>*, THOMSON REUTERS, https://ca.practicallaw.thomson reuters.com/0-5043650?originationContext=document&scopedPageUrl=Home%2fPracticalLawGlobal&tra=DocumentItem&contextData=(sc.Default) (last visited February 2023) An anti-dilution provision protects an equity holder from dilution due to subsequent offering of equity securities.

preferences, preferred investors' voting rights and information rights, unsophisticated investors are unable to negotiate these complicated terms. As a result, unsophisticated investors are inclined to invest in common stock, whose purchase agreement in early-stage financing consists of much simpler terms, such as the stock price and the number of shares offered.

However, common stock has a major disadvantage in early-stage financing, including financing under Regulation CF. The payments to stockholders are subordinated to payments to creditors when a company is liquidated.[89] As preferred stockholders enjoy contractual liquidation preferences over common stockholders, common stockholders could be left with nothing if all remaining proceeds are paid to preferred stockholders.

The emergence of the open-sourced Series Seed documents provides an accessible, cost-effective set of documents for preferred stock offerings in Series Seed[90] Using this set of documents can substantially shorten the negotiation process and save legal fees as it sets aside provisions that will only be used in late stages of equity financing and provides standard terms for provisions used in early-stage equity financing, such as a liquidation preference of one time(s)[91] the original issue price plus declared but unpaid dividends. If this set of documents is used more broadly in equity offerings under Regulation CF, the percentage of preferred stocks could increase.

2. Debt

Debt securities provide fixed returns to investors. The major types of debt securities issued in Regulation CF offerings are promissory notes, including term notes and revenue sharing notes (RSN) [92]

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89 11 U.S.C. § 507 (stating that in a liquidation, stockholders are paid behind creditors).

90 *See* SERIES SEED, https://www.seriesseed.com/ (last visited February 2023).

91 *Id.* The Liquidation Preference provision in the term sheet of Series Seed documents is worded as "One times the Original Issue Price plus declared but unpaid dividends on each share of Series Seed, balance of proceeds paid to Common. A merger, reorganization or similar transaction will be treated as a liquidation."

92 Many Form C fillings that issued debts simplistically reported the security it offered as "debt". About half of debt issuers further clarified the type of debt they offered. In Q3 of 2020, only one debt issuer reported the type of security it offered was bond, the rest of debt issuers reported their securities issued were notes. However, it is still quite confusing as a revenue sharing note is a kind of promissory note and falls within the definition of debt securities, yet it sometimes appeared as a standalone category of securities in Form C filings. MainVest, a platform specializing in intermediating projects issuing revenue sharing notes, helped close 119 projects predominantly offering revenue share notes in 2020, accounting for approximately 1/7 of all offerings initiated (but only a very small fraction of total amount raised). This fact makes the 1.8-2.1 percentage of revenue sharing notes among all securities issued very unreliable. Another funding platform specializing in promoting debt offerings is NextSeed (now has been acquired by Republic). Offerings on NextSeed typically issue term

While it is relatively new in financing the early cycle of ventures, revenue share debts, whose basic structure is for the investor to get repaid a percentage of the issuer's future revenue, has already been used for financing oil and gas companies and in film production. [93]

The fundamental distinction between RSNs and term notes is that the repayment of RSNs is tied with the issuer generating some revenue. If the issuer of RSNs does not generate revenue after the closing of the offering under Regulation CF, the repayment will not start.[94]

The key provisions of an RSN are the payment multiple and revenue share percentage. If an investor invests $10,000 in an issuer offering RSNs, and the payment multiple is 2, the investor is entitled to be repaid $20,000 on the maturity date. The higher the payment multiple, the greater the investor will be repaid. When the issuer starts to repay, the amount of each payment the investor will receive is the purchaser's share percentage[95]× revenue sharing percentage × revenue of the issuer generated during the corresponding period.

To further clarify how an RSN works, assume an investor invested $2000 in a RSN offering, and the offering raised $200,000 in total. The investment multiple is 2, and the hypothetical revenue sharing percentage is 5%. If the investor's share percentage is 1%, then the issuer is entitled to be repaid $4,000 as of the maturity date. For this example, the maturity date is 5 years, and the payment is made quarterly.

Table 2[96]

Quarter	Revenue	×Revenue Sharing Percentage	Total payment to all investors	× Investor's percentage	Repayment to the investor

notes and revenue sharing notes. Meanwhile, the debt instrument promoted by Wefunder is also a revenue sharing note. Hence, the article considers term notes and revenue sharing notes as major forms of debt securities issued in Regulation CF offerings.

93 *See* J. Brad Bernthal, *The Evolution of Entrepreneurial Finance: A New Typology*, BYU L. REV. 773, 791 (2018).

94 *The Mechanics of the Revenue Sharing Note*, MAINVEST (Aug. 12, 2020), https://mainvest.com/blog/the-mechanics-of-the-revenue-sharing-note. The investment contract provided by MainVest defines the sharing start date as the day when the issuer has revenue greater than 1 dollar, and the first payment day as some point in time after the sharing start date. In other words, the RSN would be repaid only after an issuer has revenue.

95 The purchaser's share percentage refers to the ratio of the investor's purchase amount compared to the total amount raised.

96 The whole case is hypothetical.

1	0	5%	0	1%	0
2	$200,000	5%	$10,000	1%	$100
3	$ 400,000	5%	$20,000	1%	$200
4	$ 500,000	5%	$25,000	1%	$250
5	$800,000	5%	$40,000	1%	$400

If the investor receives $2,000 before the maturity date of the RSN, then the issuer's obligation of repayment will be terminated. Conversely, if the investor receives an amount less than $2,000 on the maturity date, then the issuer owes the investor the amount of $2,000 less the amount already paid to the investor.

The advantage of RSN, as touted by MainVest, is to align the incentives of both investors and an issuer to generate more revenues for the issuer[97] The disadvantage is that the amount of repayment to investors is correlated with the issuer's revenue, it could fluctuate, and is unpredictable in some situations such as in the Covid-19 pandemic era.

The following table summarizes the terms of 40 offerings in-progress on MainVest.[98]

[97] MAINVEST, *supra* at note 94.
[98] *See generally* MAINVEST, https://mainvest.com/businesses/grid (October 2020) (noting businesses raising funds on the site must provide projections of revenue and gross profit in next five years, and balance sheets, if available). Please be aware that the crowdfunding campaigns on the above-mentioned MainVest website are updated in real-time. The information presented in Table 3 only reflects the situation at the time the author accessed the website and may not reflect the current status of the campaigns.

Table 3: Summary of Terms of RSN Offerings on MainVest

Investment Multiple	1.2-2, median around 1.5-1.6. Sometimes issuers offer higher multiples to early investors. Some issuers offer lower multiples if the debts are repaid in full at a certain period ahead of maturity.
Business's Revenue Sharing Percentage	Percentage of gross revenue. The revenue sharing percentage increases simultaneously with the increase in total amount raised in the offering. Could vary drastically across offerings. As high as 6%-9.6%, as low as 0.3%-1.5% and 0.7%-1.2%, the widest range is 0.6%-6%.
Minimum Investment Amount	Typically, 100
Repayment Schedule	Quarterly
Maturity Date	4-10 years

The term note is a traditional promissory note. The term note provides an annualized interest rate, maturity date, and repayment schedule. The note issuers promise to pay back the investor's principal plus interest in full on the maturity date. As compared to variable payments to investors in the case of RSN, term note's monthly payments to investors are fixed.[99]

The following table compares the term note with the RSN.

[99] *See Securities and Security Exemptions: What is a Crowd Term Note*, REPUBLIC, https://republic.com/help/what-is-a-crowd-term-note-1; for a sample promissory term note offering, *see e.g.*, NextSeed, *Crowdfunding Offering Statement*, POKEOLOGY (Nov. 2017), https://www.sec.gov/Archives/edgar/data/1720051/000172005117000001/document1.pdf. The interest rate is 13.25% per annum, accrued monthly; term is 48 months; and the issuer would make monthly payments of principal and interest during the Term.

Table 4: Comparison of Term Note and RSN

Type of Notes	Return on Investment	Payments	Benefits	Downsides
Term Note	Annualized Interest Rate	Fixed, paid monthly	Consistent and predictable payments with a stated interest rate.	If the issuer pays back the principal in full early, then the investor loses a portion of expected interest.
Revenue Sharing Note	A multiple on the investment principal.	Varied. The amount varies based on the issuer's revenue generated. Payments can be made monthly, quarterly, even yearly.	If the issuer does well, the investor will be paid back ahead of the repayment schedule and thus earn a higher return.	Some issuers offer a lower multiple if they pay back in full early. The investor will not be repaid until the issuer generates revenue.

3. Convertible Notes

Though the popularity of convertible notes lags far behind the common stock, debts, and SAFEs in Regulation CF offerings, it is still worth mentioning as it not only competes with the preferred stock for the fourth most-issued securities under Regulation CF, but also is the foundation of the SAFE.

A convertible note is a note that will convert into equity stock when stated conversion events take place. As a note on its face, convertible notes also bear a maturity date and interest rate. However, nonconvertible promissory notes will pay back investors by cash in compliance with a stated repayment schedule, as illustrated in the prior subsection. In contrast, the accrued but unpaid interest of convertible notes will also be converted into equity stock together with investors' principals.

One of the most outstanding terms in the convertible note contracts is the conversion price cap. If investors invest in a company by purchasing notes and then find the company's valuation soars later, they could regret their decisions to invest in notes instead of equity. This is because they may lose an opportunity to generate coveted returns, and subsequently participating in the company's next rounds of equity financing will be costly. To address this problem, the "conversion price cap", which will give advantages to convertible noteholders of a company over equity investors of later rounds of equity financing with respect to the price of equity stock issued, was invented.[100] If a conversion price cap applies in the conversion of convertible notes into equity securities, the conversion price could be substantially lower than the price of the equity securities.

The most widely used mechanism of the "conversion price cap" is the conversion discount.[101] The conversion discount gives convertible noteholders a discount on the price of the equity stock issued in the next financing when a conversion occurs. For instance, assume a discount is 20%, the price of the preferred stock issued in next equity financing, say Series A, is $1 per share, and a $1,000 convertible note converts into the Series A preferred stock, the price of the stock that the convertible note investor will receive is $1x (1-20%) =$0.8. In this instance, the $0.8 conversion price is $0.2 lower than the price of the Series A preferred. At the conversion price, the number of shares of the Series A preferred that the convertible note investor will receive is $1,000/$0.8=1250. On the other hand, an investor of Series A who pays $1,000 for the preferred stock issued will only receive 1000 shares. Thus, for the discount, the holder of the $1,000 convertible note will receive 250 shares or 25% more than a $ 1,000 preferred stockholder. The premium of 250 shares or 25% ownership is the return for convertible note investors under a 20% discount.

The post-conversion amount that a convertible note investor can receive under a discount can be formulated as follows:

$$Post - ConversionAmount = \big(1/(1 - Discount)\big) * NotePurchaseAmount$$

The valuation cap is also common as a conversion price cap. It puts a ceiling on the pre-money valuation[102] of the issuer for convertible noteholders.

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100 *See* Coyle & Green, *supra* note 87, at 163.

101 *See Convertible Debt Terms-Survey of Market Trends (2019/2020,* FENWICK https://assets.fenwick.com/documents/Convertible-Debt-2020.pdf. (Fenwick surveyed over 100 convertible notes offering during January 2019 to March 2020 and found 82% percent of convertible notes issued in seed financing [Fenwick called it "First Money"] contained a discount. Of all the discounts set, the median is 20%.)

102 Pre-money valuation is defined as the valuation of the issuer immediately prior to the injection of money from the first equity financing.

When conversion occurs, convertible noteholders are entitled to convert their notes at the valuation cap, instead of the actual valuation of the issuer at the time of conversion. Although the application of a valuation cap will be discussed in the following At Ease Rentals Corp. Convertible Notes Offering case study, the post-conversion amount that a convertible note investor can receive under a valuation cap can be formulated as follows:

$$Post - Conversion\ Amount = \left(\frac{Actual\ Valuation\ at\ Conversion}{Valuation\ CAP}\right) * Note\ Purchase\ Amount$$

A valuation cap often appears in a convertible note agreement in partnership with a discount but is seldom a standalone provision.[103] Notably, a discount and a valuation cap cannot be applied simultaneously. Investors should choose one they deem more desirable when the conversion of the notes occurs.[104]

A few convertible note agreements also include a Most Favored Nation (MFN) provision. Under this provision, if the company subsequently issues convertible notes with terms superior to the previously issued convertible notes, the previous convertible noteholders can elect to exchange their notes for subsequent notes with superior terms.[105]

The conversion provisions are also crucial. A popular convertible note template on the marketplace is the debt version of Keep It Simple Security (KISS) documents devised by 500 Startups, a startup accelerator based in San Francisco.[106] The examination of conversion provisions of convertible notes will be based on the KISS convertible note template.

Both a discount and a pre-money valuation cap are in place in the KISS convertible note. The KISS convertible note will convert into preferred stock when the company raises no less than $1 million in the next round of equity financing selling preferred stock. By default, the converted preferred stock would be the same series as the preferred stock issued in next equity financing, but at the option of the

103 FENWICK, *supra* note 101, at 4.

104 *See* Susan J. Chaplinsky and Joseph M. Becker, *Convertible Notes: A Form of Early-Stage Financing*, DARDEN BUSINESS PUBLISHING, Dec. 13, 2019, at 3.

105 *See* Elements of Convertible Instruments, HOLLOWAY (last updated Sep. 13, 2022), https://www.holloway.com/g/venture-capital/sections/elements-of-convertible-instruments?sn=%23most-favored-nation.

