

Notes

Equity Crowdfunding of Film—Now Playing at a Computer Near You*

I. Introduction

In 1999, *The Blair Witch Project* shocked Hollywood and the entire filmgoing world.¹ The film portrays the alleged “found footage” of a documentary made by three film students who ventured into woods believed to be haunted by the ghost of an eighteenth-century witch.² While there are elements of the plot and premise that are undoubtedly shocking and startling, the real surprise was the film’s enormous commercial success despite filming on such a limited budget.³ Reportedly made on a production budget of just \$30,000,⁴ the film grossed an astonishing \$248,639,099 at the worldwide box office.⁵ Focusing on these numbers, a hypothetical \$1,000 investment in *The Blair Witch Project* would bring the investor a return of over \$4 million. Of course, determining a movie’s profits involves considerably more than simply subtracting the production budget from the box office returns.⁶ Yet, the numbers illustrate the point that movies made on small budgets have the potential to bring huge returns on relatively small investments.

While these high returns may attract any person with a disposable income looking to invest, film finance has traditionally been an activity

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1. Nicholas Barber, *Was The Blair Witch Project the Last Great Horror Film?*, BBC NEWS: CULTURE (Oct. 30, 2015), <http://www.bbc.com/culture/story/20151030-was-the-blair-witch-project-the-last-great-horror-film> [https://perma.cc/6U2B-LTYV].

2. *Id.*

3. Gitesh Pandya, *Summer 1999 Box Office Wrapup*, BOX OFFICE GURU (Sept. 21, 1999), <http://www.boxofficeguru.com/summer99.htm> [https://perma.cc/C2YL-SX7K].

4. *The Blair Witch Project*, BOX OFFICE MOJO, <http://www.boxofficemojo.com/movies/?id=blairwitchproject.htm> [https://perma.cc/CJR4-MTFS]. It should be noted that sound mixing, reshoots, and other postproduction activities took the budget up to around \$500,000. Barber, *supra* note 1 (explaining that, while the movie’s production budget was less than \$30,000, postproduction costs increased the final budget to around \$500,000).

5. Barber, *supra* note 1; BOX OFFICE MOJO, *supra* note 4.

6. See Derek Thompson, *How Hollywood Accounting Can Make a \$450 Million Movie ‘Unprofitable’*, ATLANTIC (Sept. 14, 2011), <http://www.theatlantic.com/business/archive/2011/09/how-hollywood-accounting-can-make-a-450-million-movie-unprofitable/245134/> [https://perma.cc/C9TS-4KMC] (describing the creative accounting often employed by studios).

reserved for only the wealthiest Americans.⁷ Until recently, if unknown filmmakers wanted to break into the industry, getting their movie produced often meant courting the friendship of rich individuals in the hopes that they would invest.⁸ Some people have even suggested that the influence these wealthy benefactors wield by backing movies contributes to Hollywood's lack of diversity, which shrouded the 2016 Academy Awards in controversy.⁹ With the advent of the Internet and the rise of social media, a new method of funding films not requiring a filmmaker to pander to wealthy individuals is becoming increasingly popular: crowdfunding.¹⁰

Crowdfunding, as its name would suggest, refers to the raising of capital through "relatively small contributions from a large number of people."¹¹ The concept of crowdfunding is not technically new, as charities, politicians, and nonprofits have employed this method for years.¹² The concept really exploded in popularity, though, when websites like Kickstarter and Indiegogo gave aspiring inventors, entrepreneurs, and artists an open forum to pitch their ideas to the world in the hopes of receiving funding.¹³ A "creator," be it in connection with a film, an invention, art, or any number of other projects that require raising capital, generates a listing that describes her project to potential "backers" browsing the site.¹⁴ The creator sets a fundraising goal and backers can pledge money to her project.¹⁵ The backer is only charged the amount of her promised contribution if and when the project reaches its fundraising goal.¹⁶ The vast majority of pledges on these

7. See Zack O'Malley Greenburg, *Panning for Silver Screen Gold: How to Invest in Films*, FORBES: MEDIA & ENTERTAINMENT (Dec. 10, 2014), <http://www.forbes.com/sites/zackomalleygreenburg/2014/12/10/panning-for-silver-screen-gold-how-to-invest-in-films/#5d799bbd7d0e> [<https://perma.cc/X29U-KMCP>] (describing film investment as expensive and risky).

8. See *id.* (discussing how wealthy entrepreneurs have been "swaggering into Hollywood" to invest in movies); see also Jason Brubaker, *How to Meet Rich People So You Can Get Movie Money*, FILMMAKING STUFF (Dec. 18, 2013), <http://www.filmmakingstuff.com/film-making-lesson-6-meet-rich-people/> [<https://perma.cc/YU4E-BU35>] (detailing the importance of meeting "a few rich people" if a person wants to make a movie).

9. Joel Anderson, *Can Equity Crowdfunding Revolutionize Film Financing?*, EQUITIES.COM (Feb. 10, 2016), <https://www.equities.com/news/can-equity-crowdfunding-revolutionize-film-financing> [<https://perma.cc/GQ5P-H3JS>].

10. See Greenburg, *supra* note 7 (highlighting directors' success using crowdfunding websites to fund million-dollar movies).

11. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 10.

12. Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1434 (2012).

13. INDIEGOGO, <https://www.indiegogo.com> [<https://perma.cc/PNU8-JLFE>]; KICKSTARTER, <https://www.kickstarter.com> [<https://perma.cc/RX92-PFRA>].

14. *Kickstarter Basics: Kickstarter 101*, KICKSTARTER, <https://www.kickstarter.com/help/faq/kickstarter%20basics> [<https://perma.cc/M2B4-H5F8>].

15. *Id.*

16. *Id.*

sites are relatively small; the median pledge on Kickstarter is only \$25.¹⁷ As of February 2017, Kickstarter, founded in 2009, has successfully funded over 117,000 projects with over \$2.8 billion pledged to these projects.¹⁸

Film projects already make up a substantial number of the projects on these sites. In 2014, 3,846 film and video projects were successfully funded on Kickstarter, second only to music projects.¹⁹ It is not just small-time filmmakers using these sites to fund low-budget projects. Over 90,000 fans of the TV show *Veronica Mars* gave \$5.7 million to fund a movie based on the show, which was taken off the air seven years earlier.²⁰ Additionally, since 2011, at least one Kickstarter film has been nominated for an Academy Award each year, with three crowdfunded projects nominated in 2016.²¹ While these sites allow fans and film buffs to give money to fund projects, they do not allow the backer to actually invest in the project and share in any profits the movies might have.²² Rather, in exchange for the donation, the filmmaker usually offers the backer some sort of reward.²³ For the *Veronica Mars* movie, for example, rewards ranged from a PDF of the movie script for a \$10 donation to a speaking part in the film in exchange for a \$10,000 pledge.²⁴

While this rewards-based model of crowdfunding has undoubtedly successfully created a new opportunity for filmmakers looking to get their projects funded, an offer of an equity stake in the film would likely greatly expand the funder base, enticing many more people to fund film projects. The problem with an equity model of crowdfunding has traditionally been that offering a portion of the movie's profits in exchange for capital involved the sale of a security, triggering the application of federal securities laws.²⁵ Thus, in the past, for a filmmaker to make such an offer to the public, she

17. *Building Rewards*, KICKSTARTER, <https://www.kickstarter.com/help/handbook/rewards> [<https://perma.cc/ZB8C-MSD2>].

18. *Stats*, KICKSTARTER, <https://www.kickstarter.com/help/stats> [<https://perma.cc/6J6T-KGUR>].

19. *2014: By the Numbers*, KICKSTARTER, <https://www.kickstarter.com/year/2014/data> [<https://perma.cc/9NEP-8FDB>].

20. Sarah Rappaport, *Kickstarter Funding Brings 'Veronica Mars' Movie to Life*, CNBC: MEDIA (Mar. 12, 2014), <http://www.cnbc.com/2014/03/12/kickstarter-funding-brings-veronica-mars-movie-to-life.html> [<https://perma.cc/C4HM-PYMF>].

21. David Ninh, *The Envelope, Please: Celebrating the Kickstarter Creators Nominated for Oscars*, KICKSTARTER BLOG (Feb. 24, 2016), <https://www.kickstarter.com/blog/cheers-to-this-years-oscar-nominated-kickstarter-films> [<https://perma.cc/5SYN-3C4V>].

22. See Bradford, *supra* note 11, at 16 (describing how sites like Kickstarter and Indiegogo use a reward or prepurchase model).

23. *Id.*

24. *The Veronica Mars Movie Project*, KICKSTARTER, <https://www.kickstarter.com/projects/559914737/the-veronica-mars-movie-project/description> [<https://perma.cc/N7UK-54U6>].

