

# CHARTING A NEW REVOLUTION IN EQUITY CROWDFUNDING: THE RISE OF STATE CROWDFUNDING REGIMES IN RESPONSE TO THE INADEQUACY OF TITLE III OF THE JOBS ACT

Christopher Douglas Mitchell\*

## Abstract

*The revolution is not an apple that falls when it is ripe. You have to make it fall.*  
- Ernesto “Che” Guevara<sup>1</sup>

States, through the recent implementation of intrastate crowdfunding exemptions, have become significant players in the creation of an equity crowdfunding industry in the United States. Crowdfunding is an alternative capital-raising source for businesses and entrepreneurs, where investing and capital-raising takes place through solicitations of small amounts of money from a large number of people, typically via the Internet. While the federal crowdfunding provisions in Title III of the federal Jumpstart Our Business Startups Act (“JOBS Act”) have received much publicity, states are taking a leading role in enacting equity crowdfunding laws. State-enacted intrastate crowdfunding laws authorize securities offerings by residents of a single state so long as the securities are sold to residents of only that state. Securities offerors who meet a state’s intrastate crowdfunding exemption can engage in a securities offering without registering the offering with the federal or applicable state government.

U.S. Supreme Court Justice Louis Brandeis famously referred to states as the “laboratories of democracy.” The experiments that take place in these “laboratories” are often a direct result of the action, or inaction, of the federal government. In recognition of this reality, this Article explores the link between intrastate crowdfunding laws and Title III of the JOBS Act. States are enacting their own crowdfunding regimes for two primary reasons. First, states have grown tired of waiting for the implementation of the federal crowdfunding regime by the U.S.

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\* J.D. 2015, S.J. Quinney College of Law, University of Utah. I would like to thank Professor Jeff Schwartz for his many comments, insights, and critiques of this Article. I would also like to thank the *Global Markets Law Journal* staff for their hard work and helpful reviews.

1. MICK WINTER, CUBA FOR THE MISINFORMED: FACTS FROM THE FORBIDDEN ISLAND 60 (2013).

Securities and Exchange Commission, which, as of this Article's publication, over three years after the JOBS Act's passage, has yet to enact final regulations. Second, many believe the federal crowdfunding regime, when finally enacted, will be too costly for most issuers and, thus, will not provide a feasible capital raising option for small businesses and new start-up companies. As a result, states are taking the initiative by enacting intrastate crowdfunding regimes, while still complying with federal securities laws by meeting the federal securities exemptions in section 3(a)(11) of the Securities Act of 1933, Rule 506 of Regulation D, or Rule 147.

While intrastate crowdfunding laws are a useful capital-raising tool for many small businesses and start-up companies, they suffer from major impediments. And, these impediments have limited the utility of the intrastate crowdfunding laws and have led to their underutilization by securities issuers.

Ultimately, this Article finds that intrastate securities laws are not able to fully meet the capital-raising needs of small businesses and start-up companies. Due to a lack of capital raising sources, these companies are stuck between a proverbial rock and a hard place. On the one hand, the costs associated with the federal crowdfunding provisions make it an impractical capital-raising source. While on the other hand, intrastate crowdfunding laws passed by states, while not cost prohibitive, suffer from ailments that prevent them from acting as effective capital-raising mechanisms.

In recognition of this quandary, this Article recommends that a new federal "small business" crowdfunding regime be created. This regime would authorize nationwide crowdfunding offerings and would require minimal reporting and disclosure requirements, keeping offering costs at a minimum. Additionally, to limit the effect of potentially fraudulent activity, the issuer would be limited to raising \$500,000 in any twelve-month period and each individual investor would be limited to an investment of \$1,000 in any twelve-month period. This new crowdfunding regime would provide an affordable and effective capital raising mechanism for many small businesses and start-ups.

## I. Introduction

A new era in securities regulation began when the United States Congress passed, and President Obama signed,<sup>2</sup> the Jumpstart Our Business Startups Act<sup>3</sup> ("JOBS Act") in April 2012.<sup>4</sup> The JOBS Act was touted as a major breakthrough in the equity investing industry that would reduce the costs for many types of equity capital fundraising.<sup>5</sup> President Obama proclaimed, "For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in."<sup>6</sup>

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2. See Mark Landler, *Obama Signs Bill to Promote Start-Up Investments*, N.Y. TIMES, Apr. 6, 2012, at A12.