106 *See* the convertible note version of KISS, KISS, https://500startups.app.box.com/s/8ybxx9y3bhk4mte50v7k (last visited Feb. 19, 2023). KISS is devised by 500 Startups in partnership with Cooley, a prestigious law firm based in Silicon Valley specializing in startup financing. The KISS convertible note is used by some funding portals as the default convertible note template, such as SeedInvest; *see SeedInvest adopts 500 Startups KISS Convertible Note*, SEEDINVESt (Sep. 9, 2016), https://www.seedinvest.com/blog/raise/500-startups-kiss-convertible-note.

company it could also be a separate "shadow" series of preferred stock.[107] The shadow series has nearly all the same rights as the series issued in the next equity financing, except the liquidation preference per share of the shadow series equals the conversion price.[108]

The intent of issuing the shadow series is to eliminate the liquidation preference premium that the provisions of discount and valuation cap could create. As illustrated earlier, the application of the discount enables convertible holders to receive more shares of preferred stock than investors of subsequent equity financing. Assume a liquidation preference, structured as a liquidation multiple such as one time the price of the preferred stock. In this scenario, suppose a convertible noteholder with a $1,000 note and a 20% discount converts the note into the same series of preferred stock that will be issued in the next financing round. Consequently, the noteholder would have a liquidation preference of $1,250. (First, calculate the price of the preferred stock with the 20% discount: $1,000 ÷ (1 - 20%) = $1,250; then, apply the liquidation preference multiple of one time the price of the preferred stock to calculate the liquidation preference: 1 x $1,250 = $1,250.) The consequence would give the noteholder two premiums over a $1,000 preferred stockholder: the stock ownership premium – 250 more shares than the preferred stockholder; and the liquidation preference premium – an extra $250 in liquidation. If the note converts into the shadow series whose liquidation preference equals the conversion price, here the discount price ($0.8 per share), after conversion the holder of 1,250 shares of shadow series would have a liquidation preference equal to that of the holder of 1,000 shares of preferred stock issued in next financing.

If a corporation transaction occurs prior to the conversion of the notes,[109] such as the company is acquired prior to conversion of the notes, convertible holders can select to receive either (1) all accrued and unpaid interest due plus twice the purchase price of the notes; or (2) the company's common stock at the cap, i.e., at the conversion price calculated as dividing the valuation cap by the numbers of all shares of common stock on a fully-diluted basis.[110]

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[107] KISS, *supra* note 106, at section 1(h).

[108] KISS, *supra* note 106, at section 1(q). In addition to the liquidation preference, price-based anti-dilution protection and dividend rights are also adjusted in accordance with the conversion price. The conversion price here is defined as the lesser of applying the discount or the valuation cap, and the conversion amount equals the purchase amount of the notes plus accrued unpaid interest.

[109] The corporate transition defined in KISS convertible note equals "change of control" and "dissolution events" in other alike agreements. The corporate transaction here includes a merger, consolidation, sale of all or substantially all of assets ("change of control"), liquidation, winding-up, and dissolution ("dissolution events").

[110] *See*, *supra* note 106, at section 1(h).

If the note matures but still does not convert or is not paid in a corporate transaction, then the bondholders of the majority interest can elect to convert the accrued unpaid interest plus the purchase amount into a newly created Series Seed preferred stock at the cap in pursuance to the terms and provisions contained in the most recent Series Seed documents.[111]

The KISS convertible note also includes an MFN provision. Meanwhile, a major investor, defined as an investor who invests $50,000 or more in the offering, is entitled to access financial statements of the issuer (information rights), and invest in next equity financing on the same terms and at the same price with other investors up to his or her purchase amount of the notes (participation rights).[112]

In sum, the KISS convertible note is very friendly to investors. It provides participation rights and information rights to a major investor, and an MFN provision. It also provides both a discount and valuation cap. But more crucial is it provides specific protections to investors in the event of acquisition of the company and similar substantial transactions, especially liquidation and dissolution of the company prior to conversion. In such events, investors can select to be paid back as much as interest plus twice their principals, or to receive common stock of the company in anticipation of pro-rata shares of proceeds resulting from the transaction. This protection on substantial corporate transactions gives investors a chance of large return if the company is to be acquired for a good price, or a liquidation preference if the company is to be liquidated. Similarly, on maturity, the KISS notes can convert into a series of preferred stock, which could also give investors desirable future returns. Above all, as the terms in the KISS convertible note are comprehensive, investors and issuers can negotiate their agreements based on modifying the standard KISS terms, such as removing the MFN provision.

In addition to the KISS standard convertible note, a variant named "Crowd Note" is also adopted by some crowdfunding platforms. The crowd note is virtually a convertible note in nearly all aspects, except the crowd note contains no maturity date and automatic conversion provisions.[113] For no automatic conversion provision in place, the benefit is claimed to keep issuers' cap table "clean",[114] and help founders of the crowd note issuers dispense with obligations to a large number of shareholders, such as provide information to and keep records of numerous shareholders.[115]

Let us see how a discount and valuation cap work in a real-world offering of convertible notes.

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[111] *Supra* note 106, at section 1(iii).

[112] *See supra* note 106, at section 5.2.

[113] Bill Clark, *Crowd Note vs. Convertible Note: What's the Difference?*, MICROVENTURES BLOG (Feb. 22, 2019), https://microventures.com/crowd-note-vs-convertible-note-whats-the-difference.

[114] *Id.*

[115] *Id.*

A Case Study: At Ease Rentals Corp. Convertible Notes Offering[116]
Summary of Terms

Offering Amount (principal)	Minimum $120,000 Maximum $500,000
Interest Rate	6%
Maturity	36 months
Discount	20%
Valuation Cap	$5,000,000 pre-money valuation
MFN	No

First let us use the case to illustrate how a discount and valuation cap work.

Assume the corporation raises $500,000 in the convertible notes offering. For the sake of simplicity, accrued interest will be omitted in our discussion.

Under the 20% discount, if the corporation issues equity stock at $1 per share, then each convertible noteholder will receive the equity stock issued at $1× (1-20%) =$0.8 per share. Then the $500,000 collectively paid by all convertible noteholders will convert into $500,000/$0.8=625,000 shares of equity stock, 1.25 times the shares that subsequent equity investors will receive.

Then we discuss how the $5,000,000 pre-money valuation cap works. If the corporation is valued at $10,000,000 in the next financing event and offers equity shares at $1 apiece, then under the valuation cap, the convertible noteholder would convert into equity shares as if the corporation is valued at $5,000,000. In this case, the convertible noteholders can own $500,000/$5,000,000=10% of the corporation's equity stock after conversion or receive equity stock at the price of $0.5 per share.

In the above situation, a valuation cap yields more return than a discount, as $0.5 is lower than $0.8. if the corporation's pre-money valuation is $8,000,000, then the price of equity under the discount and valuation cap is the same at $0.8. However, if the corporation's pre-money valuation in the next round of financing is below $5,000,000, say $4,000,000, converting the $500,000 notes only amounts to $400,000 in the following equity stock, meaning the stock price is $1.25 per

116 *See At Ease Rentals Corp. Convertible Promissory Note, Series 2020*, SEC, https://www.sec.gov/Archives/edgar/data/1808653/000180865320000001/doc2.pdf. At Ease Rentals Corp. provides an online leasing platform. It filed Form C with the SEC in June 2020. The offering memorandum of convertible note is appendix 2 to the Form C.

share for noteholders. In this situation, the discount is more favorable to noteholders, and the convertible noteholders will not select to convert their notes at the cap.

Noteworthy is that the issuer provides that in a non-qualified equity financing, which means the amount raised in an equity financing below the stated threshold of a qualified financing, the company can at its discretion issue a shadow series of equity stock to noteholders. The shadow series has no contractual voting rights, inspecting rights or information rights. Meanwhile, the legally vested voting rights will be granted to the funding portal through a voting proxy agreement. The liquidation preference of the shadow series is also based on the conversion price. This optional conversion provision gives noteholders a choice to convert their notes in the event of a non-qualified equity financing.

4. SAFE

In light of Table 1, the SAFE has consistently been one of the most popular types of securities issued in Regulation CF offerings and became the most-issued security among such offerings in the third quarter of 2020. SAFE was invented by Y Combinator ("YC"), a reputable startup accelerator, in 2013.[117]

As YC announced that the SAFE was much simpler than the convertible note, the greatest distinction between these two instruments is that the SAFE does not have the terms of interest rate and maturity date. Hence, interest will not accrue under a SAFE agreement. In contrast, the valuation cap and discount remain in SAFE contracts. In sum, it removes convertible note's characteristics of debts, and keeps the rest.

SAFE does not fit the equity/debt dichotomy. It has no two crucial hallmarks that debt securities have: maturity date and an interest rate. Also, unlike equity securities, it does not grant investors voting rights and rights to receive dividends. Thus, some legal scholars define the SAFE as an equity derivative contract.[118]

YC provides four versions of SAFE templates – SAFE with Valuation Cap, no Discount; SAFE with Discount, no Valuation Cap; SAFE with Valuation Cap and Discount; and Safe with MFN, no Valuation Cap or Discount.[119] As their

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[117] *See* John F. Coyle and Joseph Green, *Contractual Innovation in Venture Capital,* 66 HASTINGS L.J. 133, 168-171 (2014), for a good account of how Y Combinator SAFE contract was invented.

[118] *See* John F. Coyle and Joseph Green, *The SAFE, the KISS, and the Note: A Survey of Startup Seed Financing Contracts,* 103 MINN. L. REV. HEADNOTES 42, 46 (2018) ("The SAFE is best conceptualized as an equity derivative contract by which the investor commits capital to the company today in exchange for the right to receive stock in the company in a future financing if certain contractual conditions are met.").

[119] Carolynn Levy, *Safe Financing Documents,* Y COMBINATOR (2022),

names suggest, their distinctions are the selection and combination of the provisions of valuation cap, discount, and the MFN.

The discount provision in YC SAFEs functions similarly to its counterpart in convertible notes. The MFN is somewhat different. Under the MFN provision in the corresponding YC SAFE template, if the company issues any subsequent convertible securities with terms that investors deem preferable to their SAFEs, these investors can elect to amend their SAFEs to be identical to those preferable subsequent convertible securities.[120] Subsequent convertible securities include, for instance, other SAFEs, convertible debt instruments and other convertible securities.[121] As such, if the company issues convertible notes with better terms than previous SAFEs, SAFE holders are also entitled to enjoy the better terms on newly issued convertible notes.

The valuation cap is considered by some funding platforms to be the most important term in SAFE agreements.[122] Different from the pre-money valuation cap in convertible notes, the valuation cap in SAFEs puts a cap on the post-money valuation of the cap.[123] YC defines "post-money" in SAFEs as the period after (post) all the SAFE money is accounted for but before (pre) the new money in next round that offers equity, converts, and dilutes the SAFEs.[124]

The initial SAFE contracts designed by YC provided a pre-money valuation. YC explained that when SAFE was invented, the funding amounts raised by SAFEs had been much smaller. In response to a changing situation that funding amounts in financing using SAFEs were growing larger, YC redesigned the post-SAFE-money SAFE. YC argues that this cap provides both investors and founders a huge advantage – "the ability to calculate immediately and precisely how much ownership of the company has been sold."[125] Thus, founders could promptly know how much the dilution is caused to their common stock as soon as investors know how much ownership they have purchased.[126]

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https://www.ycombinator.com/documents/.

120 *Post-money Safe – MFN Only*, Y COMBINATOR 1, 3 https://www.ycombinator.com/assets/ycdc/Postmoney%20Safe%20-%20MFN%20Only%20-%20FINAL2bc87fa3d2ec5072a60d653aec9a885fb43879781e44341fa720a8e7d1cc42ff.docx (last visited February 2023).

121 *Id.* at 2.

122 *Valuation Cap,* WEFUNDER, https://help.wefunder.com/deal-terms/295252-valuation-cap (states that "the Valuation Cap is the most important term of a convertible note or a SAFE"); *see also* WEFUNDER, *infra* note 176, at 3 (comment on the SEC's proposed rule on Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets that "[t]he valuation cap is the most important term").

123 *Post-money Valuation Cap,* Y COMBINATOR https://www.ycombinator.com/assets/ycdc/POstmoney%20Safe%20-%20Valuation%20Cap%20Only%20-%20FINALf2a64add6d21039ab347ee2e7194141a4239e364ffed54bad0fe9cf623bf1691.docx (last visited February 2023)

124 Levy, *supra* note 119.

125 *Id.*

126 The equation for the relation of pre-money valuation and post-money valuation is post-

In addition to the valuation cap, terms in relation to conversion and liquidation also differ significantly from those in convertible notes.

A YC SAFE will automatically convert into a separate series of preferred stock, named "SAFE Preferred Stock" when the company conducts "equity financing". The SAFE preferred stock in large part has rights identical to those in the preferred stock issued to new investors, except the liquidation preference, price-based anti-dilution protection and dividend rights of SAFE preferred stock are based on the conversion price,[127] rather than the price of newly issued preferred stock. In essence, the SAFE preferred stock is the equivalent of the shadow series preferred stock in the KISS note.

Noteworthy is that all YC SAFE templates define the "equity financing" as financing transactions issuing and selling preferred stock.[128] To clarify, if the company issues common stock, which is also a kind of equity security, a YC SAFE will not convert into preferred stock, as an offering of common stock does not qualify as a transaction of equity financing under the above-mentioned equity financing term in the YC SAFE. Of note, the YC SAFE's definition of equity financing is identical to that of corresponding terms in the KISS note.