25. Crowdfunding, Release Nos. 33-9974, 34-76324, 7 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, 274) [hereinafter Crowdfunding]; Bradford, *supra* note 11, at 33.

was required to register with the Securities and Exchange Commission (the “SEC” or the “Commission”), a process typically prohibitively expensive for the relatively small amount of capital sought by the filmmaker.²⁶ Recently, after a public push by small businesses and investors, President Obama signed into law the Jumpstart Our Business Startups (JOBS) Act, which provides a crowdfunding exemption to federal securities law.²⁷ Although the President signed the act into law on April 5, 2012, the SEC did not adopt the final rules for the new crowdfunding exemption until October 30, 2015, and the rules did not go into effect until May 16, 2016.²⁸ This new exemption opens the door for equity crowdfunding and has the potential to give everyday investors the opportunity to participate in the financing of movies like *The Blair Witch Project* with the hopes of substantial returns from the films’ profits. As discussed in Part IV of this Note, though, the minuscule odds of funding a *Blair Witch*-type hit may not be worth the overall riskiness of these types of investments.

This Note examines this new crowdfunding exemption to federal securities laws and analyzes its potential impact on the financing of independent films. Part II of the Note surveys securities laws before the enactment of the JOBS Act—specifically the aspects of the laws serving as barriers to equity crowdfunding and the rationale for the exemption. Part III analyzes the JOBS Act and the rules promulgated by the SEC, explaining how the crowdfunding exemption works in practice. Part IV focuses on film finance—evaluating the benefits and risks of the equity financing of movies, both from the perspective of the filmmaker and the potential investor.

II. The Problem—The Pre-JOBS Act Securities Laws that Made Equity Crowdfunding Unworkable

The meaningful regulation of securities began in the 1930s in response to the Stock Market Crash of 1929 and the Great Depression that followed.²⁹ One of the primary causes of the crash was the “frenzied” speculation in stocks by investors who were promised huge profits by “silver-tongued” brokers without any meaningful disclosure to the investors of information about the companies in which they were investing.³⁰ In the hopes of preventing future catastrophes in the markets, Congress passed the Securities

26. Crowdfunding, *supra* note 25, at 7.

27. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.).

28. Press Release, U.S. Sec. & Exch. Comm’n, SEC Adopts Rules to Permit Crowdfunding (Oct. 30, 2015), <https://www.sec.gov/news/pressrelease/2015-249.html> [<https://perma.cc/PG26-EGG5>] [hereinafter SEC Adopts Rules].

29. Sharon Yamen & Yoel Goldfeder, *Equity Crowdfunding—A Wolf in Sheep’s Clothing: The Implications of Crowdfunding Legislation Under the JOBS Act*, 11 BYU INT’L L. & MGMT. REV. 41, 42–43 (2015).

30. *Id.*

Act of 1933³¹ (the Securities Act) and the Securities Exchange Act of 1934³² (the Exchange Act).³³

The Securities Act, sometimes referred to as the “truth in securities” law, has two main objectives: (1) to ensure that investors receive financial and other meaningful information concerning any security offered for public sale, and (2) to protect against fraud in the sale of securities.³⁴ The primary means by which the act accomplishes these goals is through the registration of securities.³⁵ In general, all securities within the meaning of the Securities Act must be registered with the SEC.³⁶ Further, the Exchange Act permits the SEC to require continued periodic reporting by registered companies with publicly traded securities.³⁷

A. A “Security”

In understanding the breadth of these acts, it is crucial to understand what constitutes a “security.” The Securities Act defines a security very broadly.³⁸ The Supreme Court broadened the definition even further by announcing the test as “whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.”³⁹ The Court later dropped “solely” from this test,⁴⁰ and more recently, the Court stated, “Congress’ purpose in enacting the securities laws

31. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)).

32. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78pp (2012)).

33. Yamen & Goldfeder, *supra* note 29, at 43.

34. *The Laws That Govern the Securities Industry*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/about/laws.shtml#secact1933> [<https://perma.cc/2FR2-E2ES>].

35. *Id.*

36. *Id.* The SEC was created by the Exchange Act, which gave the organization broad authority over all aspects of the securities industry and gave that body the power to “register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation’s securities self regulatory organizations.” *Id.*

37. *Id.*

38. See 15 U.S.C. § 77b(a)(1) (2012) (defining a security as “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, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing”).

39. SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

40. Bradford, *supra* note 11, at 30–31.

was to regulate investments, in whatever form they are made and by whatever name they are called.”⁴¹

Under this formulation, the rewards-based crowdfunding model, employed by websites like Kickstarter and Indiegogo, is free from the reach of the registration requirement of the Securities Act.⁴² Simply, the money given on these sites is not an investment. The creators offer these backers no expectation of financial return in exchange for their contributions, and “because investors on reward or pre-purchase sites are not offered stock, notes, or anything else that falls within the definition of security, federal securities law does not apply.”⁴³

While rewards-based crowdfunding has and may continue to operate without any interference from federal securities law, it is these rules that have stood as the major impediment to equity crowdfunding in the United States.⁴⁴ The sale of an equity stake in a motion picture on a crowdfunding site fits the Court’s broad definition of the sale of a security.⁴⁵ First, offering portions of the venture to such a great number of investors through crowdfunding is “almost by definition” a common enterprise.⁴⁶ Additionally, since equity crowdfunders solicit funds solely in exchange for a share of either future earnings or revenue, these investors would have an expectation of profits.⁴⁷ Lastly, these profits, if there are to be any, come solely from the work of the filmmaker and others involved in the actual production and distribution of the film, not the investors contributing money online.⁴⁸ Therefore, before the passage of the JOBS Act, a filmmaker looking to raise money for a project by offering a share of any future profits would have had to register the security with the SEC, unless an exemption applied.⁴⁹

B. *Registering a Security*

For an independent filmmaker looking to raise a relatively small amount of money, registration is simply not a viable option.⁵⁰ The costs associated

41. *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990) (emphasis omitted).

42. Bradford, *supra* note 11, at 32.

43. *Id.*

44. Crowdfunding, *supra* note 25, at 7.

45. See Bradford, *supra* note 11, at 33–34 (evaluating equity-based crowdfunding under the *Howey* test).

46. *Id.* at 33.

47. *Id.* at 33–34.

48. *Id.* at 34.

49. 15 U.S.C. § 77e(c) (2012); Crowdfunding, *supra* note 25, at 7.

50. See, e.g., Crowdfunding, *supra* note 25, at 7 (“Some observers have stated that registered offerings are not feasible for raising smaller amounts of capital, as is done in a typical crowdfunding transaction, because of the costs of conducting a registered offering and the resulting ongoing reporting obligations under the Securities Exchange Act of 1934 (Exchange Act) that may arise as a result of the offering.”); Bradford, *supra* note 11, at 42 (“[R]egistration is not a viable option for early-stage small businesses seeking relatively small amounts of capital.”).

with the actual registration and the ongoing disclosure requirements are exceedingly high.⁵¹

The costs of an initial SEC registration typically include underwriting compensation, a registration fee paid to the SEC, legal and accounting fees and expenses, printing and engraving costs, a Financial Industry Regulatory Authority filing fee, electronic filing fees when using a service for filing, stock exchange listing fees (if applicable), Blue Sky filing fees (if applicable), and transfer agent and registrar fees when the issuer retains the services of a third party to handle its stock records.⁵²

While these costs are lower for smaller offerings, accounting, legal, and other associated fees can easily add up to more than \$50,000.⁵³ Further, this process takes a significant amount of time,⁵⁴ and once registered, the offeror must carry the expensive ongoing burden of continued compliance and reporting required under the Exchange Act.⁵⁵

For a small project, the whole process is paradoxical. Consider a film project in dire need of money for production. In a desperate measure, the filmmakers decide to solicit the public for funds, but in order to do so they would need a significant amount of money for registration.⁵⁶ In sum, registration is an incredible financial undertaking for any typical startup, but it is especially unworkable for a filmmaker seeking to finance an independent movie with a limited budget, scope, and project duration.

C. Exemptions to the Registration Requirement

Because of the handcuffs in which the registration requirement puts many small businesses, even before the JOBS Act, a number of exemptions existed to help these companies raise capital.⁵⁷ The traditional exemptions that small businesses utilize are those pursuant to § 3(a)(11),⁵⁸ § 4(a)(2),⁵⁹

51. Paige M. Lager, Note, *The Route to Capitalization: The Transcendent Registration Exemptions for Securities Offerings as a Means to Small Business Capital Formation*, 94 TEXAS L. REV. 567, 569, 573 (2016).

52. Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 908 (2011).

53. *Id.* at 909.

54. *Id.* at 909–10.

55. See Lager, *supra* note 51, at 569 (estimating that the ongoing cost of regulatory compliance for a registered public offering is \$1.5 million per year).

56. See *id.* at 573 (noting the “chicken or the egg” problem created by the prohibitively expensive registration and reporting requirements).

57. Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493, 501–02 (2014).

58. 15 U.S.C. § 77c(a)(11) (2012).

59. *Id.* § 77d(a)(2).

Regulation A,⁶⁰ and Regulation D.⁶¹ Yet, none of these exemptions would permit equity crowdfunding.⁶²

Section 3(a)(11) exempts intrastate offerings from registration, but as crowdfunding invariably crosses state lines, this section cannot be employed for this purpose.⁶³

Similarly unhelpful is § 4(a)(2), which exempts from registration “transactions by an issuer not involving any public offering.”⁶⁴ Although the Securities Act does not actually define “public offering,”⁶⁵ the Supreme Court has stated, “the applicability of [the exemption] should turn on whether the particular class of persons affected needs the protection of the Act.”⁶⁶ In making this determination, courts consider both the “sophistication”⁶⁷ of the solicited investors and their access to meaningful information.⁶⁸ The ambiguity surrounding these concepts and their application to the exemption led the SEC to adopt a safe harbor to § 4(a)(2) in Rule 506 of Regulation D, discussed below.⁶⁹ Regardless, it is impractical for a potential crowdfunding website to operate under the 4(a)(2) exemption, as that would require the website to somehow ascertain the sophistication of its users and to furnish the requisite level of information to potential investors.⁷⁰ Equity crowdfunding from a website similar to Kickstarter or Indiegogo is therefore not permitted under this exemption.

Regulation A, as it existed pre-JOBS Act,⁷¹ provided small companies the opportunity to legally make up to \$5 million offerings without undergoing full registration with the SEC.⁷² Regulation A seemed attractive to crowdfunders, as it had no prohibition on general solicitation.⁷³ Yet, Regulation A required what amounted to a “mini-registration,” which although less extensive than what the Securities Act required, still involved preparing offering materials, obtaining a qualification statement by the SEC,

60. 17 C.F.R. §§ 230.251–.263 (2016).

61. *Id.* §§ 230.500–.508.

62. Dorff, *supra* note 57, at 502.

63. 15 U.S.C. § 77c(a)(11).

64. *Id.* § 77d(a)(2).

65. Heminway & Hoffman, *supra* note 52, at 912.

66. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

67. This refers to those “[o]fferees who possess financial and business knowledge that allows them to appreciate the risks of the investment.” Heminway & Hoffman, *supra* note 52, at 914.

68. *Id.* at 913–15.

69. *Fast Answers: Rule 506 of Regulation D*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/answers/rule506.htm> [<https://perma.cc/8EWM-DZ7K>].

70. See Heminway & Hoffman, *supra* note 52, at 915–16 (pointing out the aspects of § 4(a)(2) that make equity crowdfunding unworkable under the exemption).

71. In addition to creating the crowdfunding exemption, the JOBS Act made changes to Regulation A, creating what has been termed Regulation A+. For a more thorough discussion of this change to federal securities law, see Lager, *supra* note 51, at 581–87.

72. Bradford, *supra* note 11, at 48.

73. *Id.*

and in some cases, going through qualification and registration in multiple states.⁷⁴ In 1997, the average cost of a Regulation A offering was \$40,000–\$60,000⁷⁵—basically the entire production budget of *The Blair Witch Project*.⁷⁶ Further, between 2012 and 2014, qualification for a Regulation A exemption took an average of three hundred days.⁷⁷ This process is simply too expensive, time consuming, and burdensome for the types of small offerings that equity crowdfunding seeks to attract.⁷⁸

Traditionally, small businesses looking to raise money have relied on Regulation D as an exemption to registration.⁷⁹ Under Regulation D, “[e]ligible issuers can rely on Rule 504 to raise up to \$1 million within a twelve-month period, on Rule 505 to raise up to \$5 million within a twelve-month period, and on Rule 506 to raise an unlimited amount of capital.”⁸⁰ The largest problem with these exemptions for crowdfunding was, and still is, their restrictions on general solicitation, or the company’s ability to advertise and market its securities to the general public.⁸¹ Prior to the JOBS Act, Rules 505 and 506 both contained general prohibitions on solicitation to the public,⁸² while Rule 504 only allows for solicitations if the security is sold: (1) only in states requiring delivery of a disclosure document, (2) in at least one state requiring delivery of a disclosure document and that document is distributed to all purchasers in all states, or (3) pursuant to a state exemption that limits sales to accredited investors.⁸³ Since one of the major purposes of crowdfunding is to make a broad pitch to the public, these restrictions are practically prohibitive.⁸⁴ Further, Rules 505 and 506 permit

74. *Id.*; Lager, *supra* note 51, at 575.

75. Bradford, *supra* note 11, at 48.

76. *See supra* note 4 and accompanying text.

77. Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21,806, 21,869 (Apr. 20, 2015) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 240, 249, 260) [hereinafter Amendments to Regulation A].

78. Bradford, *supra* note 11, at 48.

79. Amendments to Regulation A, *supra* note 77, at 21,869.

80. *Id.*

81. Dorff, *supra* note 57, at 502.

82. Bradford, *supra* note 11, at 46–47. The JOBS Act amended Rule 506 to allow for general solicitations so long as the investors in the offering are all accredited investors. *See* 17 C.F.R. § 230.506(c)(2) (2016) (“All purchasers of securities sold in any offering under paragraph (c) of this section are accredited investors.”). This creates the opportunity for what has been termed “accredited crowdfunding.” Dorff, *supra* note 57, at 517–18.

83. 17 C.F.R. § 230.504 (2016). Most relevantly for the purposes of this Note, Regulation D’s definition of accredited investor includes a person: (1) “whose individual net worth, or joint net worth with that person’s spouse, exceeds \$1,000,000” excluding the value of the person’s primary residence; or (2) “who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.” *Id.* § 230.501(a)(5)–(6). For a full explanation of who qualifies as an accredited investor under Regulation D, see *id.* § 230.501(a).

84. Dorff, *supra* note 57, at 502.

a maximum of thirty-five nonaccredited investors,⁸⁵ with 506 adding on the additional requirement from § 4(2) that the nonaccredited investors be sophisticated.⁸⁶ Crowdfunding's reliance on small donations from a large number of investors makes these Rules' caps on the number of nonaccredited investors unworkable.⁸⁷ In sum, while these Regulation D exemptions may be extremely valuable for a typical startup approaching rich, accredited investors, they are not suitable for equity crowdfunding aimed at a broad audience.

With all of these exemptions inadequate to support equity crowdfunding, it became clear that a new exemption was needed if a profit-sharing model of crowdfunding was to legally exist in the United States.⁸⁸ Not long after websites like Kickstarter and Indiegogo gained significant popularity, a movement formed in 2010 to lobby the government to amend securities law to enable equity crowdfunding.⁸⁹ This movement quickly gained the support of many academics,⁹⁰ entrepreneurs,⁹¹ and, of particular interest for the purposes of this Note, Hollywood actors.⁹² These forces quickly caught the attention of the President and Congress, and in 2012, Congress passed the bipartisan JOBS Act, containing the framework for a crowdfunding exemption to the Securities Act.⁹³

III. The Solution—Title III of the JOBS Act and Regulation Crowdfunding

On April 5, 2012, President Obama signed the JOBS Act into law, hailing it as a “potential game changer” for startups and small businesses in

85. 17 C.F.R. §§ 230.505(b)(2)(ii), 230.506(b)(2)(i) (2016).

86. *Id.* § 230.506(b)(2)(ii).

87. *See supra* note 17 and accompanying text.

88. Bradford, *supra* note 11, at 44.

89. *See The Road to Legalizing Crowdfunding – The Thank You Chart*, STARTUP EXEMPTION (Apr. 20, 2012), <http://www.startupexemption.com/archives/294#axzz455MlcNYU> [<https://perma.cc/7GCF-JGD8>] [hereinafter *Legalizing Crowdfunding*] (providing a timeline of the lobbying effort for a startup exemption covering crowdfunding).

90. *E.g.*, Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, 13 U. PA. J. BUS. L. 973, 974 (2011).

91. *E.g.*, *About Us*, STARTUP EXEMPTION, <http://www.startupexemption.com/about-us#axzz45CTZudru> [<https://perma.cc/M6ZV-YRJE>].