3. See generally Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

4. *Id.*; see Jenna Wortham, *Law Opens Financing of Start-Ups to Crowds*, N.Y. TIMES (Sept. 22, 2013), <http://www.nytimes.com/2013/09/23/technology/law-opens-financing-of-start-ups-to-crowds.html?pagewanted=all&r=0>.

5. See Wortham, *supra* note 4; Landler, *supra* note 2.

6. Landler, *supra* note 2.

John Boehner, the speaker of the House of the Representatives, believed the bill would be “good news for entrepreneurs and aspiring small businesspeople struggling to overcome government barriers to job creation.”<sup>7</sup> The JOBS Act granted the Securities and Exchange Commission (“SEC”) authority to create and implement detailed regulations that would enact new regimes or enhance currently existing equity capital fundraising options.<sup>8</sup>

There was substantial excitement, in particular, around Title III of the JOBS Act (“CROWDFUND Act”),<sup>9</sup> the so-called “crowdfunding” provision of the JOBS Act.<sup>10</sup> The CROWDFUND Act created a new provision in the Securities Act of 1933 to authorize equity stock investments in a business venture by hundreds, or thousands, of regular individuals.<sup>11</sup> Under the CROWDFUND Act, an equity stock issuer can pool small, individual investments and raise a substantial amount of business capital.<sup>12</sup> This idea was popularly labeled “crowdfunding,” because of the ability of large crowds of individuals to invest in, and fund, businesses.<sup>13</sup>

The Oxford English Dictionary defines crowdfunding as “[t]he practice of funding a project or venture by raising many small amounts of money from a large number of people, typically via the Internet.”<sup>14</sup> As one commentator noted, “Crowdfunded securities are a relatively recent, high-growth phenomenon borne, at least in part, from frustration with traditional capital-raising methods and process.”<sup>15</sup> “It represents a logical . . . combination of existing and evolving social media memes with traditional elements of corporate finance.”<sup>16</sup>

For example, suppose a small restaurant needs \$300,000 to purchase new kitchen appliances and serving equipment. Prior to the growth of equity crowdfunding, the restaurant effectively had four options: apply for a bank loan, issue bonds, or other similar private loans; persuade a wealthy investor to invest in the

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7. *Id.*

8. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306, §§ 301–05, 503, 602 (2012).

9. *Id.*

10. Securities Act of 1933, 15 U.S.C. 77a-77mm (2012).

11. See John S. Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 587–90 (2013); 126 Stat. 306, §§ 301–05.

12. 126 Stat. 306, §§ 301–05.

13. See Tanya Prive, *What Is Crowdfunding and How Does It Benefit the Economy*, FORBES (Nov. 27, 2012), <http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy/>. The precursors to for-profit crowdfunding came from websites that solicited non-equity funding from the “crowd” by raising money or solicit donations without the promise of financial return from large groups of individuals. These websites include Kickstarter or Indiegogo. See *id.*; see also *How It Works*, INDIEGOGO, <https://www.indiegogo.com/learn-how-to-raise-money-for-a-campaign> (last visited July 20, 2015); *Seven Things to Know about Kickstarter*, KICKSTARTER, <https://www.kickstarter.com/hello?ref=footer> (last visited July 20, 2015). Other companies, such as Prosper, engage in a type of limited, personal equity crowdfunding by engaging in so called “peer-to-peer” lending “by connect[ing] people who need money with those who have money to invest.” See *Peer-to-Peer Lending Means Everyone Prospers*, PROSPER, <https://www.prosper.com/welcome/how-it-works/> (last visited Feb. 23, 2015). Prosper does so by registering its offerings with the Securities and Exchange Commission. See *SEC Filings*, PROSPER, <https://www.prosper.com/prospectus/> (last visited Feb. 23, 2015).

14. *Crowdfunding*, OXFORD DICTIONARIES, [http://www.oxforddictionaries.com/us/definition/american\\_english/crowdfunding](http://www.oxforddictionaries.com/us/definition/american_english/crowdfunding) (last visited July 20, 2015).

15. Joan MacLeod Heminway, *Investor and Market Protection in the Crowdfunding Era: Disclosing to and For the “Crowd”*, 38 VT. L. REV. 827, 831 (2014).