In a liquidity event (defined as an IPO, a direct listing and a change-of-control such as an acquisition), YC SAFE holders are entitled to receive the greater of their purchase amount of these SAFEs (cash-out amount) or the amount in portion to shares of common stock as if their SAFEs convert into common stock at the price equal to the valuation cap divided by all common stock outstanding (conversion amount)[129] Therefore, if an IPO or an acquisition happens, unable to

money valuation = pre-money valuation + new cash raised. The post-money valuation cap imposes a cap on the valuation of the issuer in the wake of its sale of SAFEs. For instance, assume the post-money cap of a SAFE issuer is $10 million, if the issuer sells SAFEs for $1 million, it sells 10% ($1m/$10m) of its ownership to SAFE purchasers. Later the post-money valuation cap of the issuer becomes $15 million, and the issuer raises another $1 million in the form of SAFEs, then it sells 6.67% (1m/15m) of its ownership in this offering. YC argues in the case of post-money cap the calculation of ownership sold is clearer and easier than using pre-money cap. A pre-money valuation cap imposes a cap on the valuation of the issuer prior to an equity financing. For instance, in such a case, as new money comes in, the pre-money valuation of the issuer will change accordingly, consequently the earlier- and later-issued SAFEs will dilute each other. For YC′s introduction to the post-money valuation cap, *see generally* Prime for post-money safe version 1.1 (https://www.ycombinator.com/assets/ycdc/Primer%(20for%20post-money%20safe%20v1.12af8129e12efffd963eeab383b7309142c84f415e5cdb0bc210d573f779177a1c.pdf). For a brief account of the distinction between a pre-money valuation cap and YC′s post-money valuation cap*, see generally Post-money Safe User Guide*, Y COMBINATOR https://www.natlawreview.com/article/seed-funding-basics (last visited February 2023).

127 *Post-money valuation cap*, *supra* note 123, at 1-4.

128 *Id.* at 2-4.

129 *Id.* at 1-3 (all common stock outstanding here includes preferred stock and convertibles calculated on an as-converted to common stock basis).

convert their SAFEs into common stock, SAFE holders can only receive cash. Further, in a dissolution event, such as liquidation, SAFE investors can only receive the purchase amounts.

The YC SAFE template provides that the liquidation priority of a SAFE is the same as non-participating preferred stock.[130] If SAFE holders elect to receive the cash-out amount, the payments are junior to payments to debt instruments, on par with payments to other SAFEs and preferred stock, and senior to payments to common stock. If SAFE holders elect to receive the conversion amount, the payments are junior to those to debt instruments, and on par with payments to common stock and other SAFEs and preferred stock on an as-converted-to-common-stock basis.[131]

The YC SAFE deviates from the KISS note in terms of conversion and liquidation. The conversion of the KISS note into the shadow series will only occur when the company elects to do so. In contrast, the YC SAFE will convert automatically into the SAFE preferred stock. Further, when an acquisition or liquidation of the company happens, YC SAFE holders cannot convert their SAFEs into common stock prior to the acquisition or liquidation. Instead, they can only receive cash. If these holders select to receive the cash-out amount, they are only paid back the purchase amount of the SAFEs. In contrast, in the event of acquisition or liquidation of the company, the KISS noteholders can either convert their notes into common stock, or a cash payment equal to unpaid interest plus twice the purchase amount of their notes. Apparently, the term of cash payments to KISS noteholders is much more generous than the cash-out amount to YC SAFE holders. Meanwhile, if the company is to be acquired in a stock-for-stock acquisition, after KISS noteholders convert their notes into common stock of the company prior to the acquisition, such KISS noteholders will become common stockholders of the acquirer. This result gives KISS noteholders a possibility of significant future returns if the stock price of the acquirer goes up.

In addition to the prevalent YC SAFEs, there are two variants of SAFEs that are widely used in Regulation CF offerings.

The first variant a crowd SAFE designed by Republic, a leading funding portal focusing predominantly on SAFE offerings.

A Republic crowd SAFE differs from the original YC SAFE in many respects. First, the crowd SAFE allows securities issued in an equity financing event to be common stock and preferred stock. Thus, a crowd SAFE is convertible when the company issues common stock in the next equity financing.[132] Second, even when an equity financing or a series of equity financings happens, issuers of

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130 *Id.* at 2.
131 *Id.*
132 *See Republic Crowd SAFE example template for C Corp with discount and valuation cap*, 3-4, https://republic.co/crowdsafe/download/cap_and_discount_c_corp (last visited February 2023)

crowd SAFEs can elect to convert crowd SAFEs into a shadow series of preferred stock or extend the conversion beyond all rounds of equity financings to avoid conversion until a liquidity event happens.[133] In a liquidity event, such as an acquisition or an IPO, holders of crowd SAFEs can choose to receive either the purchase amount or convert their SAFEs into shares of common stocks or preferred stocks if issued by the company.[134] Third, the holders of the converted shadow series will have no contractual voting and information rights and should enter into a voting proxy agreement with Republic under which Republic is authorized to exercise shadow series stockholders' legally vested voting rights.[135]

Republic expressly states its crowd SAFE is "super founder-friendly".[136] Under its terms, the conversion of a crowd SAFE into common or preferred stock could happen as late as an IPO or when an acquisition of the SAFE issuer takes place. Republic explains the intent of such a conversion provision is to address the "messy cap table" problem.[137] A cap table is a list of a company's securities and their holders.[138] If an offering of SAFEs involves numerous investors, then a long list of holders of SAFEs will appear on the issuer's cap table, making the issuer's cap table look messy.

A messy cap table could cause both legal and practical issues. Section 12(g) of the Exchange Act requires an issuer with total assets exceeding $10 million and a class of securities held by either 2,000 holders, or 500 non-accredited investors, to register that class of securities with the SEC.[139] Regulation CF exempts a crowdfunding issuer with total assets at the end of its last fiscal year of $25 million or less from the Section 12(g) registration requirement.[140] Put differently, if a company with total assets of more than $25 million issues a class of SAFEs to more than 500 non-accredited investors, then the issuer shall register the class of SAFEs with SEC. This could impose significant costs on a startup. Meanwhile, as a matter of practice, venture capitalists and late-stage investors could feel negative when they see a messy cap table consisting of numerous small investors.

By delaying the conversion of SAFEs to an IPO or an acquisition, the Republic crowd SAFE allows all SAFE investors to appear on a cap table collectively as one line item[141] as SAFE investors are not stockholders and have no

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133 *Id.* at 2
134 *Id.* at 2-3.
135 *Id.* at 3-4.
136 *See The Crowd SAFE*, REPUBLIC, https://republic.co/crowdsafe#:~:text=Crowd%20SAFE%20is%20an%20investment,to%20achieve%20their%20growth%20milestones (last visited February 2023)
137 *Id.*
138 *See* Noah Pittard, *Choosing the Right Cap Table Platform*, COOLEYGO (Dec. 6, 2021), https://www.cooleygo.com/what-is-a-cap-table/.
139 15 U.S.C. § 78l(g).
140 17 C.F.R. § 240.12g-6 (2021).
141 *See* REPUBLIC, *supra* note 136.

ownership of the issuer before conversion. In doing so, the crowd SAFE resolves the problem that venture capitalists disfavor a messy cap table full of small SAFE investors. However, all Crowd SAFE investors still count towards the Section 12(g) threshold.[142]

The Second variation is the Wefunder SAFE. Wefunder in fact uses the templates of YC SAFEs as its default SAFE agreements.[143] But Wefunder has adopted the lead investor mechanism since May 2020. A lead investor enjoys broad authority, especially exercising voting rights on behalf of all SAFE investors.[144] As such, Wefunder adjusted provisions of the standard YC SAFE to accommodate the authority of the lead investor.

All SAFEs sold on Wefunder are beneficially owned by XX Investments LLC, a SEC-registered transfer agent serving as a custodian, instead of being held by individual investors. This setting allows the XX Investment LLC to appear on the issuer's cap table as one line item and does not count toward the Section 12(g) threshold.[145]

The Wefunder SAFE will grant voting rights to the custodian, and the custodian's exercise of voting rights is directed by the lead investor. It is the lead investor who ultimately votes on behalf of all Wefunder SAFE investors. Meanwhile, terms of the Wefunder SAFE can be amended by one lead investor, except the valuation cap.[146] A lead investor's compensation correlates to the performance of the issuer. Investors are required to contribute 10% of the profits they receive from the issuer.[147]

In addition to the terms relating to the lead investor, the Wefunder SAFE also has some other unique terms. It allows the issuer to repurchase a minor investor's SAFE at any time prior to conversion. This repurchase by the issuer is

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[142] *See How are SPVs different than the Crowd SAFE?*, WEFUNDER, https://help.wefunder.com/spvs-custodians-founders/spv-versus-crowd-safe?from_search=1105333520 ("With a Crowd SAFE, all of your investors - even if they have not converted their SAFE to own equity - still count towards the 12(g) threshold") (last visited Feb. 19, 2023).

[143] *See Founders FAQ*, WEFUNDER, https://help.wefunder.com/#/terms-and-contracts. ("Wefunder offers the Y Combinator SAFEs as part of our default contracts you can use out of the box, modified only to allow unaccredited investors.") (last visited Feb. 19, 2023).

[144] *See Lead Investor,* WEFUNDER, https://help.wefunder.com/basic-jargon/lead-investor?from_search=111180929 (last visited Feb. 19, 2023); 17 CFR § 227.201(m), *infra* note 176. "Wefunder rolled out the concept of a Lead Investor in May 2020" and "Appendix A: Wefunder's current solution using a custodian and lead investors."

[145] WEFUNDER, *Supra* note 142.

[146] *See Wefunder Crowdfunding SAFE,* WEFUNDER, https://wefunder.com/faq/securities ("The company can designate a Lead Investor Representative, and all investors agree to allow that person to unilaterally amend the SAFE. But that person may not change the Valuation Cap.")

[147] *See* 17 CFR § 227.201(m), *infra* note at 9. "investors on Wefunder are now told they will be charged 10% of their profits in the future if the SEC deems such payments permissible…"

to reduce the mess on the issuer's cap table. Meanwhile, once such SAFEs convert into equity, the resulting shareholders should grant the company's current CEO the power of attorney to vote all shares on their behalf. This provision is to centralize voting rights and accelerate the process of future next financing rounds, [148] however, it effectively deprives shareholders, converted from prior safeholders, of their voting power.

Attitudes toward SAFE bifurcate significantly among crowdfunding platforms. StartEngine unambiguously expressed its aversion to the SAFE. In a blog post,[149] its CEO, Howard Marks put forward reasons why SAFE is unsafe for crowdfunding investors[150] Marks was amazed at some other platforms on which nearly half of the crowdfunding fundraisers had issued SAFE, and touted 68% of crowdfunding offerings on StartEngine had issued stock[151] In a stark contrast to

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148 *Wefunder Crowdfunding SAFE, supra* note 146 ("Once the SAFE converts into equity, investors … grant the current CEO a power of attorney to vote all shares and execute any documents on their behalf. This mitigates the potential problem of hundreds of minor shareholders slowing down further follow-on financings.")

149 *See* Howard Marks, *Are SAFE Notes Not Safe for the General Public?*, (March 16, 2020) https://www.startengine.com/blog/are-safe-notes-not-safe-for-the-general-public/, At that time, StartEngine did not allow SAFE offerings to be launched on its platform. *See* StartEngine (@StartEngine), FACEBOOK (Mar. 16, 2020), https://www.facebook.com/StartEngineLA/posts/the-sec-recently-proposed-banning-safes-in-regulation-crowdfunding-in-a-new-blog/3075424452520974/ (quoting Howard Marks' above blog post); Howard Marks also tweeted about why he wrote such a blog post, *see* Howard Marks (@howardmarks), TWITTER (Mar. 16, 2020, 11:42 AM), https://twitter.com/howardmarks/status/1239623149630570496; *see* also Caleb Naysmith, *Why I mainly invest in Startups through StartEngine* (Mar. 21, 2021), https://medium.datadriveninvestor.com/why-i-only-invest-in-startups-through-startengine-8a2049059c36. Not only does StartEngine not sell SAFE notes, but they have also spoken out about how they are potentially unsafe", citing the above Howard Marks' blog post. However, Howard Marks deleted his blog post arguing SAFE contracts are not safe for the general public, and posted a new blog post stating that SAFE contracts are needed to be modified to protect retail investors, especially on transparency and conversion. *See* Howard Marks, *SAFE Agreements: What They Mean for Investors & How They Could Work for Equity Crowdfunding* (Sept. 23, 2022), https://www.startengine.com/blog/safe-agreements-what-they-mean-for-investors-how-they-could-work-for-equity-crowdfunding/. Meanwhile, investors are still not be able to purchase SAFEs on StartEngine, *see What types of securities can I buy on StartEngine?* (June 24, 2022 1:08pm), https://help.startengine.com/en_us/what-do-i-get-when-i-submit-an-investment-S12R6uCMK.

150 *Are SAFE Notes Not Safe for the General Public?*, *supra* note 149. These reasons include: (1) as the conversion of SAFE into equity securities depends on another funding round of the issuer, in fact the change of next funding round is very rare, thus the conversion of SAFE is uncertain; (2) SAFE holders have no claim to the payment of dividend as equity security holders generally have; (3) SAFE holders have no voting rights in the ventures they invest in; (4) SAFEs have little liquidity in secondary market. As securities issued under Regulation CF are allowed to trade after one year of issuance, SAFEs, if not converted, are hard to value and thus have little liquidity in the secondary market.

151 *Id.*

StartEngine, Republic announces that in a crowdfunding offering on that site, investors typically receive a Crowd SAFE security.[152] It seems StartEngine and Republic are at two opposite extremes in the treatment of the SAFE.

Wefunder, the rest of the "big three" crowdfunding platforms, adopts a centrist attitude to the use of the SAFE. Wefunder provides templates of convertible notes, SAFE[153] and Revenue Share notes.[154] For the applicability of each investment contract, Wefunder recommends early-stage technology startups having a reasonable chance of being funded by venture capital funds adopt a convertible note or a SAFE, while early-stage brick and mortar businesses with expected positive cash flow use a revenue share contract.[155]

C. Is the SAFE Truly Safe?

After Y Combinator invented SAFE and touted its standardization, the use of SAFE quickly gained traction in the West Coast and in seed financing for technology startups,[156] while it has little recognition in the broader ambit of financing for American startups and seed companies.[157] As such, some literature argues that SAFE is designed for startups in the technological area that have access to venture capital funds and a high possibility of next equity financing. In contrast, the SAFE may not be the best form of securities to use in crowdfunding offerings for non-tech companies.[158]

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[152] See *Understanding Deal Terms*, REPUBLIC, https://republic.co/learn/investors/what-the-deal-terms-mean ("When you invest on Republic, you typically receive a Crowd SAFE security.") (last visited Feb. 19, 2023).