92. *E.g.*, Angus Loten, *Whoopi to SEC: Let Small Firms Raise Capital*, WALL STREET J. (Mar. 23, 2011), <http://blogs.wsj.com/in-charge/2011/03/23/whoopi-to-sec-let-small-firms-raise-capital/> [<https://perma.cc/9C2G-S25B>].

93. Mark Landler, *Obama Signs Bill to Promote Start-Up Investments*, N.Y. TIMES (Apr. 5, 2012); *Legalizing Crowdfunding*, *supra* note 89, http://www.nytimes.com/2012/04/06/us/politics/obama-signs-bill-to-ease-investing-in-start-ups.html?_r=0 [<https://perma.cc/YQ3R-8FXJ>].

search of capital.⁹⁴ While the Act contains various provisions aimed at making it easier for companies to raise funds, Title III of the JOBS Act provides an exemption from the registration requirements for certain crowdfunding transactions.⁹⁵ Specifically, Title III adds § 4(a)(6) to § 4 of the Securities Act, creating a new exemption that makes equity crowdfunding available to non-reporting companies looking to raise a maximum of \$1 million in any twelve-month period.⁹⁶ Although the Act provides the framework for equity crowdfunding, it remained unusable until the SEC promulgated rules to carry out the exemption.⁹⁷ The JOBS Act initially gave the SEC 270 days to accomplish this task,⁹⁸ but the final rules, termed Regulation Crowdfunding, were not adopted until October 30, 2015 and did not go into effect until May 16, 2016.⁹⁹ In its pronouncement of the rules, the SEC set out the functionality of the crowdfunding exemption, the conditions for issuers seeking to use the exemption, and the requirements for the intermediary “funding portals” that facilitate the crowdfunding through their platforms.¹⁰⁰

A. *The Crowdfunding Exemption*

1. *Limit on Capital Raised.*—Starting May 16, 2016, the exemption from registration provided by § 4(a)(6) became available to a U.S. issuer, provided that “the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under [§ 4(a)(6)] during the 12-month period preceding the date of such transaction, is not more than \$1,000,000.”¹⁰¹ This limit applies to the issuer, not to a particular project.¹⁰² Therefore, as an example, if A seeks to produce two films in a single year, she may not raise \$1 million for each project through crowdfunding. Instead, the exemption limits her to \$1 million raised between the two projects. Further, A may not circumvent the limitation by creating separate subsidiary organizations for each film, as the calculation of the amount sold by a particular issuer in a twelve-month period includes “amounts sold by entities controlled by, or under common control with, the

94. President Barack Obama, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012) (transcript available at <https://www.whitehouse.gov/photos-and-video/video/2012/04/05/president-obama-signs-jobs-act#transcript> [<https://perma.cc/R8CP-VEBU>]).

95. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 306, 315 (2012) (codified in scattered sections of 15 U.S.C.).

96. 15 U.S.C. § 77d(a)(6) (2012).

97. Joe Wallin, *President Obama Signed the JOBS Act! Now What?*, STARTUP L. BLOG (Apr. 23, 2012), <http://www.startuplawblog.com/2012/04/23/president-obama-signed-jobs-act/> [<https://perma.cc/7JNL-7YEV>].

98. §§ 303(b), 304(a)(2), 126 Stat. 306 at 321–22.

99. Crowdfunding, *supra* note 25, at 1; SEC Adopts Rules, *supra* note 28.

100. Crowdfunding, *supra* note 25, at 14–16, 151–52.

101. 15 U.S.C. § 77d(a)(6)(A).

102. Crowdfunding, *supra* note 25, at 18–20.

issuer.”¹⁰³ Whether an entity is under “common control” with the issuer depends on whether or not the issuer possesses the power to direct or cause the direction of the management and policies of the entity.¹⁰⁴

This monetary limitation concerns the raising of capital under § 4(a)(6) and has no effect on the issuer’s ability to raise capital through other methods, including the use of other exemptions such as those under Regulation D.¹⁰⁵ This portion of the rule is crucial for movie producers, as making a movie today often costs well over \$1 million.¹⁰⁶ A filmmaker may use traditional methods of financing, including those methods involving separate exemptions to the registration requirement under the Securities Act, in addition to raising up to \$1 million through an offering under the crowdfunding exemption.¹⁰⁷

2. Investment Limits.—In addition to a cap on the amount of capital that can be raised through equity crowdfunding, the law contains strict limits on the amount an individual may invest.¹⁰⁸ If either an investor’s annual income or net worth is less than \$100,000, the individual is limited to investing “the greater of: \$2,000 or 5 percent of the lesser of the investor’s annual income or net worth.”¹⁰⁹ For an investor whose annual income and net worth exceed \$100,000, the individual may invest “10 percent of the lesser of the investor’s annual income or net worth.”¹¹⁰ Additionally, the law limits any one investor from purchasing more than an aggregate amount of \$100,000 worth of securities from crowdfunding offerings.¹¹¹ To illustrate, under these rules,

103. *Id.* at 18.

104. Since the JOBS Act provides no definition of control, the SEC decided to use the definition provided in Securities Act Rule 405. *Id.* at 19–20. Rule 405 states, “[t]he term control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” 17 C.F.R. § 230.405 (2016) (emphasis omitted).

105. Crowdfunding, *supra* note 25, at 18.

106. See Adam Leipzig, *Sundance Infographic 2015: Dollars and Distribution*, CULTURAL WKLY. (Jan. 28, 2015), <http://www.culturalweekly.com/sundance-infographic-2015-dollars-and-distribution/> [<https://perma.cc/YTJ8-R7G5>] (noting that the estimated average budget for indie dramatic features at the Sundance Film Festival in 2015 was \$1.7 million).

107. See Crowdfunding, *supra* note 25, at 18 (“Capital raised through other means should not be counted in determining the aggregate amount sold in reliance on Section 4(a)(6).”).

108. *Id.* at 25.

109. *Id.*

110. *Id.* This represents a departure from the rules proposed in the JOBS Act. Under the SEC’s final pronouncement of the rule, both the investor’s annual income and net worth must exceed \$100,000 in order to be able to invest up to 10% of her income. Under the JOBS Act, *either* the investor’s net worth or annual income had to exceed \$100,000 in order to invest 10% of her income. Under the final rules, an investor with an annual income of \$50,000 and \$105,000 in net worth is subject to an investment limit of \$2,500, in contrast to \$10,500 under the proposed rules. *Compare id.* (permitting 10% investment only when both annual income and net worth equal or exceed \$100,000), *with* 15 U.S.C. § 77d(a)(6)(B) (allowing 10% investment if either annual income or net worth are \$100,000 or greater).

111. Crowdfunding, *supra* note 25, at 8.

an individual with a net worth in excess of \$100,000 but an annual income of \$90,000 is subject to an investment limit of \$4,500, while an individual with a net worth in excess of \$100,000 who makes \$101,000 annually may invest up to \$10,100.¹¹² Further, an investor may not resell securities purchased in a crowdfunding transaction for a period of one year.¹¹³ In constructing these limitations, the SEC attempted to balance its desire to provide issuers with more access to capital with its paternalistic goals of protecting investors from potentially risky investments.¹¹⁴

Neither § 4(a)(6) nor the rules implementing the crowdfunding exemption distinguish between accredited and nonaccredited investors.¹¹⁵ As noted above, the limitations on the permitted number of nonaccredited investors stood as a major impediment to equity crowdfunding, which seeks to amass funding from a wide group of individuals.¹¹⁶ Unlike some of the exemptions under Regulation D, Regulation Crowdfunding allows any number of nonaccredited investors to invest in crowdfunding offerings, subject only to limitations on the amount of their investment.¹¹⁷ It should be noted, however, that while Regulation Crowdfunding expands the market of individuals permitted to provide capital compared with Regulation D, the exemption limits the investment of any such individual, regardless of wealth, to \$100,000 in any twelve-month period for crowdfunding offerings.

3. *Interaction with State Law.*—The new crowdfunding exemption preempts state law.¹¹⁸ This is an incredibly important aspect of the law, as crowdfunding characteristically reaches a wide variety of people, frequently crossing state lines in the process.¹¹⁹ Compliance with each state's securities laws would have cost issuers significant amounts of time and money, and these costs saved through preemption may ultimately be passed along to the investors.¹²⁰ While this preemption greatly benefits the issuer, it deprives investors of an additional layer of protection.¹²¹

B. *Issuer Requirements*

1. *Advertising and General Solicitation.*—For equity crowdfunding to truly thrive, it is critical that issuers have some ability to advertise their

112. For a chart providing more examples of the application of the limits, see *id.* at 26.

113. *Id.* at 11.

114. *Id.* at 26.

