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CROWDFUNDING AND THE NOT-SO-SAFE SAFE

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INTRODUCTION

ON May 16, 2016, more than four years following the enactment of the Jumpstart Our Business Startups Act (the “JOBS Act”), the much-anticipated era of retail crowdfunding officially began in the United States.¹ On the very first day that the Securities and Exchange Com-

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¹ Generally speaking, the term “crowdfunding” refers to the “practice of funding a project or venture by raising money from a large number of people, each of whom contributes a relatively small amount, typically via the Internet.” See Crowdfunding, Oxford English Dictionary Online (3d ed. 2015), [http://www.oed.com/view/Entry/429943?redirectedFrom=crowdfunding& \[https://perma.cc/LGH3-RUG5\]](http://www.oed.com/view/Entry/429943?redirectedFrom=crowdfunding&[https://perma.cc/LGH3-RUG5]). As used herein, the terms “crowdfunding” and “retail crowdfunding” refer to the process of raising capital from non-accredited investors through securities offerings under § 4(a)(6) of the Securities Act of 1933 (codified as amended at 15 U.S.C. § 77d(a)(6) (2012)), and the SEC’s Regulation Crowdfunding, 17 C.F.R. § 227 (2016), and are not meant to include other types of securities offerings or fundraising campaigns that are also often considered forms of crowdfunding, such as online securities offerings to accredited investors under Rule 506(b) or Rule 506(c) of Regulation D, 17 C.F.R. §§ 230.506(b)–(c) (2016), mini-public offerings under Regulation A (as amended by the JOBS Act and now commonly called Regulation A+), 80 Fed. Reg. 21,805 (June 19,

mission's ("SEC") new Regulation Crowdfunding went into effect, seventeen companies launched crowdfunding campaigns on various online platforms—known as “funding portals”—that registered with the SEC to host offerings. Over the past several months, dozens of companies have solicited investments through these portals to finance the development of biodegradable toothbrushes,² custom-printed condoms,³ and glow-in-the-dark vegetation,⁴ among other projects.⁵

While it is far too early to pass judgment on the long-term prospects of the crowdfunding project more generally, it is possible at this juncture to assess how certain aspects of crowdfunding are developing and to identify potential pitfalls for the players in this new arena. In at least one area—the menu of financing instruments being offered to prospective retail investors—we believe that early market participants may be unintentionally sabotaging the crowdfunding experiment. Specifically, we believe that the forms of a relatively new startup-financing instrument, the simple agreement for future equity (“SAFE”), currently offered by crowdfunding portals such as WeFunder⁶ and Republic,⁷ contain terms that are likely to frustrate the ability of investors to share in the upside of successful crowdfunding companies. In other words, crowdfunding investors who purchase SAFEs may discover that these instruments are anything but.

To be clear, we do not argue here that the SAFE has no role to play in providing capital to early-stage companies. Outside of the crowdfunding context, there are situations in which the SAFE may be a sensible instrument for startups to use when fundraising. In the crowdfunding con-

2015), or rewards-based fundraising campaigns on popular platforms such as Kickstarter and Indiegogo.

² See Do., LLC, Offering Statement (Form C) (May 16, 2016), <https://www.sec.gov/Archives/edgar/data/1674379/000167025416000015/0001670254-16-000015-index.htm> [<https://perma.cc/G3B5-PV6L>].

³ See Graphic Armor, Inc., Offering Statement (Form C) (May 16, 2016), https://www.sec.gov/Archives/edgar/data/1674376/000166516016000067/xslC_X01/primary_doc.xml [<https://perma.cc/B7T6-G23N>].

⁴ See TAXA Biotechnologies, Inc., Offering Statement (Form C) (May 16, 2016), https://www.sec.gov/Archives/edgar/data/1674082/000167025416000002/xslC_X01/primary_doc.xml [<https://perma.cc/47EY-3NNT>].

⁵ See Jack Wroldsen, *Crowdfunding Investment Contracts*, 11 Va. L. & Bus. Rev. (forthcoming 2017) (discussing the wide variety of projects seeking funding from the crowd).