[153] The templates of SAFEs provided by Wefunder are directly drawn from Y Combinator, *see Who should use a SAFE? How does it work?*, WEFUNDER, https://help.wefunder.com/terms-and-contracts/304897-wefunder-safe ("Wefunder offers the Y Combinator SAFEs as part of our default contracts you can use out of the box.") (last visited Feb. 19, 2023).

[154] Wefunder defines its revenue share contract as a promissory note under which a repayment amount, typically 1.5 times to 3 times the amount investors invest in the offering, will be paid back to investors. *See Investor FAQ*, WEFUNDER, https://help.wefunder.com/#/contracts/304788-loans-promissory-notes (last visited Feb. 19, 2023).

[155] *See How do I choose the contract and set the terms?*, WEFUNDER, https://help.wefunder.com/terms-and-contracts/298029-which-investment-contract-should-i-use (last visited Feb. 19, 2023).

[156] According to a report by AngelList, nearly 80% of the early-stage financing on AngelList in the period of Jan-July 2019 was done through SAFEs. *See* Abe Othman, *For Seed Funding, SAFEs Have Won Against Convertible Notes*, ANGELLIST (Aug. 21, 2019), https://angel.co/blog/for-seed-funding-safes-have-won-against-convertible-notes (AngelList is a San-Francisco based website funneling funds from accredited investors to startups and venture funds).

[157] *See Angel Funders Report*, ANGEL CAPITAL ASSOCIATION (2019), https://www.angelcapitalassociation.org/angel-funders-report/ (According to the 2019 Angel Funders Report, of all angels investing deals across the U.S. and Canada, 44% used convertible notes, in contrast, only 1.6% opted for SAFEs.)

[158] *See* Joseph Green and & John F. Coyle, *Crowdfunding and the Not-So-Safe SAFE*, 102

One risk surrounding the SAFE is as SAFE is a convertible security, the board of directors of the company issuing the SAFE does not owe fiduciaries duties to SAFE holders. Delaware courts have long held that the obligations of issuers of convertible securities to convertible holders are prescribed by terms of the agreements under which the convertibles are issued. Hence, until convertibles are converted into common stock, convertible issuers do not owe a fiduciary duty to convertible holders, as corporations only owe a fiduciary duty to holders of their equitable interest, i.e., stockholders, especially common stockholders.[159] In this light, to realize their conversion rights, SAFE holders rely on issuers' bona fide implementation of the SAFE agreement, risking losing the protection of state corporate law. However, this jurisprudence applies to all kinds of convertibles, including convertible notes that are also offered in Regulation CF offerings. As such, the lack of protection by state corporate law is not a risk unique to SAFE holders.

The SEC has long been concerned with the risk of SAFEs in Regulation CF offerings. On May 9, 2017, the SEC issued an investment bulletin to alert potential investors interested in SAFEs to its accompanying risks.[160] The SEC cautioned that SAFE investors in fact receive no common stock, as SAFEs could only convert to actual equity upon the happening of some triggering events, such as the issuer being acquired by or merged with another company, or the issuer going public or getting funded by another round of financing involving issuing equities.[161] The SEC further stressed that a triggering event contained in a SAFE agreement could never happen.[162] For instance, if a triggering event is the company's next financing, but the company makes enough money to sustain itself and does not plan to conduct any financing, then the triggering will not happen, and SAFE holders are forced to keep holding their SAFEs with no likelihood of conversion. Another example is if a triggering event is the company issuing preferred stock in next financing, but the company issues convertible notes, more SAFEs or common stock, then the triggering event is not satisfied, and SAFEs will not convert into equity securities.

The SEC's particular caution towards SAFE is somewhat justified. As illustrated above, the SAFE inherits most of its terms from its progenitor - the convertible note. On its face, a SAFE is a convertible security as it can convert into

VA. L. REV., ONLINE 168, 174 (2016).

159 *See* Simons v. Cogan, 549 A.2d 300 (Del. 1988) (holding the issuing corporation of convertible debentures did not owe fiduciary duty to convertible debenture holders, "Before a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist. The obvious example is stock ownership.")

160 *Investor Bulletin: Be Cautious of SAFEs in Crowdfunding,* SEC (May 9, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes.

161 *Id.*

162 *Id.*

equity securities. However, as the SEC noted, the triggering events for the conversion of SAFEs can be deliberately crafted to circumvent conversion. SAFE investors in theory can be passed out of conversion until the issuer is acquired or goes public, the probability of which is supposed to be low.[163]

Some legal literature casting doubt on the safety of SAFE echoes the SEC's suspicion that the conversion of SAFEs is precarious. For instance, Greenand and Coyle highlight the risk that a non-tech company never raises additional equity capital, sells itself or goes public.[164] They argue that non-tech companies can launch products and services and generate positive cash flow after initially raising funds through issuing SAFEs under Regulation CF without the need to raise additional equity capital or sell. They also point out that since the resulting series of preferred stock after SAFE's conversion has no voting rights, as provided by the Republic Crowd SAFE and a Wefunder SAFE with a lead investor, SAFE holders have to rely on the issuer's founders to take charge of corporate affairs without any say, and more sophisticated investors, such as a lead investor in Wefunder SAFE's case, to negotiate favorable terms for themselves.[165]

In conclusion, they suggest that if an issuer intends to offer SAFE-like securities, a better option is a convertible note, as convertible notes have a maturity date and interest rate. However, in their opinion, common stock, preferred stock, and debt instruments are the most ideal types of securities that issuers should use in Regulation CF offerings.[166]

However, as mentioned earlier, common stock issued under Regulation CF in large part is non-voting common stock or common stock with a voting proxy provision under which common stockholders grant their voting rights to the issuer's CEO. Consequently, neither holders of common stock of these types nor SAFE holders have any voting rights. The greatest benefit for common stockholders in this context is that the issuer's board of directors owes fiduciary duties to common stockholders as required by state corporate law.

The most outstanding risks specific to the SAFE arise from its conversion. The conversion of YC SAFEs into preferred stock is problematic. This is because, as the YC SAFE narrowly defines "equity financing" as financing events issuing preferred stock, a YC SAFE will not convert into the stated SAFE preferred stock in any round of the issuer's subsequent financing offering of common stock.

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[163] In 2019, there were 112 private companies going public through IPOs. *See* Jay R. Ritter, *Initial Public Offerings: VC-backed IPO Statistics Through 2022*, 3, (March 8, 2023), https://site.warrington.ufl.edu/ritter/files/IPOs-VC-backed.pdf. In contrast, there were 735 campaigns raising capital using Regulation CF in 2019, Brian, 19 *US Equity Crowdfunding States – Year Review,* CROWDWISE, (Jan. 10, 2020), https://crowdwise.org/funding-portals/2019-equity-crowdfunding-stats-data/).

[164] Green & Coyle, s*upra* note 158, at 177.

[165] *Id.* at 179.

[166] *Id.* at 181-182.

The Republic crowd SAFE poses particular risks to investors. Under its term, the issuer can elect not to convert the SAFE into equity stock in any subsequent round of equity financing until the issuer goes public through an IPO or a change of control occurs.[167] It is obvious that the chance of an IPO or an acquisition is quite low. If no liquidity event happens and the issuer never converts the SAFEs into equity stock even after a round or rounds of equity financing have been consummated, the crowd SAFE investors will hold their SAFEs for an indefinite period of time.

An empirical study surveyed 750 offerings from May 2016 to May 2018 and found during that period, nearly a quarter of offerings issued SAFEs.[168] Successful SAFE offerings slightly outnumbered unsuccessful ones, and the success rate of technology companies issuing SAFEs were three times that of non-technology companies issuing SAFEs.[169] They also found larger issuers had a higher success rate in reaching their Regulation CF offering goals, and that larger issuers were more likely to issue preferred stock than SAFEs.[170] As such, the authors also suggested that SAFE could not be the ideal security in Regulation CF offerings.[171]

Even though some empirical and scholarly studies did not favor SAFEs in Regulation CF offerings, SAFEs are continuingly popular in the real world. The proponents of the SAFE in the crowdfunding industry are so strong that they even thwarted the SEC's regulatory effort to ban the use of SAFEs in offerings under Regulation CF.

In addition to the bulletin reminding investors of the risks of the SAFE, in March 2020, the SEC took one step further, attempting to ban the issuance of

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[167] In a liquidity event, Republic SAFE investors can select to receive a cash payment equal to the original purchase amount or shares of equity stock equal to the purchase price/the liquidity price if no equity financing happened prior to the liquidity event or the purchase price/the first equity financing price if one or multiple rounds of equity financing occurred prior to the liquidity event. *See* Republic Crowd SAFE example template for C Corp with discount and valuation cap, *supra* note 132. A liquidity event is defined as an IPO or a change of control transaction. A change of control includes a controlling block of the issuer being acquired, a merger or a consolidation, a sale of all or substantially all assets, etc. *See* Section 2 Definitions.

[168] Smirnova, E., Platt, K., Lei, Y. and Sanacory, F, *Pleasing the crowd: the determinants of securities crowdfunding success*, 13 REV. OF BEHAV. FIN. 165, (2021), https://doi.org/10.1108/RBF-07-2019-0096 (This article sampled closed Regulation CF offerings from May 2016 to May 2018 and tried to figure out the factors in relation to the success of a Regulation CF offering. A closed offering refers to an offering past its deadline to raise its target amount; a successful offering refers to a closed offering that met or surpassed its target offering amount. A larger issuer refers to an issuer with more assets).

[169] *Id.* at table 2 and 3 (The distinction of success rate between tech SAFE issuers and non-tech SAFE issuers is statistically significant).

[170] *Id.* at table 4 and 7.

[171] *Id.* at 16.

SAFEs in Regulation CF offerings. In its proposed rule entitled, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets,[172] the SEC proposed to ban the issuance of SAFEs in Regulation CF offerings. The SEC argued the offer and sale of SAFEs to "retail investors in an exempt offering could result in harm to investors who may face challenges in analyzing and valuing such securities, or who may be confused by the descriptions of such securities on the funding portals."[173] The SEC intended to limit the types of securities issuers can offer under Regulation CF to equity securities, debt securities, and convertibles.[174]

After the proposed rule was publicly available for comments, the SEC encountered a number of commentators who objected to their prohibition on issuing SAFEs under Regulation CF.[175] Weighing these dissenting opinions, the SEC dropped its proposal banning the use of SAFEs in crowdfunding offerings,

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[172] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital, 17 CFR Parts 227, 229, 230, 239, 240, 249, 270, and 274, Securities Act Release No. 33-10763 (proposed Mar. 31, 2020), https://www.govinfo.gov/content/pkg/FR-2020-03-31/pdf/2020-04799.pdf.

[173] *Id.* at 18801.

[174] *Id* at 18031. The SEC stated that "we are proposing to amend Regulation Crowdfunding … and to limit the types of securities that may be offered under the exemption to correspond with the eligible securities provision of Regulation A. Thus, the types of securities eligible for sale in an offering under Regulation Crowdfunding would be limited to equity securities, debt securities, and securities convertible or exchangeable to equity interests…" Thus, "Simple Agreements for Future Equity (SAFE) securities would no longer be eligible under Regulation Crowdfunding."

[175] *See* Final Rule: Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets,17 CFR Parts 227, 229, 230, 239, 240, 249, 270, and 274, Securities Act Release No. 33-10884; 34-90300; IC-34082, 184 (Nov. 2, 2020). Nearly all the dissident comments were from the crowdfunding industry, including representatives from notable crowdfunding portals, such as CEO of Wefunder, deputy general counsel of Republic, partner general counsel of Y Combinator. These comments highlighted the importance and popularity of SAFE in seed and crowdfunding financing, argued that SAFE terms were simplified so as to make ordinary investors understand them without resorting to costly legal services, and stressed that many of SAFEs issued were converted into preferred stock and that investors buying SAFEs did not care about voting rights. Letter from Wefunder to U.S SEC. Wefunder, *Re: Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets; File Number S7-05-20* (May 28, 2020), https://www.sec.gov/comments/s7-05-20/s70520-7246786-217248.pdf. Letter from Republic to U.S SEC. Republic, *Re: Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets* (June 1, 2020), https://www.sec.gov/comments/s7-05-20/s70520-7258471-217640.pdf Letter from Y Combinator to U.S SEC. Y combinator, *Re: Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets* (May 29, 2020), https://www.sec.gov/comments/s7-05-20/s70520-7254270-217568.pdf.

and instead reminded Safe issuers using Regulation CF of their disclosure obligations under 17 CFR § 227.201(m).[176]

The success of Wefunder and Republic in persuading the SEC to lift its ban on the use of the SAFE could be attributed to their positions as leading funding portals in the crowdfunding industry, as well as the significance of SAFE offerings for each platform. [177] As Republic and StartEngine have their own unreserved yet diametrically opposite preferences over SAFEs, issuers in effect select the types of securities they are inclined to offer by choosing the platform on which they will launch their campaigns. Meanwhile, investors frequenting platforms specializing in promoting SAFE offerings could also be more open to campaigns issuing SAFEs. This platform-specific preference over SAFEs complicates the task of reaching a straightforward conclusion on the effect of SAFEs in Regulation CF offerings, as the success rate of SAFE offerings could vary across platforms, let alone vary across tech-issuers and non-tech issuers.

In Y Combinator's most recent SAFE templates, an investor entering into a SAFE contract should make a representation that the investor is an accredited investor.[178] Since accredited investors are much more likely to possess more professional knowledge in investing than small investors, and learn of the risks inherent in Safes better than non-accredited investors, such representation could mitigate SAFE's risks for investors in association with its conversion as alerted by the SEC. However, this kind of representation also gives rise to a side effect that small investors are excluded from investing in companies adopting YC SAFE templates. A possible solution to this problem is for small investors to pool their money into a special purpose vehicle (SPV) satisfying the requirements of accredited investors, and collectively purchasing and hold Safes through the SPV.