115. 15 U.S.C. § 77d(a)(6) (2012); Crowdfunding, *supra* note 25, at 28.

116. See *supra* notes 79–87 and accompanying text.

117. Crowdfunding, *supra* note 25, at 25, 28.

118. 15 U.S.C. § 77r(b)(4) (2012).

119. See generally Ajay K. Agrawal et al., *The Geography of Crowdfunding* (Nat'l Bureau of Econ. Research, Working Paper No. 16820, 2011).

120. Crowdfunding, *supra* note 25, at 481–82.

121. *Id.* at 482.

offerings to the public.¹²² As its name suggests, crowdfunding requires a crowd, and without the ability to market the security to a broad audience, projects will have great difficulty securing funding.¹²³ Under the rewards-based model, a project's success often depends on the creator's ability to promote its product on social media websites like Facebook and Twitter.¹²⁴ Before the JOBS Act, most of the exemptions from the registration requirement of the Securities Act proscribed this type of solicitation,¹²⁵ and this prohibition served as a major barrier to equity crowdfunding.¹²⁶

The new crowdfunding exemption under § 4(a)(6) authorizes general solicitation, including on social media, on a limited basis.¹²⁷ The law only allows "notices which direct investors to the funding portal or broker."¹²⁸ No limitation exists as to how an issuer may distribute such a notice, but the SEC limits what the advertising notice may include.¹²⁹ The Commission permits an issuer to include a statement announcing the offering and the name of the intermediary facilitating the offering, along with a link to the intermediary's site.¹³⁰ Further, the issuer may specify the "terms of the offering" and "information about the legal identity and business location of the issuer, limited to the name of the issuer of the security, the address, phone number and website of the issuer, the e-mail address of a representative of the issuer and a brief description of the business of the issuer."¹³¹

Although these items represent the full extent of what an issuer may include in the advertising notice, the issuer has the flexibility to omit any of the enumerated items.¹³² As noted by one commentator, this flexibility effectively allows the issuer to make what amounts to a "teaser" ad to promote its offering.¹³³ A clever filmmaker is given license to create a shroud of mystery around its advertisement in the hopes of "going viral" and attracting a large number of potential investors to the website hosting the offering.

122. See *supra* note 81 and accompanying text.

123. Dorff, *supra* note 57, at 502.

124. See Salvador Briggman, *A Great Strategy for Kickstarter Success*, CROWD CRUX, <http://www.crowdcru.com/a-great-strategy-for-kickstarter-success/> [http://perma.cc/Q8GK-C55R] (suggesting the use of social media sites to promote a project); *Promotion*, KICKSTARTER, <https://www.kickstarter.com/help/handbook/promotion> [https://perma.cc/BVV8-CJLZ] (same).

125. The exception to this was Regulation A, which was unattractive to crowdfunders for other reasons. See *supra* notes 71–78 and accompanying text.

126. See *supra* note 81 and accompanying text.

127. See 15 U.S.C. 77d-1(b)(2) (2012) (prohibiting the advertisement of the "terms of the offering," save those that direct prospective investors to the issuer's website).

128. *Id.*

129. Crowdfunding, *supra* note 25, at 136–39.

130. *Id.* at 139.

131. *Id.*

132. *Id.* at 140.

133. Lager, *supra* note 51, at 590.

2. *General Information About the Issuer and the Offering.*—The SEC allows the exclusion of information on advertising notices largely because of the information the issuer must provide to investors in its offering.¹³⁴ The Commission requires the issuing party to provide general information about the business,¹³⁵ as well as information about the businesses' owners and officers¹³⁶ and capital structure.¹³⁷ Because the SEC recognizes that many projects seeking to raise money through equity crowdfunding, such as independent films, will not have a traditional corporate structure and traditional officers, directors, or managers, the SEC requires “disclosure only to the extent an issuer has individuals serving in these capacities or performing similar functions.”¹³⁸ Although the rules mandate that the issuer provide potential investors with a business plan, the Commission realizes that offerings will come from a variety of industries with companies at varying stages of development and thus provides no specific requirements for what must be included in such a plan.¹³⁹ Similarly, the SEC mandates that an issuer disclose material factors that make an investment particularly speculative or risky, but it provides no specific standards for what must be included.¹⁴⁰

In addition to information about the business venture, issuers must also provide information about the offering. This includes the target offering amount, the offering price or the method for determining the price, and the deadline to reach the offering amount.¹⁴¹ The issuer must also include a “reasonably detailed description of the purpose of the offering” so that investors have a basic idea of how their money will be used.¹⁴²

3. *Financial Disclosure.*—An individual or company seeking to finance a project through equity crowdfunding must also make certain financial disclosures.¹⁴³ An issuer must provide a narrative discussion of its financial condition.¹⁴⁴ While the SEC does not prescribe specific content or format, the Commission advises that the discussion include “the issuer’s historical

134. See Crowdfunding, *supra* note 25, at 140 (“There is no requirement for legends on these notices because the issuer will be directing investors to the materials on the intermediary’s platform that will include those required legends.”).

135. *Id.* at 50–51.

136. If a company has it, information must be disclosed about its officers and 20% beneficial owners. This information includes positions held with the issuer, how long the individuals have held such positions, and the various individuals’ prior business experiences. *Id.* at 46–49.

137. *Id.* at 57.

138. *Id.* at 46.

139. *Id.* at 49–51.

140. *Id.* at 68–69.

141. *Id.* at 55–56. In an effort to protect investors, the Commission requires the offeror to inform the investor of her right to cancel before the deadline. *Id.* at 56. The rules give the issuer discretion to value the security and set the price provided that its valuation method is disclosed to investors. *Id.* at 148–50.

142. *Id.* at 52.

143. 15 U.S.C. § 77d-1(b)(1)(D) (2012).

144. Crowdfunding, *supra* note 25, at 75.

results of operations in addition to its liquidity and capital resources.”¹⁴⁵ For a filmmaker, this may include a description of past projects and their level of success, as well as the amount of capital on hand from other methods of fundraising.

The issuer must provide the investor with certain financial statements, depending on the size of the offering.¹⁴⁶ For offerings of \$100,000 or less, the issuer need only disclose “the amount of total income, taxable income and total tax as reflected in the issuer’s federal income tax returns” and financial statements both certified by the principal executive officer to be true and complete.¹⁴⁷ Issuers offering between \$100,000 and \$500,000 must provide financial statements reviewed by an independent public accountant, unless they already have financial statements that have been audited by an independent public accountant, in which case, the issuer must provide those instead.¹⁴⁸ These same rules apply to issuers offering more than \$500,000 using the crowdfunding exemption for the first time.¹⁴⁹ If an issuer offering more than \$500,000 has previously sold securities in reliance on Regulation Crowdfunding, she must offer financial statements audited by an independent public accountant.¹⁵⁰

The reporting requirement does not terminate for issuers after the initial offering. The rules require an issuer to give investors progress reports¹⁵¹ and to post an annual report on its website.¹⁵² The annual report should include the information provided in the original offering statement, as well as financial statements “certified by the principal executive officer of the issuer to be true and complete in all material respects.”¹⁵³

C. *Intermediary Requirements*

The JOBS Act and the SEC rules implementing the law require all issuers to conduct crowdfunding offerings under § 4(a)(6) through a

145. *Id.* at 76–77.

146. *Id.* at 91–92.

147. *Id.* at 91. The only caveat to this rule is that if the issuer has available financial statements that have been audited or reviewed by an independent accountant, the issuer must provide those financial statements instead. *Id.*

148. *Id.* at 91–92.

149. *Id.* at 92. This represents a departure from the proposed rules under the JOBS Act. *See* 15 U.S.C. § 77d-1(b)(1)(D)(iii) (2012) (requiring audited financial statements for all issuers making an offering of more than \$500,000). The SEC decided this would be too costly and burdensome for these issuers, worrying that they would have to incur the expense of an audit before having any proceeds or assurance of proceeds. Crowdfunding, *supra* note 25, at 98–99.

150. Crowdfunding, *supra* note 25, at 92.

151. *Id.* at 111. This burden only falls on the issuer if the intermediary does not furnish progress reports. *Id.*

152. *Id.* at 120–21.