⁶ WeFunder, *Legal Primer for Founders*, <https://wefunder.com/faq/legal-primer> [<https://perma.cc/J3VG-RJ5C>].

⁷ Republic, *The Crowd Safe*, <https://republic.co/crowdsafe> [<https://perma.cc/DWF7-MH4D>].

text, however, the vast majority of companies raising money are unlikely to ever raise institutional venture capital (“VC”). Since the SAFE was developed as a means of investing in startups that expect to raise such funding at a later date, it is not the right tool for channeling retail investment capital to crowdfunding companies. Even if the terms of the SAFEs currently offered by WeFunder and Republic were to be rewritten, the use of the SAFE in crowdfunding would still present a number of issues from the perspective of a retail investor. Accordingly, we argue that the most promising solution to the problems we identify in this Essay is for the funding portals to remove the SAFE from their menus of financing instruments.

This short Essay proceeds as follows. Part I surveys the types of securities available to crowdfunding companies via the new funding portals. Part II describes the origins of the SAFE. Part III describes the types of crowdfunding companies that have issued SAFEs to date and argues that many of these companies are unlikely to raise institutional VC. Part IV surveys and criticizes the terms of the SAFEs currently on offer by several funding portals. The Essay concludes by discussing several possible solutions to the problems identified herein.

I. TYPES OF CROWDFUNDING SECURITIES

The JOBS Act crowdfunding provisions did not include any explicit restrictions on the types of securities that issuers could sell in crowdfunding offerings.⁸ The SEC considered regulating the types of crowdfunding securities, soliciting comments regarding whether it should, for instance, only permit crowdfunding issuers to offer plain-vanilla equity securities.⁹ Based on feedback the SEC received during the comment period and its interpretation of congressional intent in Title III of the JOBS Act, the SEC decided to allow issuers to offer any type of security in a crowdfunding offering, so long as investors are given adequate disclosure about the structure and terms of the investment.¹⁰ The SEC declined to narrow the list of instruments that companies could offer crowdfund-

⁸ See Securities Act of 1933, ch. 38, § 4(a)(6), 48 Stat. 74 (codified as amended at 15 U.S.C. § 77d(a)(6) (2012)).

⁹ See Crowdfunding, 78 Fed. Reg. 66,428, 66,458 (proposed Nov. 5, 2013).

¹⁰ See Crowdfunding, 80 Fed. Reg. 71,388, 71,427 (Nov. 16, 2015).

ing investors in order to give issuers some flexibility as this new market develops.¹¹

As a result, startups looking to raise capital through crowdfunding have had free rein to choose whichever instruments they believe best fit their needs. They have offered crowdfunding investors a variety of securities thus far, including common and preferred equity, debt instruments (with rates of return and payment schedules that are either fixed or vary with the company's revenues), and convertible securities (such as convertible notes and SAFEs).¹² Most of these instruments have longstanding roles in early-stage technology startup and small-business finance. For many years, early investors in tech startups received the same common stock that a startup's founders received, until it became more common for those early-stage angel investors to purchase convertible notes.¹³ Institutional VC investors have traditionally negotiated for preferred stock with liquidation preferences and other minority protections.¹⁴ Debt instruments with fixed or variable repayment schedules have long been staples of financing for small businesses with revenue models that generate sufficient cash flow to service the debt and provide an adequately attractive risk-adjusted return to the lenders, be they community banks, the Small Business Administration, or high-net-worth individuals. Compared to these other instruments, the SAFE is the new kid on the block, having emerged at the end of 2013 and only more recently becoming widely used as a startup-financing tool.¹⁵ To understand how this new instrument may have an adverse impact on the new crowdfunding ecosystem, it is first necessary to briefly discuss the origins of the SAFE.

II. THE SIMPLE AGREEMENT FOR FUTURE EQUITY ("SAFE")

The SAFE was developed by Y Combinator, the well-known startup accelerator based in Silicon Valley, as a means of investing in startups that expected to raise institutional VC at a later date.¹⁶ Although the

¹¹ See *id.* at 71,506.

¹² See Wroldsen, *supra* note 5.

¹³ See John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 *Hastings L.J.* 133, 146–48 (2014).

¹⁴ *Id.* at 149–51.