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[176] 17 CFR § 227, *supra* note 175 at .201(m) mainly bears on requiring an issuer to disclose whether the security the issuer is offering has voting rights, and whether such voting rights are limited or diluted.

[177] Wefunder does not recommend SAFEs directly; however, a significant portion of the offerings on its platform were issued as SAFEs. In 2020, Wefunder offerings under Regulation CF raised approximately $70.9 million, with almost $28 million raised through SAFE offerings. On Republic, an even larger proportion of the offerings were issued as SAFEs, with over $30 million raised out of the $37.7 million total offerings under Regulation CF in 2020 (Brian, "Top 10 Equity Crowdfunding Sites – 2020" (updated as of Jan. 2021), https://crowdwise.org/funding-portals/top-10-equity-crowdfunding-sites-2020/). The amounts of SAFE offerings on the two platforms were estimated based on the graph provided in the source.

[178] *Supra,* note 123 at 4. ("The Investor is an accredited investor as such term is defined in Rule 501 of Regulation D under the Securities Act, and acknowledges and agrees that if not an accredited investor at the time of an Equity Financing, the Company may void this Safe and return the Purchase Amount."), available at: htpps://www.ycombinator.com/assets/ycdc/Postmoney%20Safe%20-%20Valuation%20Cap%20Only%20-%20FINALf2a64add6d21039ab347ee2e7194141a4239e364ffed54bad0fe9cf623bf1691.docx

SAFE's prominence is even more remarkable for crowdfunding offerings reaching or approaching the maximum $5 million raising amount. As of early July of 2022, there were 19 offerings reaching the $5 million limit under Regulation CF, 13 of which were SAFE offerings; and there were 28 offerings with amounts raised exceeding $4.6 million, 15 of which were SAFE offerings. The proportion of SAFE offerings among the highest-raised ones under Regulation CF is well above that of SAFE offerings accounting for all offerings under Regulation CF. This phenomenon highlights the heft of the SAFE in crowdfunding, and further illustrates that a total ban on SAFE crowdfunding offerings is ill-advised from a practical perspective.

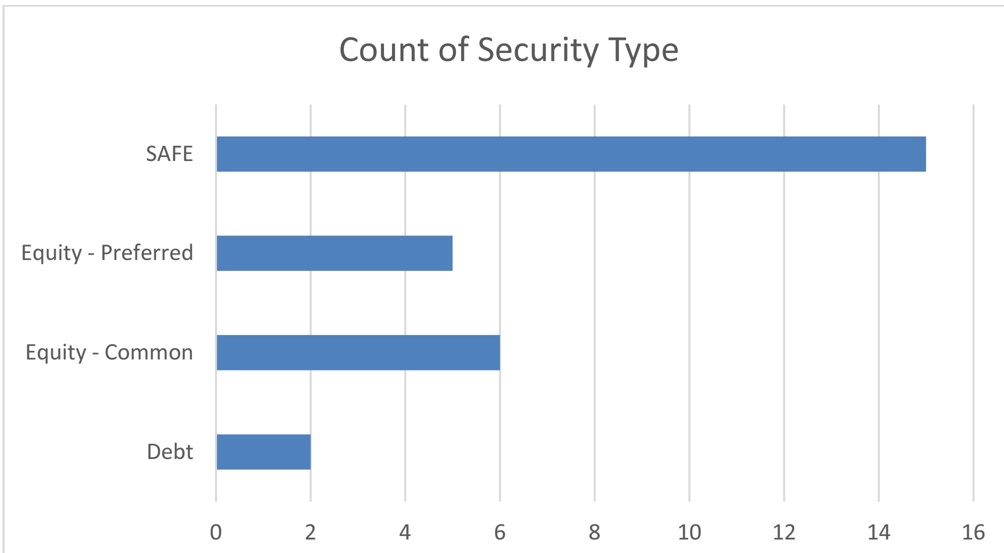

Figure 1 Type of Security with offering amount above $4.6million
Source: Kingscrowd, as of early July 2022

IV. CHINA'S REGULATION AND PRACTICES OF EQUITY CROWDFUNDING

As shown above, there are various types of securities issued in offerings under Regulation CF, far beyond equity securities. While in China, regulators employ the term "equity crowdfunding financing" to describe financing activities whereby companies issue equity securities through online funding platforms.[179] The reason for Chinese regulators' omission of debt securities in crowdfunding financing could be because prior to 2020, for private issuers, the only type of debt

[179] *See* Section 9 of Guiding Opinions of the People's Bank of China, the Ministry of Industry and Information Technology, the Ministry of Public Security, et al, on Promoting the Sound Development of Internet Finance, No.221 [2015] of the People's Bank of China, [CLI Code] CLI.4.251703(EN), https://www.pkulaw.com/en_law/fa5a327e7533e328bdfb.html

security that was governed by the Securities Law of People's Republic of China (China Securities Law or CSL) were corporate bonds.[180] The then effective CSL required companies intending to issue corporate bonds have substantial assets and profits.[181] This requirement precluded startups, which typically have few or even negative profits, from issuing corporate bonds on open markets. Meanwhile, a startup will face difficulties in obtaining good credit ratings for its bonds, which compels the startup to pay high interest rates[182] Thus, startups in China seldom issue bonds for financing. However, common stock and preferred stock were not prevalent types of securities issued in China's crowdfunding transactions either.

A. Basic Regulatory Framework of Equity Crowdfunding in China

The CSL provides that all the public offerings of stock, corporate bonds, and some other types of securities[183] should be registered with the China Securities Regulatory Commission (CSRC)[184] Article 9 of the CSL[185] defines "issuing securities to unspecified or specified offerees cumulatively more than 200" as a public offering. The specificity of offerees is interpreted as being determined by the special relationship between offerees and the issuer[186] Put differently, this section sets up the number of offerees as the parameter to determine a public offering. Thus, offering stock through equity crowdfunding shall be registered with the CSRC or be held illegal, unless the number of offerees is less than 200, and the offerees are specific to issuers.

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180 For the evolution of securities governed by the CSL, see *infra* Section 4.1.

181 *See* CODE CIVIL [C. CIV.] CLI.1.233280(EN) art. 16, https://www.pkulaw.com/CLI.1.233280(EN) (Article 16 of the 2014 CSL required a corporation intending to issue bonds have RMB30M in assets and profits payable for one-year interest).

182 *See Leveraged Commentary & Data (LCD): High Yield Bond Primer,* PITCHBOOK, *(*2022), https://www.spglobal.com/marketintelligence/en/pages/toc-primer/hyd-primer#sec.1.

183 *See* PITCHBOOK, *supra* note 182. Each revision to the CSL added some types of securities to its regulatory reach. The most recent CSL was revised in December 2019, and has taken effect since March 1, 2020, *see* Xi Jinping, *Order of the President of the People's Republic of China*, NATIONAL PEOPLE'S CONGRESS OF PEOPLE'S REPUBLIC OF CHINA (Dec. 28, 2019), http://www.npc.gov.cn/englishnpc/c23934/202109/9886ca6f805e4663a9a725d6f72066dd.shtml.

184 Xi Jinping, *supra* note 183.

185 *Id.*

186 Lin Ye, *Securities Law* 87-88 (4th ed. 2013). This book does not specify what constitutes a special relation. And there are few cases clarifying the "specificity" element in the definition of public offering.

B. Rulemaking Efforts in Equity Crowdfunding

In December 2014, Securities Association of China (SAC) enacted its proposed rule on private equity crowdfunding financing.[187] SAC is a self-regulatory organization under the guidance of the CSRC. SAC could exercise supervisory power over its member securities companies and practitioners of the securities industry, and subject them to disciplinary action when they violate SAC rules.

The SAC rule on equity crowdfunding prescribed the standards for the investors, fundraisers (interchangeably with "entrepreneurs") and funding portals participating in the equity crowdfunding transactions. In respect of funding portals, the SAC proposed rule requires that all the funding portals register with and apply for membership of the SAC, have net assets of no less than RMB 5 million and at least two professional investment advisors, maintain necessary technology facilities and management, and assume some responsibilities including verifying the authenticity of information provided by investors and entrepreneurs, verifying the legality of projects, monitoring frauds, and educating investors. The rule also prohibited funding portals from engaging in certain types of activities, such as insider trading, defrauding investors, and directly making loans.[188]

Regarding investors and fundraisers, the SAC rule required that fundraisers be barred from publicly issuing securities or issuing securities to unspecific offerees, and shareholders of the fundraisers or the resulting companies after the consummation of each crowdfunding financing be no more than 200 in aggregate.[189] Obviously, the SAC rule strictly observed Section 10 of the 2014 CSL and prohibited fundraisers from publicly offering securities in reliance on crowdfunding. Under this requirement, if a fundraiser already has some shareholders such as its founders and key employees, the number of investors that can buy stock issued by the fundraiser in a crowdfunding offering would be 200 less the number of the fundraiser's existing shareholders. As every fundraiser has at least one shareholder, the number of investors finally purchasing the stock issued would be always less than 200.

Particularly, the SAC rule limited investors eligible to participate in the equity crowdfunding to the following three types: (1) accredited investors designated by the CSRC[190]; (2) entities or individuals investing no less than RMB

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[187] *See* e.g., Regulation on Private Equity Crowdfunding Financing (Provisional) (Exposure Draft) (中国证券业协会关于就《私募股权众筹融资管理办法（试行（征求意见稿）》公开征求意见的通知), SAC [2014] No. 236., http://fgcx.bjcourt.gov.cn:4601/law?fn=dae001s952.txt. Now the rule is taken down from the SAC website and only can be found on third-party sources

[188] *Id.* at art. 5-9.

[189] *Id.* at art. 12.

[190] *See Interim Measures For The Supervision And Administration Of Private Investment*

1 million in a single financing project; and (3) some institutional investors such as pension funds.[191]

As the name of the proposed rule suggests, this rule structured offerings of securities under crowdfunding strictly as private placements. Under this proposed rule, only a handful of investors such as affluent personal investors, and large financial institutions, are eligible to participate in crowdfunding offerings. Meanwhile, fundraisers can only issue securities to less than 200 specific investors. In sum, this proposed rule disregarded the component "crowd" of "crowdfunding", rather, it only provided another venue of private offerings to a very select group of investors.

However, the SAC proposed rule never became a final rule. In 2015, a joint notice issued by People's Bank of China (China's central bank), the CSRC and other eight regulatory authorities within the State Council (China's central administration)[192] clarified that equity crowdfunding financing is regulated by the CSRC. This was the first time that the regulatory authority to regulate crowdfunding in China was demarcated. Now that the CSRC became the only regulatory body to regulate crowdfunding, the SAC, which is supervised by the CSRC, in consequence was not empowered to make rules on equity crowdfunding.

The CSRC reiterated that it had been considering enacting rules for equity crowdfunding multiple times, and even made it a priority in its 2019 rulemaking undertakings, however, the long-awaited CSRC rule on equity crowdfunding is still far from sight. Efforts to provide a legal framework for crowdfunding in China seem to be faltering now. After six years of the SAC's first proposed rule, and five years of the CSRC being authorized to regulate equity crowdfunding, a binding rule still does not exist. In fact, the CSRC has not issued any provisional rule yet. The absence of an effective rule poses great legal risks to equity crowdfunding in China.

C. China's Equity Crowdfunding Practices

There used to be some equity crowdfunding portals in China, just to name a few, Renrentou (means "everyone can invest") and Tianshijie (means "Angels' Street"). To circumvent the requirement that all public offerings of stock shall be registered with the CSRC, these portals developed a structure under which there

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Funds, GLOBAL REGULATION (Aug. 21, 2014), https://www.global-regulation.com/translation/china/159262/interim-measures-for-the-supervision-and-administration-of-private-investment-funds.html. According to the CSRC, the accredited investors refer to: entities with assets no less than RMB 10 million; individuals with financial assets no less than RMB 3 million or with annual income of RMB 500 thousand in recent three consecutive years; pension funds, private equity funds and other institutional investors.

[191] *See supra* note 187 at art. 14.

[192] *See supra* note 180.