153. *Id.* at 122.

registered broker or a funding portal.¹⁵⁴ The Exchange Act broadly defines broker as “any person engaged in the business of effecting transactions in securities for the account of others.”¹⁵⁵ This term is well established in federal securities law, and the law has long required brokers to register with the SEC.¹⁵⁶ The concept of a “funding portal” is new and was created exclusively to facilitate crowdfunding transactions under § 4(a)(6) of the Securities Act.¹⁵⁷ Essentially, the funding portals are websites like Kickstarter and Indiegogo that display equity crowdfunding investment opportunities to potential investors browsing their sites. The vast majority of crowdfunding offers are likely to take place through these types of funding portals, as brokers are unlikely to be willing to subject themselves to the liability associated with these offerings in exchange for the limited potential for commissions from the relatively small offerings.¹⁵⁸

Funding portals, like a broker, must register with the SEC, but the requirements of registration are generally less extensive than that of a broker.¹⁵⁹ Additionally, a funding portal must become a member of a national securities association, such as the Financial Industry Regulatory Authority.¹⁶⁰

The SEC requires all intermediaries, whether brokers or funding portals, to abide by certain requirements aimed at protecting investors.¹⁶¹ The intermediaries must screen issuers, taking reasonable efforts to verify the issuer’s compliance with securities laws and conducting background and securities enforcement checks on the issuer and its officers and directors.¹⁶² Further, the intermediaries must provide investors with educational

154. 15 U.S.C. § 77d(a)(6)(C) (2012); Crowdfunding, *supra* note 25, at 151.

155. 15 U.S.C. § 78c(a)(4)(A) (2012).

156. *See Broker-Dealer Registration*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/answers/bdregis.htm> [<https://perma.cc/QE3M-SWJQ>] (explaining that, since the Securities Exchange Act of 1934, brokers, as defined by that Act, have been required to register with the SEC).

157. 15 U.S.C. § 78c(a)(80). The law defines “funding portal” as any person acting as an intermediary solely for transactions pursuant to Securities Act § 4(a)(6) that does not:

(A) offer investment advice or recommendations; (B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; (C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (D) hold, manage, possess, or otherwise handle investor funds or securities; or (E) engage in such other activities as the Commission, by rule, determines appropriate.

Id. The SEC has provided a nonexclusive, conditional safe harbor for funding portals with a list of permissible activities. *See* Crowdfunding, *supra* note 25, at 273 (discussing the permissible activities in the proposed safe harbor).

158. *See* Cohn, *supra* note 12, at 1439–40 (discussing the aspects of equity crowdfunding that make it unattractive to traditional brokers).

159. Crowdfunding, *supra* note 25, at 249–50.

160. *Id.* at 154–56.

161. *See generally id.* at 151–245. The enumeration of requirements that follows is not exclusive. For a discussion on all of the requirements, see *id.*

162. *Id.* at 168–69, 178–79.

materials, including information about the 4(a)(6) exemption and the risks associated with crowdfunding investments.¹⁶³ Intermediaries must require investors to acknowledge that they have reviewed the educational materials provided and to complete a questionnaire demonstrating their basic understanding of the statutory elements and the substantial risk involved.¹⁶⁴ Additionally, the law dictates that intermediaries “have a reasonable basis for believing that the investor satisfies the investment limits established by § 4(a)(6)(B).”¹⁶⁵ Finally, intermediaries are responsible for displaying, on their sites, all of the issuers’ required disclosures¹⁶⁶ so that such disclosures are easily accessible to potential investors.¹⁶⁷

Overall, in enacting the crowdfunding exemption, Congress and the SEC were tasked with the difficult job of striking a balance between the desire to increase the availability of capital to startups and small businesses and the desire to continue to protect investors from fraud and unforeseeable risk. Some commentators argue that these requirements do not go far enough to protect investors, while others argue that the cost of disclosure to an issuer and intermediary are too high, rendering the exemption ineffective.¹⁶⁸ It is beyond the scope of this Note to evaluate the effectiveness of the SEC in achieving its goals. Regardless of one’s views, the equity crowdfunding exemption took effect on May 16, 2016, and the remainder of this Note evaluates its potential impact on independent filmmakers and individuals interested in investing in film.

IV. The Implications—Evaluating the Potential Implications of the Equity Crowdfunding of Films

While the new equity crowdfunding exemption has the potential to impact different startups and small businesses in numerous different sectors, there is reason to believe that the new exemption will have an especially significant impact on the movie industry. There is a historical connection between crowdfunding and film finance. Indiegogo actually launched its business at the Sundance Film Festival in 2008, specifically marketing itself as “an online social marketplace connecting filmmakers and fans to make

163. *Id.* at 187–88. For a full list of what must be included in the educational materials, see *id.* at 187–95 (outlining the proposed rules on educational materials and their comments, then summarizing the final rules).

164. *Id.* at 213–15.

165. *Id.* at 204.

166. See *supra* notes 134–52 and accompanying text.

167. Crowdfunding, *supra* note 25, at 199–204.

168. Compare Yamen & Goldfeder, *supra* note 29, at 70–71 (criticizing the JOBS Act for “open[ing] the door to take advantage of” investors who may not have the financial means to recover from fraudulent brokers), with Lager, *supra* note 51, at 591–93 (noting the high costs imposed on issuers for compliance with the exception).

independent film happen.”¹⁶⁹ Further, the success of crowdfunding films in the rewards-based model serves as a proof of concept moving forward. As previously noted, in 2014, Kickstarter successfully funded 3,846 films, second only to music as the industry with the most successfully funded projects.¹⁷⁰ Seeing these numbers, it is inevitable that individuals and companies interested in serving as intermediaries in equity crowdfunding transactions will set up funding portals aimed at film offerings.¹⁷¹ Some of the early portals are already marketing film-related offerings with great success.¹⁷² This creates unique opportunities for both filmmakers and potential investors, but each group should carefully contemplate certain considerations before deciding whether or not to utilize equity-based crowdfunding.

A. *The Filmmaker Perspective*

1. *A New Source of Capital.*—The most obvious benefit to filmmakers of the new equity crowdfunding exemption is the availability of an additional stream of capital. The 2008 financial crisis fundamentally altered the landscape for independent-film producers trying to raise money for their films.¹⁷³ Prior to the crisis, independent films were largely funded by bank loans collateralized by presale commitments from foreign distributors.¹⁷⁴ These commitments, often sold before the film had been produced, generally accounted for more than half the film’s production budget.¹⁷⁵ The crisis caused many foreign distributors to abandon the acquisition of American films, shifting their focus instead to local films.¹⁷⁶ This left American

169. GEOFF KING, *INDIE 2.0: CHANGE AND CONTINUITY IN CONTEMPORARY AMERICAN INDIE FILM* 90 (2014).

170. See *supra* note 19 and accompanying text (showing successfully funded film and video projects at 3,846 and successfully funded music projects at 4,009).

171. Since the removal of the ban on general solicitation under Rule 506, see *supra* note 82, multiple equity-based crowdfunding platforms have been formed specifically aimed at financing film. R. B. Jefferson, *The Top 5 Equity Based Crowdfunding Sites for Film Finance*, LAW. ROCK (May 26, 2014), <http://www.lawyersrock.com/equity-based-crowdfunding-2/> [<https://perma.cc/MBL2-PC94>]. Because of the limitations under Rule 506, only accredited investors may use these sites. *Id.* Now that the new exemption is in effect under § 4(a)(6), investors are likely to see similar equity crowdfunding sites geared towards film be made available to nonaccredited investors.

172. See, e.g., *Legion M: The First Hollywood Studio Owned by Fans*, WEFUNDER, <https://wefunder.com/legionm> [<https://perma.cc/T2WY-MKNNR>] (offering an equity stake in a film studio). For a greater discussion on Legion M, see *infra* notes 220–22 and accompanying text.

173. Lauren A.E. Schuker, *Indie Films Suffer Drop-Off in Rights Sales*, WALL STREET J. (Apr. 20, 2009), <http://www.wsj.com/articles/SB124018425311033183> [<https://perma.cc/GE7J-ZEDL>].

174. For a more thorough discussion on how this process worked, see Sahil Chaudry, *The Impact of the JOBS Act on Independent Film Finance*, 12 DEPAUL BUS. & COM. L.J. 215, 216–19 (2014).