¹⁵ *Id.* at 168–69.

¹⁶ Y Combinator's form of SAFE is available at <https://www.ycombinator.com/documents/#safe> [<https://perma.cc/82M4-R3JU>].

SAFE resembles a classic seed-stage convertible note in most respects, the SAFE is not a debt instrument. It lacks the convertible note's maturity date and does not accrue interest while it remains outstanding. The SAFE is also not an equity instrument, and its holders are owed no fiduciary duties until the instrument converts into equity. Moreover, the SAFE does not pay dividends and the SAFE holder has no right to vote on matters submitted to shareholders.¹⁷ The SAFE is, in essence, a contractual derivative instrument. It is a deferred equity investment that will prove valuable to the holder if, and only if, the company that issues it raises a subsequent round of financing, is sold, or goes public.

The SAFE was originally created to facilitate early-stage investments in the companies participating in Y Combinator's accelerator program. Startups that have been through the semi-annual Y Combinator program include several so-called "unicorns" (startups with private valuations of at least \$1 billion), most notably Airbnb and Dropbox.¹⁸ These technology companies aspire to follow a fairly well-defined growth trajectory: They raise significant sums of capital, spend it quickly to achieve as much growth as possible as quickly as possible, raising more money along the way to continue their expansion at breakneck pace until achieving a liquidity event—usually in the form of a sale of the company or, in fewer cases, an initial public offering.¹⁹ Savvy startup investors typically view the outcomes of seed investments in these companies as essentially binary: The companies will either succeed or go bust, leaving the investors with either a lucrative multiple return on their investment or a loss of most, if not all, of their principal. Often, in the downside scenario, the founders and investors try to salvage as much of their investments (and reputations) as possible through a sale or acqui-hire, but

¹⁷ To be clear, the SAFE is not unique in this regard. Common and preferred stockholders of private companies in the tech sector rarely receive dividends, as these companies typically invest all available capital in future growth. Convertible notes also do not grant the holder the right to vote on matters submitted to the shareholders.

¹⁸ Harold J. Krent & Dawn K. Young, *Self-Interested Fiduciaries and the Incubator Movement*, 66 *Syracuse L. Rev.* 611, 618 (2016).

¹⁹ The fact that not all startups *achieve* this growth trajectory should not distract from the essential point that many, if not most, tech startups aspire to it. See Paul Graham, *Startup = Growth*, <http://www.paulgraham.com/growth.html> [<https://perma.cc/UMF9-JAJD>]; see also Victor Fleischer, *The Missing Preferred Return*, 31 *J. Corp. L.* 77, 90 (2005) (describing the "home run mentality" in the VC industry); Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 *U. Pa. L. Rev.* 179, 237 n.303 (2012) (same).

modest, middling returns are not what most investors are seeking in the feast-or-famine world of seed-stage startup investing.²⁰

In addition to receiving an investment from Y Combinator for participating in the accelerator program, in many cases the initial investments in Y Combinator portfolio companies via the SAFE come from a coterie of high-profile angels and VC investors who routinely fund the accelerator's portfolio companies with relatively small amounts of seed capital.²¹ Y Combinator has marketed the SAFE as being "simple," in that it is a minimalistic contract of only a few pages, containing little legalese and contractual boilerplate as well as fewer terms than the convertible notes that these parties were already quite familiar with (and which these investors had been using for years to invest in Y Combinator companies). Switching from convertible notes to SAFEs had the added benefit—at least, from the founders' perspective—of not requiring the additional legal work often needed to extend the maturity date of convertible notes if a subsequent financing had not occurred prior to maturity. Using SAFEs also allowed founders to avoid having difficult conversations with convertible noteholders at maturity if the company was not performing as expected or was having difficulty raising a subsequent round of financing. Effectively, the SAFE purported to improve upon a very specific concern (the maturity feature of convertible notes) encountered by a particular type of company (unfunded tech startups, specifically those participating in Y Combinator's accelerator program) and a few specific groups of people (founders of hot startups and highly experienced startup investors competing for access to those companies) within the bubble of the Silicon Valley startup ecosystem. Given Y Combinator's prominence as an influencer in the startup world, startups outside the Silicon Valley ecosystem have since increasingly adopted the SAFE as a seed-financing tool.