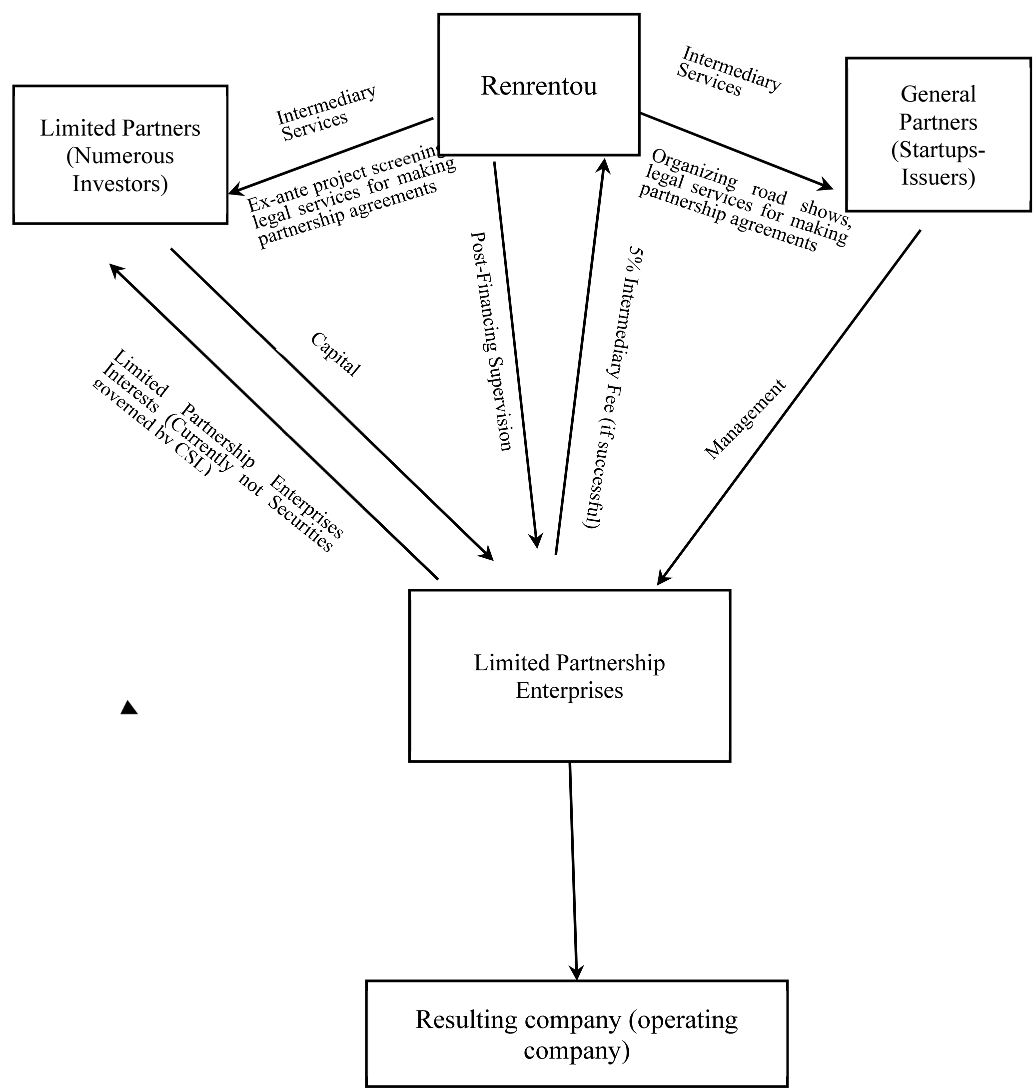
would be no CSL-governed stock issued to investors. To elaborate, investors and entrepreneurs in the first place would form a limited partnership enterprise (which can be roughly regarded as a counterpart of the limited partnership under the U.S. law), of which investors serve as limited partners, and entrepreneurs serve as general partners. Entrepreneurs raising capital through a funding portal only promise to provide investors with limited partnership enterprise interest (LPE interest), a kind of equity stake that is not governed by the CSL, in exchange for investors' injection of money. As a special purpose vehicle, the LPE would hold shares of the resulting operating company in proportion to the amount raised through the crowdfunding offering. The resulting company is the operating company that indeed does business and that is in fact run by the entrepreneurs. If the resulting company generates profits, then the profits will be distributed among investors and entrepreneurs in accordance with negotiated terms in the LPE agreement.

This structure in theory would work well since, as limited partners, investors' primary right is to participate in the distribution of incomes received by the LPE. In general, limited partners have no managerial power over the LPE they put money into. Through managing the LPE, entrepreneur-general partners control the resulting company. If the resulting company makes profits, then the profits will flow back to the LPE, and in turn, to investors and entrepreneurs.

The intermediary services that Renrentou provide include the ex-ante screening of projects, the promotion of projects such as organizing road shows for entrepreneurs, and legal services for entering into partnership agreements. Its operational mode is illustrated in the following diagram:[193]

[193] *See e.g.*, *Research Report on Internet Equity Crowdfunding and Non-Public Equity Financing in China,* XIAOMI FINANCE RESEARCH CENTER (Dec. 2017), http://www.d-long.com/eWebEditor/uploadfile/2017122218051868781711.pdf. As Renrentou and other equity crowdfunding portals in China have been discontinued, for accounts of the business model that these portals formed LPE and issued LPE interests to investors, can be found on third party sources.

Diagram 1: The Operational Mode of Renrentou



Other crowdfunding portals are modeled after Renrentou's transactional structure with minor variations. Additionally, some portals, such as Tianshijie, develop their own threshold for investors to participate in projects posted on their websites. These portals categorize investors as lead investors and participant investors on the grounds of investors' annual income, prior investment experience, risk preferences, and the like.

D. The Demise of Equity Crowdfunding Industry in China

Equity crowdfunding in China used to be prosperous. The first two equity crowdfunding platforms were founded in 2011. In 2014, there were 21 platforms. As of 2014, the three leading platforms raised RMB132 million-- a big haul within only three years. The average amount raised per project was between RMB3 million - 5 million; some large projects even raised more than RMB10 million.[194]

However, a turning point was on the horizon.

In August 2015, the General Office of the CSRC issued a notice requiring lower securities regulatory bureaus conduct special inspections of institutions engaging in equity financing via the Internet.[195] This notice marked a pivot of regulatory mentality on equity crowdfunding. The notice defined equity crowdfunding as entrepreneurs publicly raising capital by offering equity on online crowdfunding platforms. The notice further claimed that equity crowdfunding transactions have "public, small-sum and open-to-crowd" characteristics and therefore should be regulated.[196] In claiming so, this notice excluded private offerings from the definition of equity crowdfunding. The position that offerings under equity crowdfunding are public is diametrically opposed to the position adopted by the SAC's proposed rule, which made equity crowdfunding offerings private.

After declaring the public nature of equity crowdfunding, the notice reiterated that all public offerings should be registered with the CSRC, non-public offering should not use public advertising or general solicitation, and private fund managers should raise capital only from accredited investors[197] The notice further required that local governments inspect and correct illegal and non-compliant conduct on all equity crowdfunding platforms. Under the notice, lower securities regulatory bureaus should especially focus on whether (1) financiers on funding platforms engage in general solicitation, (2) securities are issued to unspecific investors, (3) the number of shareholders exceeds 200 cumulatively, and (4) private equity funds are raised in the name of equity crowdfunding.[198] This notice marked

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[194] *See Internet crowdfunding Annual Report (*年互联网股权众筹盘点报告*)*, IT ORANGE (Apr. 12, 2015), http://www.199it.com/archives/339253.html .

[195] (中国证监会办公厅关 对通过互联网开展股权融资活动的机构进行专项检查的通知) [Notice of the General Office of the China Securities Regulatory Commision on Conducting Special Inspections of Institutions Engaging in Equity Financing via the Internet] (promulgated by China Securities Regulatory Commission, effective Aug. 3, 2015), CLI.4.256388(EN) https://www.pkulaw.com/en_law/49bbf6b0dada8031bdfb.html (China) (the original notice from the CSRC available at http://www.gov.cn/xinwen/2015-08/07/content_2909930.htm).

[196] *Id.*

[197] *Id.*

[198] *Id.*

the beginning of the CSRC's continued crackdown on China's equity crowdfunding industry.

In December 2017, the CSRC stated on its website that the experiment of equity crowdfunding had not yet started. The CSRC warned that any platform promoting its services of equity crowdfunding could make misstatements or engage in illegal activities. [199] This announcement expressly unveiled the CSRC's position: unless and until the rule on equity crowdfunding is issued by the CSRC, equity crowdfunding in China is adamantly deemed illegal by the CSRC.

Now it seems the equity crowdfunding industry in China is all but dead. Renrentou, Tianshijie and Dajiachou, all formerly prosperous securities-based crowdfunding platforms in China, are now discontinued.[200] Other remaining crowdfunding platforms structure the campaigns on their platforms as reward-based crowdfunding, and bar any offerings of securities in campaigns initiated on their platforms .

The reason for the regulatory crackdown of the equity crowdfunding industry in China was murky, as regulatory bodies gave no official explanations on the de facto ban on equity crowdfunding and no literature addresses the question.

Considering the turmoil in China's stock market contemporaneous with the CSRC's crackdown on equity crowdfunding, a plausible explanation is that the great crash of China's stock market in middle to late 2015 catalyzed the CSRC's harsh treatment of equity crowdfunding. In August 2015, China's Shanghai Composite Index plummeted 43% percent from its peak in July 2015.[201] The CSRC notice requiring local governments to inspect crowdfunding platforms was also issued in August 2015 amid the trough of the historic stock market rout.

Meanwhile, since 2016, China's fraud-ridden peer-to-peer lending platforms have gone broke across the board. P2P investors in China have lost more than $115 billion.[202] While P2P is different from crowdfunding, the horrifying

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[199] CHINA SECURITIES REGULATORY COMMISSION, https://www.CSRS.gov.cn/pub/newsite/tzzbh1/tb12386rx/201712/t20171207_328398.html (last visited Oct. 2020.) The statement has been taken down from the CSRC's website, but can be found on other Chinese new outlets, e.g., on People's CN, an online news outlet run by People's Daily, the official newspaper of Chinese Communist Party, available at: http://money.people.com.cn/stock/n1/2017/1219/c67815-29714926.html

[200] When accessing the website of Renrentou, it shows this website has not obtained ICP (Ministry of Industry and Information Technology) filing status. Websites of Tianshijie and Dajiachou are both blank.

[201] Timothy B. Lee, *China's stock market crash, explained in charts*, VOX (Aug. 26, 2015, 10:29 am), https://www.vox.com/2015/7/8/8911519/china-stock-market-charts.

[202] Michael Tattersall, *Chinese regulators estimate that their P2P lending crackdown resulted in $115 billion in losses for investors*, BUSINESS INSIDER (Aug. 18, 2020, 7:03 am), https://www.businessinsider.com/chinese-p2p-investors-lost-115-billion-in-regulatory-crackdown-2020-8 .

outcome of the collapse of P2P platforms probably discouraged China's regulators from further allowing public offerings to be launched on internet platforms.

V. ESTABLISHING THE LEGAL FRAMEWORK FOR CHINA'S CROWDFUNDING INDUSTRY

Establishing a legal framework for China's crowdfunding industry is a slog. First, the legal framework should be beyond just tackling "equity" crowdfunding. As illustrated earlier, the majority of securities issued in offerings under Regulation CF are not equity. A sensible legal framework should allow debts, convertibles, and non-traditional securities like SAFEs to be issued in crowdfunding offerings in addition to equity securities.

Second, a well-advised legal framework should balance the capital formation of the market against investor protection. If the disclosure obligations under the framework are too tenuous, investors lacking material information cannot make well-informed decisions. If the legal obligations are too heavy, considering the amount that can be raised through equity crowdfunding is relatively small compared to IPOs or private placements, the desirability of crowdfunding would be undermined.

China's equity crowdfunding industry faces legal obstacles not only because of the absence of a rule enacted by the CSRC, but also due to the narrow range of "securities" governed by the CSL and the unreasonable definition of a "public offering" in the CSL. The narrow range of securities governed by the CSL is likely to strip investors in crowdfunding offerings of the protection by the CSL's antifraud provisions. The unreasonable definition of a "public offering" in the CSL would also impede the development of crowdfunding in China.

But above all, the absence of a crowdfunding exemption in the CSL poses the greatest problem to crowdfunding in China. Without a statutory exemption, the CSRC has no authority to exempt crowdfunding offering from the CSL's registration requirement. Adding a section mirroring Section 4(a)(6) or Section 28 of the Securities Act to the CSL should be carefully considered by Chinese legislators.

A. Definition of Securities in the U.S. and China

The CSL was passed in 1998 and took effect in 1999. Subsequently, it underwent two major revisions in 2005 and 2019.[203] Though very limited, each revision broadened the range of securities regulated by the CSL.

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[203] *See* the legislative history of the CSL in parentheses before contents. Xi Jinping, *supra* note 183 (stating the CSL was passed in 1998, and revised in 2005 and 2019).

In the 1999 CSL, the law did not provide a general definition of securities. Instead, it stated that the law applied to issuance and trading of stocks and corporate bonds, and other financial instruments recognized as securities by the China State Council.[204] This implied that the statutory meaning of "securities" was unknown. What we know was the range of securities that the law intended to regulate.

The statutory range of stocks and corporate bonds is conspicuously narrow. One reason for China's then legislature to enact such a narrow range of securities could be the securities law had to honor the corresponding rule of China Company Law (CCL).[205] When the 1999 CSL was promulgated, the then governing Company Law was passed in 1993 and took effect in 1994. The 1994 CCL only allowed corporations to issue and transfer stocks and bonds. Therefore, when the 1999 CSL was introduced, it only needed to regulate the offering and transactions of stocks and bonds, since these were the only types of securities permitted under the CCL at that time. For avoiding conflicts of these two basic laws governing transactions involving issuing securities by Chinese corporations, the broadening of the range of securities in the CSL depended on an overhaul of the CCL.[206]

In the 2005 revision to the CSL, government bonds and shares of securities investment funds were added to the statutory reach of the CSL, and the China State Council was authorized to regulate the issuance and transfers of derivatives[207] In the 2019, or the latest, revision, which took effect at the beginning of 2020, depository receipts were further added to the regulatory reach of the CSL. Meanwhile, the 2019 CSL also authorized the China State Council to regulate asset-backed securities and asset management products. After these two major revisions, the statutory reach of the CSL now extends to issuances and transfers of stocks, corporate bonds, depository receipts, government bonds, shares in securities investment funds, and other securities designated by the China State Council.[208]

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204 (中华人民共和国证券法) [2019 Revision of Securities Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective July 1, 1999, rev'd by the X, Dec. 28, 2019) CLI.1.21319(EN) https://www.pkulaw.com/CLI.1.21319(EN) (China).

205 Yuwa Wei, *The Development of the Securities Market and Regulation in China*, 27 LOY. L.A. INT'L & COMP. L. REV. 479, 490-493 (2005) (arguing the 1994 China Company Law and 1999 China Securities Law regulated the issuance of securities altogether).

206 *See* Roman Tomasic & Dr.Jane Fu, *The Securities Law of the People's Republic of China: An Overview*, 10 AUSTRALIAN J. OF CORP. L. 268-289 (1999) https://ssrn.com/abstract=1440759.

207 (中华人民共和国证券法(2005修订)[Securities Law of the People's Republic of China (2005 Revision)] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan 1, 2006, rev'd by the Dec. 28, 2019) CLI.1.60599(EN) https://www.pkulaw.com/CLI.1.60599(EN) (China).

208 (中华人民共和国证券法(2019修订)[Securities Law of the People's Republic of China

22 years after its birth, the CSL still applies to very limited types of securities. Investors who purchase LPE interests issued by issuers on crowdfunding portals are unable to protect themselves by invoking the CSL if they are defrauded. This is because as illustrated above, the LPE interest is not recognized in the CSL's statutory definition of "securities", and therefore are outside the reach of the CSL. In such a dilemma, the primary legal basis for investors to reclaim their losses could be found in contract law.