16. *Id.*

business; engage in a registered stock offering; or meet one of the narrow stock offering registration exemptions in federal law.<sup>17</sup> Under the new crowdfunding provisions, the restaurant has another option, where it can sell equity securities to a large number of average investors, without fully registering the stock offering.

In an op-ed, Florida Representative Gus Bilirakis maintained that the CROWDFUND Act would alleviate small businesses and startup companies' inability to obtain funding.<sup>18</sup> He stated:

In order for someone to take that next great idea and make it a reality, they need the ability to effectively raise capital. The JOBS Act will make it easier for startup companies to get off the ground and raise money from investors. Specifically, it will allow companies to raise [capital] . . . through a large group of small investors, [] called "crowdfunding." Not only does this allow businesses to raise capital, it allows everyday investors to invest in entrepreneurs.<sup>19</sup>

People from across the political spectrum believed the crowdfunding provisions of the JOBS Act would provide a new, effective medium for small businesses and start-up companies to raise much needed capital.<sup>20</sup> Today, the idea of crowdfunding is generally known and understood by much of society and has entered the mainstream media.<sup>21</sup> In fact, the rowdy and provocative television show South Park recently aired an episode where the program's main characters created a company with the catch phrase "go fund yourself."<sup>22</sup>

It has been three years since the passage of the JOBS Act and the SEC has yet to enact the final regulations to implement a federal crowdfunding regime.<sup>23</sup> In addition, there is a large amount of controversy surrounding the potential effectiveness of the CROWDFUND Act's provisions.<sup>24</sup> Many scholars believe the

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17. See Virginia B. Morris, *Choices in Raising Capital: Sell Equity or Issue Debt?*, NAT'L ASSOC. INVESTORS CORP., <http://www.betterinvesting.org/Public/StartLearning/BI+Mag/Articles+Archives/0309abpublic.htm> (last visited July 20, 2015).

18. Rep. Gus Bilirakis, *Op-ed: Bipartisanship and 'Crowdfunding'*, TAMPA TRIBUNE, April 10, 2012.

19. *Id.*

20. See Judd Hollas, *New Data Validates JOBS Act Objectives*, BUS. NEWS DAILY (May 28, 2013), <http://www.businessnewsdaily.com/4544-crowdfunding-jobs-act-impact.html> (stating the JOBS Act's "progress will only continue once the SEC and FINRA finally release their rules governing true crowdfunding that will allow average, unaccredited investors to contribute to the development of America's next great companies").

21. See Joe McKendrick, *Crowdfunding Enters the Business Mainstream*, ZD NET, Oct. 29, 2013, <http://www.zdnet.com/article/crowdfunding-enters-the-business-mainstream/>.

22. *South Park: Go Fund Yourself* (Comedy Central television broadcast Sept. 24, 2014), available at <http://southpark.cc.com/full-episodes/s18e01-go-fund-yourself>.

23. See Dan Primack, *SEC Chair: No 'Drop Dead Date' For Equity Crowdfunding Rules*, FORTUNE (Dec. 11, 2014), <http://fortune.com/2014/12/11/sec-chair-no-drop-dead-date-for-equity-crowdfunding-rules/>. "The Securities and Exchange Commission is in no rush to finalize equity crowdfunding rules, despite having already missed its Congressionally-mandated deadline by around two years." *Id.* The SEC chair Mary Jo White recently stated, "On the JOBS Act side, adoption of final crowdfunding rules is our last major rulemaking to complete, which is also a priority for 2015." *Opening Remarks to the Investor Advisory Committee*, U.S. SEC. & EXCH. COMM'N (Apr. 9, 2015), <http://www.sec.gov/news/statement/opening-remarks-to-the-investor-advisory-committee.html>.