SAFES can be suitable investment instruments for companies—like Y Combinator portfolio companies—that are strong candidates for future VC investment. It is important to bear in mind, however, that SAFES are highly company-favorable securities—a product of the latest startup-financing frenzy—requiring investors who understand and accept the binary nature of investing in early-stage tech startups and who believe that the company will eventually be in a position to raise institu-

²⁰ See John F. Coyle & Gregg D. Polsky, *Acqui-hiring*, 63 *Duke L.J.* 281, 283–84 (2013).

²¹ Coyle & Green, *supra* note 13, at 170.

tional VC so that the SAFEs will convert to equity as intended. In the context of crowdfunding, the use of SAFEs has the potential to result in some unexpected and unfavorable outcomes for the uninitiated.

Indeed, for companies and investors outside the clubby startup world of U.S. technology hubs like Silicon Valley, the nomenclature “SAFE” may actually be somewhat misleading. Retail investors, who presumably are used to investing in traditional asset classes, such as publicly traded stocks and bonds, are unlikely to be familiar with the convertible notes and SAFEs that more sophisticated accredited investors use to invest in tech startups. As a result, they are also unlikely to find the mechanics by which SAFEs convert to equity to be particularly “simple.”²² The safety implied by the clever acronym “SAFE” actually points to the instrument’s safety for the issuing company—which is able to avoid the maturity dates associated with convertible notes—rather than any safety for the investor. A potential problem with using SAFEs in crowdfunding, therefore, is that inexperienced retail investors may mistakenly believe that they are receiving something simple and safe, a security that they believe all of the top startups and investors in Silicon Valley use, and make an investment without fully understanding the risks that they are assuming by purchasing those SAFEs.

III. TYPES OF CROWDFUNDING ISSUERS OPTING FOR SAFES

Of the 96 issuers to launch crowdfunding offerings through August 31, 2016, 30 issuers (approximately 31%) chose to offer convertible securities (such as convertible notes, SAFEs, or similar instruments) to prospective crowdfunding investors. Ninety percent of the convertible securities used were SAFEs. The remaining convertible securities were convertible notes.

Two different types of issuers have opted to use SAFEs thus far in their crowdfunding offerings:

1. Tech startups with business models and growth trajectories that are potentially attractive to VC investors; and
2. Non-tech startups with business models that are less likely to attract VC investment.

²² The SAFE’s “simplicity” presupposes an investor’s familiarity with the terms and mechanics of a convertible note (the instrument on which the SAFE was modeled).

Many tech startups using SAFEs in crowdfunding offerings to date hail from technology hubs—places like the San Francisco Bay Area, Boston, New York, and Southern California—where the influence of Y Combinator is strongest.²³ For some of these companies, using SAFEs with crowdfunding investors is not likely to cause any serious issues because the SAFE was designed for investing in these types of companies—tech startups that are likely to either raise institutional VC or fail. But even crowdfunding issuers that are tech startups and that have business models which, at first blush, would appear attractive to VC investors (and therefore suitable candidates for using SAFEs) may be less likely to raise future VC financing than the typical tech startup. Due to the additional costs and disclosures required of crowdfunding issuers, most startups that have access to traditional forms of startup fundraising will be loath to undertake a crowdfunding offering. As a result, many of the startups that choose to pursue crowdfunding as a means of raising capital do so because they have no other options, and they may still struggle to raise traditional venture financing down the road.²⁴ Additionally, some of the startups using SAFEs are not based in technology hubs, and may have turned to crowdfunding because they are outside of traditional angel and VC networks. These factors may mean the SAFE is an inappropriate instrument for these investments, since the SAFE is predicated on the expectation that the issuer will eventually raise a round of institutional VC and otherwise follow the traditional path of a high-tech venture-backed startup.