The range of securities protected by securities laws in the United States is much broader than what is protected in China. Section 2(a)(1) of the Securities Act of 1933 (the 1933 Act or the Securities Act) enumerates a cascade of eligible financial instruments as "securities." These financial instruments include notes, stocks, bonds, debentures, and various derivatives as "securities."[209] The definition of a "security" provided in the Exchange Act[210] is slightly different from the corresponding definition in the Exchange Act but is treated almost identical to that in the Securities Act by courts.[211] Although the enumeration of financial instruments as securities is quite thorough, there is still ambiguity left in the

(2009 Revision)] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 28, 2019, effective Mar 1, 2020) CLI.1.338305(EN) https://www.pkulaw.cn/CLI.1.338305(EN) (china).(It is noteworthy that this article does not provide a general definition or exhaustive enumeration of "securities". It only states that issuance and transfers of some kinds of financial instruments are governed by the CSL. This article also delegates broad power to the China State Council by administrative regulations to broaden the range of securities governed by the CSL. Further, regulation implicating issuance and resale of asset-backed securities and asset management products are expressly delegated to the China State Council in this article.)

209 15 U.S.C. § 77b(a)(1) ("[T]he term 'security' means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract … or, in general, any interest or instrument commonly known as a Securities Act, the term "security" means "any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract… or, in general, any interest or instrument commonly known as a "security", … any of the foregoing 'security', … any of the foregoing.")

210 *Id.* at § 78c(a)(10). ("The term 'security' means any note, stock, treasury stock, security future, security-based swap, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, … or in general, any instrument commonly known as a 'security'; … or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.")

211 Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985) (citing Marine Bank v. Weaver, 455 U.S. 551, 555 (1982)); United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847 (1975).

statutory language. Specifically, non-traditional securities, such as the investment contract, are not given clear definitions in neither the 1933 Act nor the 1934 Act. Therefore, it is left to courts to clarify the statutory meaning of undefined securities.

The seminal and landmark case reviewing the broad definition of securities in the 1933 Act is SEC v. W. J. Howey Co.,[212] decided by the U.S. Supreme Court in 1946. The respondents, W. J. Howey Company and Howey-in-the-Hills Service Inc. (collectively "Howey Company") were two Florida corporations under common management and control. Howey Company used mails and instrumentalities of interstate commerce to sell a land sale contract selling citrus acreage and a service contract cultivating and developing these citrus groves to prospective buyers outside Florida, without registering the offer and sale of these contracts with the SEC. The SEC brought action to enjoin the Howey Company from the offer and sale of these contracts.

The Supreme Court upheld the SEC's request, holding that these two contracts fell within the "investment contract" in Section 2(a)(1) of the 1933 Act, and thus should be registered with the SEC.[213] The Howey court held that an investment contract could constitute a security where there is a contract "whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[214] This decision became the benchmark of legal standards to determine whether an investment contract constitutes a security that should be governed by the 1933 Act.

Lower courts have further fleshed out the application of the Howey test. The fifth circuit broke down the Howey test into three factors. It said that plaintiffs claiming a contract is a security because it is an investment contract must prove the contract is "(1) an investment of money; (2) in a common enterprise; and (3) on an expectation of profits to be derived solely from the efforts of individuals other than the investor."[215] Meanwhile, since the word "solely" in the third factor sets a formidable high bar, some courts have allowed this factor to be met by expectation of profits to be derived "predominantly"[216] or "undeniably significant[ly]"[217] from a third party.

The original Howey test and its line of subsequent cases ensures flexibility for courts to adopt their approaches to interpreting many kinds of financial instruments as investment contracts.[218] In effect, courts applying the Howey test

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212 W. J. Howey Co*., supra* note *9.*
213 *Id.*
214 *Id.* at 299.
215 Williamson v. Tucker, 645 F.2d 404, 417 (5th Cir. 1981).
216 *See* SEC v. International Loan Network, Inc., 968 F.2d 1304, 1308 (D.C. Cir. 1992).
217 Miller v. Central Chinchilla Grp., Inc., 494 F.2d 414, 418 (8th Cir. 1974).
218 Miriam R. Albert, *The Howey Test Turns 64: Are the Courts Grading This Test on a Curve?*, 2 WM. & MARY BUS. L. REV. 1 (2011) (arguing that Congress deliberately enacted a broad and flexible concept of "security". The Howey court crafted the flexible test in

may subject as many kinds of financial instruments as possible to the ambit of securities, which thus affords protection of the Securities Act to investors .[219]

Courts typically apply the Howey test to determine whether limited partnership interests are securities.[220] Under the Howey test, courts commonly view limited partnership interests as securities.[221] Courts sometimes analogize the interest of a limited partner to that of a stockholder in a corporation, [222] as directors are statutorily empowered caretakers of a corporation's business and affairs,[223] while stockholders rely on directors and management to attend to their investments in this corporation. Similarly, limited-partner-investors rely on the efforts of general-partner-managers to gain profits from the common enterprise they invest in, as the powers of limited partners are quite constrained. For instance, limited partners typically have no say in managing the business and affairs of a partnership and are unable to dissolve the partnership. Consequently, if limited partners have few powers and virtually no control over the partnership, their interests in the partnership will be deemed as securities under Howey.[224]

Notes, which are clearly included in the definition of securities in the Securities Act,[225] are used in many non-investment situations. Courts have found many kinds of notes should not be treated as securities, such as notes given in connection with home mortgages, consumer financing, and short-term liens on

recognition of the Congressional intent, and courts subsequently applying the Howey test have managed to maintain its flexibility.)

219 Theresa A. Gabaldon, *A Sense of Security: An Empirical Study,* 25 J. CORP. L. 307, 332-33 (2000) (arguing that during 1982-1998, 234 cases asking "what-is-a-security" determining whether a financial instrument in question is a security implicated the term "investment contract", accounting for 61% of "what-is-a-security" cases. Of all the 234 cases, only 44 or 19% applied tests other than or in addition to Howey.)

220 Masel v. Villarreal, 924 F.3d 734 (5th Cir. 2019).

221 Albert, s*upra* note 218, at 334 (arguing that during 1982-1998, 25 cases asking whether limited partnership interests constitute investment contracts were brought, 80% percent of which were held in favor of the plaintiffs, i.e., court found limited partnership interests in question were securities.); SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980) ("Under the test for an investment contract established in SEC v. W. J. Howey Co., a limited partnership generally is a security[.]") (citing Goodman v. Epstein, 582 F.2d 388, 408-09 (7th Cir. 1978); McGreghar Land Co. v. Meguiar, 521 F.2d 822, 824 (9th Cir. 1975); 1 A. Bromberg, Securities Law: Fraud s 4.6 (332) (1969).

222 Youmans v. Simon, 791 F.2d 341 (5th Cir. 1986) (reasoning that limited partners exercise few or no power to take an active part in the management of a partnership, nor are personally liable for liabilities of the partnership. Thus, limited partnership interests satisfy the Howey test and are securities under the 1933 Act).

223 8 Del. Code § 141(a) (1953) (providing "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors…").

224 Albert, s*upra* note 218, (focusing on the extent of managerial control limited partners can in essence exercise over the partnership).

225 15 U.S.C. § 77b(a)(1) ("[T]he term of 'security' means 'any note…'").

small businesses.[226] The U.S. Supreme Court held that "Congress' purpose in enacting the securities laws was to regulate investments," and "the phrase 'any note' should not be interpreted to mean literally 'any note'" but must be interpreted as regulating investment instruments as well.[227] To determine whether a note is a security under securities law, the Supreme Court adopted the "family resemblance" test in Reves v. Ernst & Young.[228] Under this test, a note is presumed to be a security, and the presumption can be only rebutted by a showing that the note bears a strong resemblance to one of judicially crafted categories of instruments that are not securities.[229] When categorizing instruments as non-securities, courts should consider four-factors: (1) the motivations prompting a reasonable seller and buyer to enter into the transaction;[230] (2) the plan of distribution of the instrument;[231] (3) reasonable expectations of the investing public;[232] and (4) the existence of another regulatory scheme significantly that reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.[233] Under this test, term notes and RSNs can be easily categorized as securities and thus are subject to the reach of securities laws in the U.S.

If the offerings of limited partnership interests, which nearly all Chinese equity crowdfunding transactions used to involve, had happened in the U.S., they would constitute issuances of "securities." Therefore, they must be registered or find an exemption under the Exchange Act, according to securities laws and cases. However, the offerings and resale of LP enterprise interests are not regulated by the CSL. This first excuses issuers of mandatory disclosure they are otherwise required if the CSL regulates the issuance and resale of LPE interests, and second precludes investors from the protection that the CSL's anti-fraud provisions provide. In aggregate, investors' rights could be severely undermined if frauds in association with transactions of LPE interests take place.

Looking back at offerings under Regulation CF in the U.S., it becomes clear that issuances and resales of SAFEs, common stock, and preferred stock can easily fall within the jurisdiction of the Securities Act and Exchange Act. The broad

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226 Futura Development Corp. v. Centex Corp., 761 F.2d 33 (1st Cir. 1985) (citing Chemical Bank v. Arthur Andersen and Co., 726 F.2d 930 (2d Cir. 1984); Exchange National Bank v. Touche Ross and Co., 544 F.2d 1126 (2d Cir. 1976).

227 *See* Reves v. Ernst & Young, 494 U.S. 56, 61(1990).

228 *Id.* at 64 (The court held that Howey had been designed to find out whether an instrument is an investment contract under securities law. If the Howey is to be applied to cases involving notes as well, then the statutory enumeration of various kinds of securities would be superfluous).

229 *Id.* at 67.

230 *Id.* at 66 (If the buyer's purpose is to invest and generate profit and the seller's purpose is to finance, then the instrument is likely to be a security).

231 *Id.* at 66 (If there is "common trading for speculation or investment" for an instrument.)

232 *Id. at* 66.

233 *Id.* at 67.

reach of these two Acts is facilitated by the expansive language used in defining securities in each Act and the flexible Howey test. Meanwhile, notes are presumptively treated as securities. If new types of investment contracts emerge, courts can readily subject these new instruments in accordance with the Howey three-pronged test to the regulatory reach of SEC. In turn, the SEC can exercise its statutorily mandated power to protect investors' rights despite the proliferation of new financial instruments. Crowdfunding offerings are undoubtedly under the SEC's watch whatever kinds of securities are issued in these transactions.

In contrast, the rigidity in the CSL prevents the CSRC from regulating offerings and resale of LPE interests. As illustrated above, the CSL only applies to issuance of and trading in a limited range of securities, and LPE interests are plainly outside of that range. Moreover, the CSL does not provide a general definition of "securities" nor a security with as extensive of a scope as the investment contract is. Under such circumstances, Chinese courts have no room to extend the application of the CSL to offerings involving LPE interests, as opposed to what U.S. courts can do under Howey and its progeny. Although the China State Council can designate other securities as securities regulated by the CSL, the designation by the China State Council needs authorization of law or the People's Congress. Under the CSL alone, the China State Council cannot designate the LPE interest as a security regulated by the CSL.[234]

In Sum, issuances and resale of LPE interests in China eschew the oversight of the CSRC. The CSL expressly does not apply to the issuance and resale of LPE interests. Neither courts nor State Council can extend the application of the CSL to issuance and resale of LPE interests. By no means can the CSRC exercise its regulatory power over crowdfunding transactions offering and reselling LPE interests. In consequence, crowdfunding investors cannot resort to securities law or the CSRC when they are defrauded.

B. Definition of a "Public Offering" in the U.S. and China

As illustrated in the foregoing section, LPE interests are not securities regulated by the CSL. Consequently, issuance and resale of LPE interests are not subjected to the registration requirement and anti-fraud provisions in the CSL. However, even if LPE interests are regulated by the CSL, the CSL's offeree-number-based definition of "public offering" could also impede the protection of crowdfunding investors.

Article 9 of the CSL requires any public offering to register with relevant regulatory bodies. This article defines a public offering as (1) an offering of

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234 In the 2019 CSL, except enacting regulations involving transactions of asset-backed securities and asset management products, no articles expressly empower the China State Council to designate other securities as securities regulated by the CSL.

securities to unspecific offerees; (2) an offering of securities to more than 200 specific offerees cumulatively; and (3) other offerings stipulated by law and administrative regulations[235] This definition of public offering was in place in the 2014 CSL and was kept intact in the 2019 revision. Put differently, it has been effective for at least 6 years.

Case Law in the US adopts a different approach to defining a public offering. Section 4(2) of Securities Act exempts transactions by an issuer not involving any public offering from registering with SEC[236] However, the Securities Act does not provide a clear definition of a "public offering. Thus, the job of figuring out the meaning of a "public offering" is left to courts.

The U.S. Supreme Court clarified the meaning of "public offering" in *SEC v. Ralston Purina*[237] The respondent, Ralston Purina, was a private corporation. It sold nearly $2 million of stock to its employees by mail across many states in the U.S. from 1947-1951 without registering these offerings with the SEC. The SEC sued to enjoin Ralston Purina's unregistered offerings. The SEC argued that Ralston Purina sold stock to a substantial number of offerees,[238] which thus rendered Ralston Purina unable to utilize the non-public offering exemption. Although the Supreme Court noticed the SEC had consistently treated offerings involved a large number of offerees as public, the court nevertheless rejected the SEC's approach and held "there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation."[239] Instead, the court focused on whether the affected class of offerees needs the protection of the Securities Act to determine a "public offering." The court held that "[a]n offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering," [240] the inquiry "turns on the knowledge of the offerees," [241] and the investors should have "access to the kind of information which registration should disclose." [242]

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[235] *See* Securities Law of the People's Republic of China (promulgated by Standing Comm. Nat'l People's Cong., Dec. 28, 2019, effective Mar. 1, 2020), at Article 9, CLI.1.338305(EN) (Pkulaw) (China). This article excludes employee offered securities under employee stock ownership plan from the cap of 200 specific offerees. Further, a non-public offering is barred from using public advertising or general solicitation.