175. Schuker, *supra* note 173.

176. *Id.*

independent-film producers with a dearth of financing options.¹⁷⁷ Rewards-based crowdfunding has already offered filmmakers an opportunity to fill some of the void left by the decrease in foreign presales.¹⁷⁸ Equity crowdfunding has the potential to further increase an independent filmmaker's access to capital by connecting producers "to a much larger universe of potential investors and [by facilitating] a cost-effective aggregation of smaller investment amounts."¹⁷⁹ Further, by democratizing the funding process, filmmakers will not be subject to the whims of high-dollar financiers or studios and can keep intact their artistic visions.¹⁸⁰

2. *The \$1 Million Limit.*—The relatively low annual cap of \$1 million that an issuer may offer to the public may cause concern for some filmmakers considering equity crowdfunding.¹⁸¹ There is no doubt that many projects will require far more than \$1 million. As noted above, though, this limitation does not proscribe producers from using other fundraising methods in conjunction with equity crowdfunding for movies with budgets exceeding \$1 million.¹⁸² Further, for those most likely to use the exemption—namely, producers of independent films—\$1 million has the potential to go a long way. It often takes longer than a year to make a movie.¹⁸³ The producer could initially raise \$1 million to support preproduction, production, and postproduction, and a year later make another \$1 million offering to support marketing and distribution.¹⁸⁴ Further, at the 2015 Sundance Film Festival, the average budget for an indie dramatic feature was \$1.7 million and \$400,000 for documentary features.¹⁸⁵ If the rules had taken effect, equity crowdfunding could have funded more than half the budget of the average

177. Erin Davies, *Indie-Film Shakeout: There Will Be Blood*, TIME (Nov. 7, 2009), <http://content.time.com/time/business/article/0,8599,1936350,00.html> [<https://perma.cc/Y5KE-VD3Q>].

178. See Heesun Wee, *How Equity Crowdfunding Just Might Upend Film Financing*, CNBC (May 15, 2013), <http://www.cnbc.com/id/100724191> [<https://perma.cc/XPP2-76YC>] (discussing how filmmaker Zach Braff turned to Kickstarter in part because of his lack of value in the eyes of foreign distributors).

179. Matthew Savare & Richard Jaycobs, *Crowded Marketplace: How the JOBS Act Will Transform Film Financing*, FILMMAKER (Apr. 17, 2012), <http://filmmakermagazine.com/44000-how-the-jobs-act-will-transform-independent-film-financing/#.Vw1haTYrJR2> [<https://perma.cc/N4BH-AGW4>].

180. See Wee, *supra* note 178 (describing how one filmmaker turned to crowdfunding because "[studios] wanted final cut of the film and to cast stars in roles").

181. See *supra* notes 101–04 and accompanying text.

182. See *supra* notes 105–07 and accompanying text.

183. See Michael R. Barnard, *Filmmakers, It's 2013. Do You Know Where Your JOBS Act Is?* Part 2, FILMMAKING LIFE BLOG (Jan. 27, 2013), <https://michaelrbarnard.wordpress.com/2013/01/27/filmmakers-its-2013-do-you-know-where-your-jobs-act-is-part-2/> [<https://perma.cc/VUW6-YVVN>] (discussing how the crowdfunding exemption can fit the "common timetable" of making films).

184. *Id.*

185. Leipzig, *supra* note 106.

Sundance dramatic feature in 2015, proportionately similar to the amount funded by foreign presales before the 2008 crisis.¹⁸⁶

3. *Proof of Concept*.—Additionally, for films with production budgets significantly higher than \$1 million, equity crowdfunding has the potential to serve as validation of the filmmaker's idea to larger investors.¹⁸⁷ People invest in products and ideas they believe will succeed, and an effective equity crowdfunding campaign demonstrates to institutional investors that there is desire in the market for the film.¹⁸⁸ A successful campaign may also arm the producer or filmmaker with greater leverage during negotiations with traditional investors, who are notorious for trying to strong-arm producers during the negotiation of terms.¹⁸⁹

4. *Marketing Benefits*.—Equity crowdfunding also has the potential to become a powerful marketing strategy. Research shows taking a company public can have substantial marketing benefits.¹⁹⁰ It creates a buzz, which can make both media outlets and potential filmgoers excited about the film. In this way, crowdfunding increases the film's chances of obtaining distribution, as it can "act as a source of credibility to increasingly conservative distributors who can leverage the implicit promotion of a fundraising campaign for all avenues of distribution, including box office, television, and video-on-demand sales."¹⁹¹

Depending on the size of the offering and the average donation, equity crowdfunding will create devoted advocates of the films in which they choose to invest. This is one of the few true advantages over the rewards-based model. Giving people from all around the country a stake in a film's success greatly incentivizes them to actively promote the movie to friends, families, and acquaintances in their respective communities. While this type of grassroots marketing would likely have limited effect on blockbusters with substantial advertising budgets and a wide release, it could greatly impact independent films with limited releases, whose success is often judged by the per screen average.¹⁹² Knowing this, distributors of equity crowdfunded films would be wise to consider the demographics of the film's investors.

186. See *supra* notes 171–76 and accompanying text.

187. Savare & Jaycobs, *supra* note 179.

188. Jim Saksa, *The Benefits of Crowdfunding Aren't What You Think*, TECHNICAL.LY: PHILLY (Sept. 9, 2014), <http://technical.ly/philly/2014/09/09/benefits-crowdfunding-arent-think/> [https://perma.cc/E7YT-Q7ME].

189. Savare & Jaycobs, *supra* note 179.

190. See generally Elizabeth Demers & Katharina Lewellen, *The Marketing Role of IPOs: Evidence From Internet Stocks*, 68 J. FIN. ECON. 413 (2003) (exploring the potential marketing benefits of going public and of IPO underpricing).

191. Chaudry, *supra* note 174, at 233.

192. See Marc Schiller, *Why Our Obsession With 'Per Screen Average' Will Eventually Kill Independent Cinema*, INDIEWIRE (May 1, 2013), <http://www.indiewire.com/article/why-our-obsession-with-per-screen-average-will-eventually-kill-independent-cinema>

5. *The Costs and Potential Liability.*—The costs associated with using the exemption represent the greatest downside of equity crowdfunding.¹⁹³ Most obviously, equity crowdfunding requires issuers to give up a share of the profits, a problem not faced by filmmakers using the rewards-based model.¹⁹⁴ Additionally, although the exemption requirements are not nearly as burdensome as registration under the Securities Act, there are still significant costs and potential liability associated with making the required disclosures under § 4(a)(6).¹⁹⁵ For offerings under the exemption, a filmmaker is liable to investors for any losses if she “makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements . . . not misleading.”¹⁹⁶ The risk this poses to issuers requires the consultation of lawyers and other professionals to ensure substantial compliance with the complex rules. In addition, the law itself requires the enlistment of an independent accountant to either certify or audit financial statements for offerings over \$100,000.¹⁹⁷

Although it is too early to tell, funding portals will also likely pass their costs on to the issuer.¹⁹⁸ The SEC estimates the cost on intermediaries to be between \$417,000 and \$770,000 the first year, with significant annual ongoing costs to be paid as well.¹⁹⁹ According to the SEC, this could lead funding portals to charge transaction fees as high as 15% in order to recoup their costs.²⁰⁰ On a \$1 million offering, issuers may have to pay as much as \$150,000 simply to use the funding portal’s services.

6. *Risk to Intellectual Property.*—Crowdfunding also poses potential risks to a filmmaker’s intellectual property.²⁰¹ Many of the filmmakers using the exemption will likely be at the earliest stages of development. Consider a documentarian who may only have an idea for a project when she decides to seek funding through a crowdfunding offering. As there is nothing yet to copyright, posting the idea to the public puts it at risk of being stolen by anyone browsing the website.²⁰² If the filmmaker has already created the copyrightable work, disclosure to the public is equivalent to “publication”

[<https://perma.cc/4A48-9D3L>] (noting the film industry’s obsession with the per screen average metric).

193. Lager, *supra* note 51, at 596–97.

194. Chaudry, *supra* note 174, at 233.

195. Lager, *supra* note 51, at 596–97.

196. Crowdfunding, *supra* note 25, at 333–34.

197. See *supra* notes 145–49 and accompanying text.

198. Lager, *supra* note 51, at 592–93.

199. Crowdfunding Proposed Rules, Release Nos. 33-9470, 34-70741, 385 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

200. Lager, *supra* note 51, at 593.

201. Nicholas Wells, *The Risks of Crowdfunding*, 60 RISK MGMT. 26, 26–28 (2013).

202. *Id.* at 28.

under the Copyright Act, and the filmmaker must pay the additional expense of registering with the Copyright Office in order to protect it.²⁰³

The weight accorded to each of the above considerations largely depends on the specific project and why the filmmaker decided to use the exemption. For example, a filmmaker primarily motivated by equity crowdfunding's marketing benefits may be less concerned by the compliance costs, seeing them as part of the film's overall marketing budget. Similarly, a filmmaker using equity crowdfunding for a completed film's prints and advertising budget will likely have protected the intellectual property and need not be concerned with the risks of publishing the details of the project to the public. Each filmmaker, then, must consider the specific costs and benefits of the exemption as it relates to her specific project.

B. *The Investor Perspective*

Like the filmmaker, the investor should not hastily elect to participate in the equity crowdfunding of film without careful reflection on the potential implications. The prospect of large returns may be enticing, but this remote possibility will usually be outweighed by the great risks involved.