The second category of crowdfunding issuers using SAFEs—non-tech startups—presents even greater concerns. These are companies with business models and growth trajectories that often look quite different from tech startups. As a result, these companies are less likely to be candidates for VC investment and more likely to evolve into either lifestyle businesses for the founders—providing them with healthy salaries and

²³ A few crowdfunding issuers are even Y Combinator portfolio companies, so their decision to use SAFEs for their crowdfunding investors is understandable. In addition, the funding portal WeFunder, which has led the way when it comes to issuers employing the SAFE in crowdfunding offerings on its platform, is itself a Y Combinator portfolio company. Ryan Lawler, *Y Combinator-Backed WeFunder Launches to Bring Crowdfunding Startups to the Masses*, TechCrunch (Mar. 19, 2013), <https://techcrunch.com/2013/03/19/wefunder-launch/> [<https://perma.cc/SH7H-NGR2>].

²⁴ This adverse selection problem is sometimes described as a “market for lemons.” Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 *Minn. L. Rev.* 561 (2015).

the ability to distribute any profits to themselves in the form of dividends for the foreseeable future—or companies that rely on debt financing (such as bank loans) and reinvested profits to support additional growth. These companies, even if they are successful, may never raise additional equity capital, be sold, or go public, leaving SAFE holders with no way to receive returns on their investments.²⁵ The SAFE was simply not designed to be used to invest in this type of company.

IV. FUNDING PORTALS AND VARIATIONS ON A SAFE

Thus far, we have been discussing the conceptual concerns with different types of companies using SAFEs in crowdfunding, but there are also more specific issues raised by the forms of SAFEs that actual crowdfunding issuers have offered to prospective investors. These SAFEs have all been based on the forms made available to the issuers by the funding portals they chose to host their offerings. For instance, WeFunder, which has been the most popular funding portal to date thanks to its streamlined disclosure process and industry-low commission (at four percent of funds raised),²⁶ has a form of SAFE available on its website that every WeFunder company using SAFEs has adopted.²⁷ The WeFunder SAFE has a number of features that may exacerbate some of the problems we have described with the use of SAFEs in crowdfunding generally.

There are typically three scenarios in which SAFE investors receive cash back from their investment:

1. Post-Conversion Liquidity Event. In this scenario, the company sells priced equity securities following the SAFE financing, and the

²⁵ Outside the context of crowdfunding, in the unlikely event that a startup that raises seed capital using SAFEs never raises a subsequent round of equity financing and instead turns into a lifestyle company, the personal relationship of the founders with angel investors and startup community norms may lead the founders to agree to convert the SAFEs to stock without being contractually required to do so. This type of extracontractual resolution to an unwelcome outcome not contemplated in the investment contract would seem less likely for companies that are not a part of that community, with investors that they do not know personally, as we would expect to be the case for crowdfunding issuers.

²⁶ WeFunder, Risks, https://wefunder.com/faq/common_questions#q24 [<https://perma.cc/J3VG-RJ5C>].

²⁷ For an overview of the WeFunder SAFE and the forms being used by WeFunder's crowdfunding issuers, see WeFunder, Legal Primer for Founders, <https://wefunder.com/faq/legal-primer> [<https://perma.cc/9GKQ-9JDA>].

SAFEs convert into those equity securities based on the discount or valuation cap stated in the SAFE contract. At some point following the conversion, the company is sold or goes public, and the former SAFE holders receive proceeds from those liquidity events just like the other investors (such as VCs) holding those equity securities.

2. Pre-Conversion Liquidity Event. If the company is sold before it raises a subsequent round of priced equity capital (in which case the SAFEs would still be outstanding), the SAFE holders would elect to either (A) convert the SAFEs to equity and receive proceeds from the sale based on their pro rata equity ownership, or (B) receive a cash payout of their original investment amount (plus some pre-negotiated return, such as $1.5x-2x$) in connection with the sale.

3. Dissolution Event. If the company shuts down and liquidates prior to raising a subsequent round of priced equity financing, the SAFE holders would receive any residual assets up to the amount of their original investments.