[236] 15 U.S.C. § 77d (a)(2).

[237] SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

[238] *Id*. at 121. In 1947, 243 employees of Ralston Purina bought the unregistered stock, 414 in 1949, 411 in 1950, and the 1951 offer solicited 165 applications to purchase.

[239] *Id*. at 125.

[240] *Id.*

[241] *Id.* at 126.

[242] *Id.* at 127. (reasoning that though executives could have information in tantamount to those made available in a registration statement, absent such special circumstance, employees are just commonplace members of the investing public. The court found many of those employees buying stock issued by the respondent lacked access to the information that should be otherwise disclosed in registration. Ultimately, the court held the non-public offering

Ralston Purina's progeny continues to develop the bifold "knowledge of offerees and access to information" standard. The Fifth Circuit fleshed out the Ralston Purina standard in *Doran v. Petroleum Management Corp.*,[243] stressing sophistication of investors cannot substitute their access to information[244] because "the shrewdest investor's acuity will be blunted without specifications about the issuer."[245] Thus, the private offering exemption will not apply unless "each offeree ha[s] been furnished information about the issuer that a registration statement would disclose or that each offeree has effective access to such information ."[246]

The sophistication of an offeree is critical when an offeree has access to information but does not receive actual disclosure of the information from the issuer. Under the foregoing circumstance, the "investment sophistication of the offeree assumes added importance, for it is important that he could have been expected to ask the right questions and seek out the relevant information."[247]

Ralston Purina and *Doran* formulate a two-pronged test to determine when a non-public offering takes place, stating investors must have (1) sophistication and (2) access to information that a registration statement would disclose. Courts may use the number of offerees as a non-decisive metric in deciding whether an issuer can invoke the private offering exemption.[248] Though the number of offerees is a factor courts can consider, it is non-determinative and an offering to a very small group of offerees who are unsophisticated but have access to information should be a public offering.

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exemption inapplicable to Ralston Purina's offerings in question).

[243] *See* Doran v. Petroleum Mgmt. Corp., 545 F.2d 893 (5th Cir. 1977).

[244] *Id.* at 902, holding "a high degree of business or legal sophistication on the part of all offerees does not suffice to bring the offering within the private placement exemption", "sophistication is not a substitute for access to the information that registration would disclose."

[245] *Id.* at 903. (The court further pointed out "for an investor to be invested with exemptive status he must have the required data for judgment").

[246] *Id.* at 897. (The court noted the distinction between offerees who had furnished information that a registration statement would have provided and offerees who had not furnished such information directly but who were in a position to obtain the information, i.e., had access to such information. The court claimed in both situations, the information was available to offerees. *See id.* at 903).

[247] *Id.* at 905.

[248] *Id.* at 893, holding "the number of offerees" is only a factor in deciding whether an offering qualifies for the private offering exemption and "one factor weighs heavily in favor of private status of offering is not sufficient to ensure availability of exemption"; S.E.C. v. Murphy, 626 F.2d 633, at 645. (9th Cir. 1980), finding courts have developed comprehensively flexible tests for the private offering exemption, focusing on (1) the number of offerees, (2) the sophistication of the offerees, (3) the size and manner of the offering, and (4) the relationship of the offerees to the issuer.

The single numeric benchmark of defining a public offering falls short in capturing the essence of a public offering. As U.S. courts have stressed, the statutory registration requirement is to provide information necessary for investors to make well-advised investment decisions.[249] In an offering, even more than 200 specific offerees can all be very knowledgeable and experienced such that they know the securities they invest in well and have access to information they deem necessary to make informed decisions. In this situation, these more-than-200 specific offerees may not need the information a registration process could provide. Conversely, even a handful of specific offerees can be inexperienced, vulnerable to an issuer's deceptive scheme, and have no access to information needed to make informed decisions. These few investors are the subject that the registration requirements are intended to protect. Premising the definition of public offering predominantly on the number of offerees inappropriately excludes unseasoned investors from the protection that a registration process provides, especially when providing material information necessary for an investor to make informed investment decisions.

The "sophistication and information" approach developed by U.S. courts to determine a public offering is more reasonable than the offeree-number-based standard in the CSL. Assume there are 199 specific mom-and-pop investors they have little economic and investment knowledge or experience, and use their life savings to buy securities for the purpose of earning more retirement funds; compare this with 201 sophisticated investors or corporate insiders who have sufficient access to information of the issuer, resources to weigh their investment choices, and deep pockets to pay legal fees if disputes arise. Which group needs the protection of the registration process? The answer is quite straightforward—the former group of investors need the security law's protection; especially the disclosure of information a public offering process affords. However, under the CSL's numeric benchmark of public offering, an offering to 199 specific offerees who are inexperienced, risk-vulnerable, and have no access to information needed, does not constitute a public offering, and thus registration is exempted. This opens a door for malicious scammers to defraud vulnerable investors.

The central idea of equity crowdfunding is to help fundraisers raise funds from a variety of small investors seeking investment opportunities. In other words, small unsophisticated investors constitute a large part of crowdfunding investors. As to unsophisticated investors, they should not be expected to "ask the right questions and seek out the relevant information". Instead, law should dictate issuers to disclose crucial information to these investors. But under the current offeree-

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[249] *See, e.g.*, S.E.C. v. Bronson, 14 F. Supp. 3d 402 (S.D.N.Y. 2014), noting "Registration "protect[s] investors by promoting full disclosure of information thought necessary to informed investment decisions." (citing SEC v. Ralston Purina Co., 346 U.S. 119, 124, 73 S.Ct. 981, 97 L.Ed. 1494 (1953)).

number-based definition of public offering, if a crowdfunding issuer plans to issue securities to 199 specific unsophisticated offerees, this issuance would be deemed as a private offering. As the registration process is exempted, in the absence of rules specifically targeting this situation, there is no mandatory disclosure of information to these investors. This will make them extraordinarily vulnerable to financial fraud. On the other hand, under the strict numeric cutoff between a private and public offering, equity crowdfunding issuers cannot offer securities to more than 201 offerees, otherwise the offering will be public and should be registered. This arbitrary numeric benchmark hurts both offerors and offerees.

C. Establishing the Framework in China

1. An Encompassing Definition of Securities in the CSL

It is crucial to recognize that there are far more types of securities than stocks and bonds used in financing. As the U.S. Supreme Court noted in Howey, investors devised "countless and variable schemes" to seek the use of money of others on the promise of profits.[250] Some debt securities such as revenue share notes, convertible securities such as convertible notes, and non-traditional securities such as SAFEs, are frequently used in financing startups. The SAFE is especially favored in Regulation CF offerings. All these types of securities are not regulated by the CSL.

As Such, the CSL should add notes, convertible securities, and non-traditional investment instruments in between the debt and equity instruments such as SAFEs to its definition of securities. But this is not enough. Under Howey, investment contracts can be interpreted by courts to encompass many kinds of investment instruments such as limited partnership interests. Likewise, the CSL should be amended to include a general, broad, and malleable type of "security," as the investment contract is in U.S. securities laws. This type of security in the CSL should enable courts to interpret it broadly to the effect of regulating the likely mushrooming of new types of investment instruments. Frankly, the definitions of securities provided by Securities Act and Exchange Act have great referential value for amending the corresponding part in the CSL.

Meanwhile, Chinese legislators should also look at the development in the definition and types of securities under Howey and Reeves. The three-pronged test set out by Howey and its line of cases delineates the characteristics of an investment contract, while the four factors considered in Reeves carry weight in deciding not only whether notes, another crucial yet variable instrument, are securities, but also whether courts should extend the regulatory reach of securities laws to investment instruments other than notes. The jurisprudence embodied in these two remarkable

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[250] W. J. Howey Co*., supra* note 9, at 299.

cases can be directly incorporated in the process of amending the CSL's corresponding section.

2. An Exemption and Implementing Rules

The most important undertaking to revitalize China's crowdfunding industry is to provide an exemption for it.

The exemption should recognize the purpose of crowdfunding is to provide small investors with opportunities to invest, and give startups venues to raise capital, which thus should allow non-accredited investors to participate in crowdfunding offerings.

The exemption could be as terse as Section 4(a)(6) of the Securities Act. It may only provide the offering limit, the limit on investor's investments in offerings under the exemption, or some other basic requirements, such as each offering should be exclusively conducted on funding platforms registered with the CSRC. The undertaking of implementing rules should be left to the CSRC.

The disclosure obligations for issuers under the implementing rules should be scaled back relative to the registration requirements in an IPO. The costs of the disclosure required by the implementing rules should be proportional to the offering limit provided by the statutory exemption.

Regulation CF and its amendments in November 2020 should be carefully studied for the purpose of implementing rules. A shining point of Regulation CF is its tiered disclosure requirement for issuers. Issuers with different target offering amounts are subject to different disclosure requirements. Well-designed tiered disclosure requirements would not deter small issuers from participating in the offering in fear of high compliance costs.

Some sort of general solicitation should also be allowed. As issuers under crowdfunding are small businesses and startups instead of well-known corporations, if any kind of general solicitation is barred, their offering could not appeal to a large group of investors.

Last, the implementing of rules should require funding platforms undertake responsibilities to educate investors, reduce risk of fraud, and provide infrastructure such as a data room displaying the financials and status quo of issuers and channels on platforms that allow investors to communicate with each other and with executives of the issuer.

3. A Sophistication/Information-Based Definition of Public Offering

If crowdfunding offerings are exempt from registration, the definition of a public offering would not matter much to exempt offerings. The definition would matter if some kinds of securities are not allowed to offer under the crowdfunding exemption. For instance, assume SAFEs are not allowed to offer under the crowdfunding exemption. SAFE issuers could structure an offering as non-public that is not required to register.

To rationalize the definition of public offering in the CSL, the first step is to remove the arbitrary 200 threshold. This thresholder of 200 specific offerees has little scientific or empirical underpinning. In fact, a one-size-fits-all numeric cutoff to determine a public offering may not exist.

Second, the CSL should include a clear definition of specificity. The language in the CSL is too vague to determine what kind of investors are specific while the other kind are not.

By assuring investors' sophistication in investment and providing investors with access to material information, entrepreneurs can peddle their projects to more than 200 sophisticated investors in crowdfunding transactions. Deeming these kinds of transactions as non-public offerings can facilitate their consummation, and reduce accompanying transaction costs, especially costs incurred by over-disclosure and over-communication, as sophisticated investors could be more adept to extract information they need or have unique access to information of the issuer and the offering.

On the other hand, issuing securities to a small number of inexperienced offerees can constitute a public offering even though only a few offerees are involved. The flat investor-number-based definition of public offering flaws in capturing the purpose of defining an issuance as a public offering - to grant the offerees of a public offering the protection of securities law. Necessarily, transaction cost, especially disclosure cost, will arise in this case. To address this dilemma, entrepreneurs can provide these inexperienced offerees with information that would provide to or can be inferred by knowledgeable and skilled investors. The CSRC can also formulate a curtailed disclosure requirement under which material information should be provided to unseasoned investors in crowdfunding offerings.

VI. CONCLUSION

Since Regulation CF took effect, thousands of offerings have been made and hundreds of millions of dollars have been raised. The growth of the crowdfunding industry shows no signs of slowing down. Since the raise in offering limits has taken effect in March, 2021, the development of crowdfunding is expected to accelerate.[251]

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[251] *See* JD Alois, *$239 Million was Raised using Reg CF During 2020, this Amount Could Double in 2021*, CROWDFUND INSIDER (Jan 6, 2021, 11:39 AM), https://www.crowdfundinsider.com/2021/01/170982-239-million-was-raised-using-reg-cf-during-2020-amount-could-double-in-2021/ (Crowdfund Capital Advisors estimated the amount raised through Regulation CF offerings in 2021 could double that in 2020 and reach half a billion).

One controversy in Regulation CF offerings in the U.S. is the safety of the SAFE, especially the Republic crowd SAFE that allows the company to put off the conversion of the SAFE as late as an IPO or acquisition.

However, the most outstanding reason for the delayed conversion – to clean the cap table – could be addressed by using a crowdfunding vehicle. Because Rule 3a-9 of the Investment Company Act went into effect in 2021, delaying the conversion of the SAFE to an IPO or acquisition cannot be justified any more. If the corresponding provision is not modified to allow automatic conversion, the Republic Crowd SAFE could soon lose appeal.

Even though YC provides its templates, the terms of each SAFE issued could vary significantly. Investors should pay particular attention to the triggering events of conversion, limitations on voting rights, and profiles of SAFE issuers. Both empirical and scholarly studies view tech-startups as better SAFE issuers than non-tech companies. But, overall, preferred stock and common stock are deemed as more ideal types of securities that should be issued in Regulation CF offerings.

Nevertheless, the popularity of the SAFE never lost steam. SAFE is constantly among the most popular types of securities offered under Regulation CF because of its simplicity and customizability. SAFE's popularity is especially extraordinary in offerings approaching the $5 million raising cap.

Meanwhile It is still too early to assert that the SAFE is unsafe. Although in theory the conversion of the SAFE into equity securities can be very precarious, more empirical studies need to be conducted, especially on~~,~~ whether the SAFE's flexibility emboldens its issuing companies to unduly delay its conversion, or even to defraud investors by not converting at all.

It is also puzzling why there are so many common stock offerings on StartEngine and so few preferred stock offerings overall. Common stock is not widely accepted by venture capitalists as it lacks liquidation preferences. Documents provided by Seed Series could substantially simplify the negotiation process of issuing preferred stock. It is worth observing whether the popularity of preferred stock in offerings under Regulation CF will improve.

In China, the crowdfunding industry is dying due to regulatory clampdown. To resurrect this industry, the CSL needs to be further revisited and revised to bring more securities such as notes and SAFEs into its regulatory reach, and to provide an exemption from registration for crowdfunding offerings. Meanwhile, The CSRC should faithfully and efficiently exercise its rule-making authority to implement the statutory exemption if enacted. Regulation CF and its latest amendments are best references for China's pertinent rulemaking undertakings.