1. *The Risks.*—As equity crowdfunding becomes more popular, the offerings made to investors through equity crowdfunding will likely be some of the riskiest investments on the market. Even in the SEC's final rules, the Commission acknowledges that "startups and small businesses that . . . will rely on the crowdfunding exemption are likely to experience a higher failure rate than more seasoned companies."²⁰⁴ Film projects may be even more susceptible to this high failure rate.²⁰⁵ For every ten movie projects launched by a studio, one commentator estimates only one is actually produced and released.²⁰⁶ The most knowledgeable experts in the film industry option these films and yet still they fail at an incredibly high rate. Studios and other sophisticated investors manage this risk by diversifying their investments using the profits from their most successful films to cover the losses of their failed investments.²⁰⁷ While equity crowdfunders have the ability to diversify their investments, they are provided limited information about the projects and are unlikely to take the time required to properly research each

203. *Id.*

204. Crowdfunding, *supra* note 25, at 26.

205. See Alex Mayyasi, *The Odds of a Hollywood Movie Being Made Are the Same as a Startup Making It*, PRICEONOMICS (Aug. 9, 2013), <http://priceonomics.com/the-odds-of-a-hollywood-movie-being-made-are-the/> [<https://perma.cc/78D7-GLPK>] ("[T]he odds of a Hollywood movie making it into theaters are the same as Silicon Valley's 9 out of 10 figure and much longer than startups' actual failure rate.").

206. *Id.*

207. *Id.*

investment.²⁰⁸ For nonexperts, crowdfunding investments in movies represent a game of chance with the odds largely stacked against them.

The high costs associated with compliance and disclosure will likely cause filmmakers to resort to equity crowdfunding only after exhausting other funding sources.²⁰⁹ Thus, investors largely will only have available to them those opportunities already rejected by more experienced and sophisticated film investors, representing yet another reason the films offered to the public are likely to fail.²¹⁰

2. *Dilution.*—Even if an investor wisely uses the limited information available to her and finds a film more likely to succeed, she risks having her interest in the venture significantly diluted during subsequent fundraising rounds.²¹¹ While institutional investors negotiate protections from dilution with the issuer, “[n]one of these measures are likely to be available to equity crowdfunders . . . unless the portals or the SEC require them.”²¹² Thus, producers and filmmakers can manipulate the process to benefit themselves and new investors at the expense of those who invested at the equity crowdfunding stage.²¹³

3. *Potential for Fraud.*—The potential for fraud in equity crowdfunding transactions represents another risk for potential investors.²¹⁴ Section 4(a)(5) of the Securities Act requires an intermediary to “take such measures to reduce the risk of fraud” with respect to transactions made under the crowdfunding exemption.²¹⁵ Still, by loosening disclosure requirements and decreasing the transparency of businesses as compared to registered offerings, “the opportunities to scam unsuspecting Americans will inevitably increase.”²¹⁶ Investors should be skeptical of “filmmakers” promising large returns and significant box office success.

V. Observations and Conclusion

As equity crowdfunding in the United States is less than a year old, it remains difficult to predict the full impact of the new crowdfunding exemption under § 4(a)(6) on film finance. However, early results suggest

208. Dorff, *supra* note 57, at 514–15.

209. *See id.* at 517 (“[E]ntrepreneurs who can secure funding from other sources . . . will prefer those sources to equity crowdfunding.”).

210. *Id.*

211. *Id.* at 515–16. For an explanation of how dilution can happen to early stage investors, see *id.*

212. *Id.* at 517; *see also* Crowdfunding, *supra* note 25, at 387 (“Investors purchasing securities issued in reliance on Section 4(a)(6) may not have the experience or the market power to negotiate various anti-dilution provisions . . .”).

213. Dorff, *supra* note 57, at 516.

214. Yamen & Goldfeder, *supra* note 29, at 66–67.

215. 15 U.S.C. § 77d-1(a)(5) (2012).

216. *See* Yamen & Goldfeder, *supra* note 29, at 66–70 (using history to argue that crowdfunding transactions are particularly susceptible to issuers trying to defraud investors).

film-related offerings will be a significant part of the emerging market. As of April 7, 2017, investors have funded over \$23 million in equity crowdfunding offerings.²¹⁷ Of the eighty-five companies that have reached their minimum funding target, three companies have already reached the \$1 million annual cap.²¹⁸ One of these companies is Legion M—a film studio marketing itself as “the first Hollywood studio owned by fans.”²¹⁹ Legion M’s success and the great proliferation of film projects offered on rewards-based crowdfunding platforms suggest that a significant number of films and production companies will be available for investing on funding portals facilitating the new exemption. The fact that producers and investors can equity crowdfund, though, does not necessarily mean that they should.

For filmmakers, equity crowdfunding under the new exemption should be avoided in most cases. The significant costs and potential liabilities of the SEC’s rules do not justify the relatively small access to capital the new exemption affords. If possible, filmmakers are better off raising funds through traditional sources of capital or on websites like Kickstarter and Indiegogo where they are not hamstrung by the \$1 million cap or by the significant costs of disclosure and SEC compliance.²²⁰ However, there are two particular scenarios where equity crowdfunding is worth the cost.

The first is when a filmmaker has exhausted all of the less costly funding options to no avail and the new exemption provides the only hope of getting the project produced. Of course, this is an extremely risky position to be in, as there is no guarantee that the investing public will fund the project. The second and much more desirable scenario that warrants use of the exemption is a well-funded filmmaker taking advantage of the marketing and public relations benefits of equity crowdfunding—exemplified by Legion M’s use of the exemption.²²¹ In funding its production company, Legion M had already raised over \$400,000 from accredited investors before opening up the offering to the general public.²²² Legion M then raised the permitted \$1 million from over 3,000 investors and became the first “fan-owned entertainment company.”²²³ The media grabbed onto Legion M’s story, and

217. See *The Current Status of Regulation Crowdfunding*, WEFUNDER, <https://wefunder.com/stats> [<https://perma.cc/E25F-2DCE>] (providing updated statistics hourly regarding the use of the new crowdfunding exemption).

218. *Id.*

219. *Legion M*, WEFUNDER, <https://wefunder.com/legionm> [<https://perma.cc/5YHC-GKSJ>].

220. Including so-called “accredited crowdfunding” under the amended Rule 506. See sources cited *supra* note 82.

221. See *supra* notes 189–91 and accompanying text.

222. *Legion M*, *supra* note 219.

223. Samantha Hurst, *Legion M Closes Record-Setting \$1M Wefunder Crowdfunding Round & Named Itself Most Popular CF Company*, CROWDFUND INSIDER (Aug. 15, 2016), <https://www.crowdfundinsider.com/2016/08/89117-legion-m-closes-record-setting-1m-wefunder-crowdfunding-round/> [<https://perma.cc/3AVT-DNRM>]; Midori Yoshimura, *Brief: Legion M, One of World’s First Fan-owned Entertainment Companies, Launches Today*, CROWDFUND INSIDER

it has received a notable amount of good press and notoriety.²²⁴ Further, once Legion M begins producing movies, it will have an army of investors with a stake in each film's success that will undoubtedly function as a kind of grassroots marketing team. Essentially, the cost of SEC compliance becomes an investment for companies or filmmakers like Legion M, who can leverage their use of the equity crowdfunding exemption to increase profits long-term. Such a strategy works largely when a company or film is not desperate for the capital gained from the actual offering.

Separately, for investors who seek profit, equity crowdfunding of films should largely be avoided altogether. In theory, investing in a movie sounds like an exciting investment opportunity. In reality though, films represent a risky investment even for those with the requisite expertise. It is estimated that fewer than 2% of independent films make a profit.²²⁵ Further, other than the offerings by filmmakers like Legion M, the projects offered on the funding portals for investing are likely to be those turned down by all the traditional and less costly funders, making these projects even riskier than a typical independent film. The chances of investing in a film like *The Blair Witch Project* are extremely remote, and the average investor who cares about profits and losses is better off spending her money on a movie ticket, rather than an equity stake in the film's success.

—Joshua A. Gold

(Mar. 9, 2016), <https://www.crowdfundinsider.com/2016/03/82607-brief-legion-m-one-of-worlds-first-fan-owned-entertainment-companies-launches-today/> [https://perma.cc/576H-Y984].

224. *Legion M*, *supra* note 219.

225. Chris O'Falt, *Equity Crowdfunding Is Here – And It Could Be Terrible for Indie Filmmakers*, INDIEWIRE (May 17, 2016), <http://www.indiewire.com/2016/05/equity-crowdfunding-is-here-and-it-could-be-terrible-for-indie-filmmakers-290400/> [https://perma.cc/H63K-LF6D].