One scenario is not anticipated in most SAFEs and is also not addressed in the WeFunder SAFE: a scenario in which a company never raises additional equity capital and never sells itself or goes public.²⁸ This scenario is not anticipated because it is a rare outcome for venture-backed tech startups. As we have discussed, however, crowdfunding offerings are not undertaken exclusively by tech startups. Imagine a non-tech company that raises capital in a crowdfunding offering using a SAFE. The company uses that capital to launch a product or service, which starts generating significant cash flow before the company needs additional capital. The company is able to use that cash flow to obtain bank financing and may even have profits to reinvest in growing the business. At some point, that company may also have sufficiently healthy profits to start distributing those profits to its owners (the founders). This business, following a path that is extremely common—perhaps the norm—for non-tech startups and small businesses, could

²⁸ WeFunder's Legal Primer for Founders advises crowdfunding companies that SAFEs are "best for early stage startups - raising with Regulation Crowdfunding - expecting to get acquired or file for an IPO in the future." *Id.* Many early-stage companies may think that these outcomes are much likelier than they are, particularly for non-tech businesses, and will end up neither selling the business nor going public but simply continuing to operate as a private concern.

continue in this fashion in perpetuity without ever needing additional equity capital or needing to sell. If that were to happen, the SAFE holders would continue to hold their securities, earning no interest, receiving no dividends and never seeing any return of their original investment. We call this the “dividend problem.”²⁹

The WeFunder SAFE amplifies the dividend problem because a financing conversion only occurs under the contract when the issuer closes a bona fide *preferred* stock financing raising any amount at a fixed pre-money valuation. The SAFEs do not convert if the company raises equity capital by selling *common* stock.³⁰ The SAFE is often drafted this way because it presupposes that the next financing round will be a traditional VC investment and the typical VC investment is structured as preferred equity. However, crowdfunding issuers (which, as discussed above, could be tech or non-tech companies) raising subsequent equity capital from non-VC sources may choose to issue common stock instead of preferred stock. In that case, the SAFEs issued to crowdfunding investors using the WeFunder form would remain outstanding until the company is sold. Under the terms of the WeFunder SAFE, a company could theoretically raise unlimited amounts of private capital selling common stock and distribute profits to those investors and the founders via dividends without ever triggering a conversion of the SAFEs or allowing the SAFE holders to participate in those dividend payments.

The WeFunder SAFE contains yet another provision that may frustrate the ability of many SAFE holders to share in the upside of successful crowdfunding companies. The issuer can repurchase the SAFEs of

²⁹ Among the typical seed-stage startup-financing instruments, the dividend problem is uniquely an issue with SAFEs. Investors who purchase the same common stock that a company’s founders hold can rest assured that any dividends declared by the company will be paid to all common stockholders on a pro rata basis. Preferred stockholders, at least in the venture-backed startup context, always ensure that they will receive any dividends paid to the common stockholders, and often negotiate for an additional preferred dividend (despite the fact that these are almost never actually paid). Convertible noteholders typically have the option at maturity to convert into common stock and receive dividends if the company has not yet raised a qualifying round of capital triggering the conversion of the notes into equity. Though it is exceedingly rare for tech startups to pay dividends, the SAFE is the only startup-financing instrument that does not at least account for the possibility and provide the investor with some modicum of protection in this regard.

³⁰ Twenty-seven of the first sixty crowdfunding issuers offered their investors common equity securities, highlighting the likelihood of these types of issuers opting to sell common stock instead of preferred stock (which was chosen by only six of the first sixty crowdfunding issuers). Practical Law, *What’s Market: Federal Crowdfunding Offerings* (last updated Sept. 16 2016), <http://us.practicallaw.com/w-002-5319> [<https://perma.cc/TM5F-3DTC>].

non-accredited investors for the fair market value of the instrument, as determined by an independent appraiser of the company's choosing, at any time prior to conversion. This means that the investors taking the greatest risk (the seed crowdfunding investors) can be prevented from seeing the bulk of the returns from the most successful companies they fund using the WeFunder SAFE. Even if the WeFunder SAFE converts to equity, moreover, the contract provides that the SAFE converts into a non-voting series of preferred stock, leaving the crowdfunding investors at the mercy of the founders and more sophisticated investors who negotiate special rights for themselves (although post-conversion, the former SAFE holders would at least be owed fiduciary duties by the company's board of directors).³¹

WeFunder is not the only funding portal to create a form of SAFE that adds to the problems inherent in using SAFEs in crowdfunding offerings. Republic, a funding portal created by former employees of the well-known startup investment platform AngelList, created its own form called the Crowd SAFE. Like the WeFunder SAFE, the Crowd SAFE is based on Y Combinator's version but modified in various ways for use in crowdfunding offerings.³² The Crowd SAFE converts into stock in connection with any priced equity financing (preferred or common) raising proceeds of at least \$1 million.³³ Republic added a new feature to the Crowd SAFE, however, allowing the company to postpone the conversion of the instrument until a liquidity event (in most cases, the sale of the company), while promising investors that they will receive the same economics (that is, the same conversion price) regardless of when they actually convert.³⁴ The Crowd SAFE effectively allows the company to raise any form of equity capital without triggering the conversion of the SAFEs, while also neglecting (like the WeFunder SAFE) to account for a scenario in which the stockholders of the company receive their return

³¹ See, e.g., WeFunder, WeFunder SAFE—Valuation Cap, Delay Conversion until IPO/Acquisition, https://wefunder-production.s3.amazonaws.com/static/WefunderCrowdfundingSAFE_IPO.rtf [https://perma.cc/Z64Q-AALR].

³² For an overview of the Crowd SAFE and the forms being used by Republic's crowdfunding issuers, see The Crowd Safe, Republic, <https://republic.co/crowdsafe> [https://perma.cc/DWF7-MH4D].

³³ Including this type of de minimis threshold on a financing that triggers conversion as a protection for investors is common in convertible note deals.

³⁴ WeFunder now offers a form of SAFE that similarly allows companies to delay conversion of the SAFEs in this manner. WeFunder, WeFunder SAFE—Valuation Cap, Delay Conversion until IPO/Acquisition, https://wefunder-production.s3.amazonaws.com/static/WefunderCrowdfundingSAFE_IPO.rtf [https://perma.cc/Z64Q-AALR].

in the form of dividends and not in a liquidity event such as a sale or initial public offering.

CONCLUSION

The SEC has two competing missions in all of its regulatory endeavors: promoting capital formation and protecting investors. Regulation Crowdfunding has largely been viewed as heavily favoring investor protection over capital formation (particularly the disclosure requirements).³⁵ When it came to the types of securities available to crowdfunding issuers, however, the SEC took a laissez-faire approach. With many aspects of crowdfunding, such as policing individuals' annual investment limits and screening prospective issuers for fraudulent schemes, the SEC chose to rely heavily on the funding portals to make crowdfunding as safe as possible for non-accredited investors. When the SEC declined to narrow the list of permissible securities, perhaps its expectation was that the funding portals would help keep issuers from offering retail investors inappropriate securities through their platforms. Unfortunately, this does not seem to be happening in practice.

There are several possible solutions to the problems identified in this Essay. First, the funding portals could seek to limit the use of SAFEs to the "right" sort of companies—those that are likely to raise future capital from institutional investors. Policing the types of securities offered by crowdfunding companies may sound like a lot to ask of the portals but many of them already market themselves as significantly curating the offerings they make available on their platforms. Accordingly, we do not see this additional curation as overstepping.³⁶ Second, the portals could

³⁵ See, e.g., Abraham J.B. Cable, *Mad Money: Rethinking Private Placement*, 71 *Wash. & Lee L. Rev.* 2253, 2256–58 (2014) (discussing "investment caps" that limit to \$25,000 the amount that any one individual can invest in crowdfunding offerings annually).

³⁶ If funding portals are unwilling to provide this type of curation on their own, perhaps the SEC and/or the Financial Industry Regulatory Authority ("FINRA") should mandate it. Their approach in doing so could be modeled on what these regulators currently require of broker-dealers in the context of purchasing other types of derivative instruments akin to the SAFE. Retail brokerages—such as Fidelity, Vanguard et al.—are required to obtain certain information from customers seeking to purchase options or security futures through their brokerage accounts to enable the brokers to assess the suitability of these derivative instruments for those particular customers, given their financial position and investment experience. See FINRA Rule 2360(b)(16) (2014), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6306 [https://perma.cc/NP8H-U7JQ]; FINRA Rule 2370(b)(16) (2011), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6309 [https://perma.cc/B5G8-MGZH]. The FINRA rules require the broker to de-

amend the forms of SAFE currently on offer to address some of the specific issues we have raised. This would be a positive development, to be sure, but it would not address the deeper problems that flow from the fact that many of these crowdfunding issuers will never raise institutional VC. Third, the funding portals could remove the SAFE from their menu of financing instruments. We believe that this last approach represents the simplest and best solution. A crowdfunding company that wants to issue a SAFE-like security could instead issue a convertible note, which is similar to the SAFE in many respects but which accrues interest, has a maturity date, and offers retail investors other protections that are associated with debt instruments. Despite these additional investor protections, however, convertible notes are also less than ideal instruments for most companies in the crowdfunding context because, like SAFEs, they too are intended for use by companies that are likely to raise institutional VC in the near term. Alternatively, and we believe preferably, the company could issue debt, common equity, or preferred equity (the latter two providing investors with the full benefits of being

termine whether the transaction is suitable for the customer based on the “customer’s investment objectives, financial situation and needs” and the broker’s judgment of whether “the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position.” See FINRA Rule 2360(b)(19) (2014), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6306 [<https://perma.cc/NP8H-U7JQ>]; FINRA Rule 2370(b)(19) (2011), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6309 [<https://perma.cc/B5G8-MGZH>]. Since the SAFE is effectively a prepaid forward—the private company version of a future—perhaps the requirements placed on brokers allowing customers to trade security futures provide the best analogy (although the suitability assessment and required diligence are largely the same for options and futures under the FINRA rules).

Unlike registered broker-dealers, funding portals are actually not permitted to “offer investment advice or recommendations” to the investors in crowdfunding offerings conducted through their platforms. See 17 C.F.R. § 227.402(a) (2015). Funding portals are, however, allowed to “[d]etermine whether and under what terms to allow an issuer to offer and sell securities in reliance on section 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)(6)) through its platform” within the SEC’s safe harbor from the broker-dealer registration requirements of § 3(a)(80) of the Securities Exchange Act of 1934, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78(c)(a)(80) (2012)). 17 C.F.R. § 227.402(b)(1) (2015). Imposing a requirement on the funding portals similar to those already required of broker-dealers in the option and security future trading context—namely requiring the portals to pass on the suitability of financing instruments (and particularly derivative contracts like the SAFE) offered by issuers to retail crowdfunding investors through their platforms—could be an intermediate regulatory response to the issues we have raised in this Essay, short of an outright restriction on the types of securities available to crowdfunding issuers and investors to plain-vanilla equity and debt instruments.

shareholders of the company including, most importantly, the protection of fiduciary duties owed by the company's board of directors). These alternatives are, in our view, more suitable vehicles for channeling capital to crowdfunding companies than the SAFE.

In closing, it should be emphasized that all of these instruments—SAFEs, convertible notes, common stock, preferred stock, etc.—are simply labels. It is not the *name* of the instrument that matters so much as the *terms* set forth within it, that is, the balance struck between issuer and investor. It is possible to issue “common stock” that contains terms commonly used in “preferred stock” financings. It is also possible to issue “SAFEs” that contain terms that make them virtually indistinguishable from “convertible notes.” In this respect, our recommendation that funding portals remove the SAFE from their menu of financing instruments might be criticized as emphasizing form over substance. To be clear, our quarrel is not with the SAFE *qua* SAFE. Our quarrel is with the terms contained within the SAFEs currently on offer in the retail crowdfunding space as well as the specific context in which these contracts are being used. Unless and until the terms of these instruments are revised to address the concerns outlined above, we do not believe that crowdfunding issuers should use them. The revisions that would be necessary to adequately address these concerns would effectively turn the SAFE into a different instrument (a convertible note, preferred stock, etc.) in all but name, making it better, in our view, to simply remove the SAFE from the menu of financing instruments and use existing instruments that are more fit for this purpose. The SAFE is a financing instrument that was developed to fund early-stage companies that expect to raise institutional VC. This expectation informs the terms set forth in the SAFE. The vast majority of crowdfunding companies are unlikely to raise institutional VC. Accordingly, for all the reasons we have discussed, we believe that SAFEs are not well suited to being used in crowdfunding transactions.