24. See, e.g., R. Kevin Saunders II, *Power to the People: How the SEC Can Empower the Crowd*, 16 VAND. J. ENT. & TECH. L. 945, 960-61 (2014) ("The proposed disclosure requirements will likely be so burdensome that they frustrate the JOBS Act's mission to increase access to capital and create more employment."); Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1433 (2012) (stating that, "[u]nfortunately, . . . [and] despite good intentions, the newly-created exemption is fraught with

onerous registration and ongoing compliance costs of the CROWDFUND Act and its regulations will prevent small businesses and start-up companies from using the Act.<sup>25</sup> As a result, a dramatic and unexpected effort has taken hold of the crowdfunding movement. States are now creating their own intrastate crowdfunding exemptions by relying on existing federal exemptions from registration such as Rule 147, the intrastate offering exemption, and Rule 506 of Regulation D.<sup>26</sup> Under these new state laws, potential securities offerors that meet the intrastate crowdfunding exemption's requirements can solicit securities to investors within that state without having to register an offering in accordance with the federal or applicable state laws. Also, by utilizing these state laws, the businesses are able to avoid the burdensome requirements associated with the CROWDFUND Act. This Article is the first to summarize and assess this current movement by the states and the innovative use of the federal securities law that these states are utilizing to create their intrastate securities regimes. Also, this Article argues for the creation of a new federal crowdfunding regime that will more effectively facilitate equity crowdfunding offerings by small businesses and new business ventures.

The intrastate securities movement began in response to the SEC's delay in the implementation of the crowdfunding regulations and because of the immense costs associated with the CROWDFUND Act.<sup>27</sup> These intrastate exemptions allow in-state offerors to raise a significant amount of capital by soliciting small equity stakes in their company in return for small amounts of investments from a vast array of investors.<sup>28</sup> Intrastate crowdfunding laws are a more realistic and less costly capital-raising tool for small businesses and start-up companies; they have abandoned many of the costly registration and compliance requirements contained in the CROWDFUND Act and its proposed regulations.<sup>29</sup> But despite intrastate crowdfunding laws' reduced costs for offerors, they contain major impediments that restrict an offeror's ability to raise capital, largely due to the requirement that the intrastate crowdfunding laws remain in compliance with federal securities laws.<sup>30</sup>

Under the current securities regime in the United States, the federal government has preempted state securities laws that are inconsistent with the Securities Act of 1933,<sup>31</sup> and the United States remains the ultimate authority on securities laws and regulations under the Commerce Clause of the U.S. Constitution.<sup>32</sup> Thus, the states, to meet the applicable federal securities laws, must *inter alia*, restrict the offering of securities to residents of a single state, and thus greatly restrict the pool of potential investors.<sup>33</sup> Compliance with the federal

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regulatory requirements that go beyond even existing exemptions and raise transaction costs and liability concerns that may substantially reduce the exemption's utility for small capital-raising efforts").

25. See, e.g., Saunders, II, *supra* note 24; Cohn, *supra* note 24.

26. See *infra* Part IV.

27. See *infra* Part IV.C.

28. See *infra* Part IV.

29. See *id.*

30. See *infra* Part IV.B.

31. Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2012).

32. See *Whistler Invs., Inc. v. Depository Trust & Clearing Corp.*, 539 F.3d 1159, 1164–65 (9th Cir. 2008).

33. See *infra* Part IV.

securities regime reduces the effectiveness of the state enacted intrastate securities laws. This Article will seek to find a comprehensive solution to the many ailments facing both federal and state crowdfunding laws.

In seeking to do so, this Article will begin, in Part II, by charting the initial goals of the crowdfunding revolution that led to the passage of the CROWDFUND Act and the subsequent wave of intrastate crowdfunding laws. Second, in Part III, this Article will address the major shortcomings of the CROWDFUND Act and the proposed SEC rules. Specifically, this part will look at how the laws' requirements will make it impractically costly for small businesses and how the botched rollout of the federal regulations has caused state lawmakers to institute more practical state crowdfunding regimes. Third, in Part IV, this Article surveys currently enacted and proposed state intrastate crowdfunding laws. In doing so, this part will also investigate the utilization, or underutilization, of intrastate crowdfunding laws by borrowers and investors. Finally, in Part V, this Article proposes a new hybrid law that would enact a new federal exemption, aimed at facilitating equity crowdfunding by small businesses and start-up companies. In doing so, this new regime would promote investor safety by creating smaller caps on investing for each investor, rather than requiring onerous regulatory burdens that make borrowing catastrophically costly for the businesses who oftentimes need capital investments the most. Most markedly, this Article contends that the federal government should create a new crowdfunding regime that fits the capital raising needs of small businesses and start-up companies. While this type of regime would have a small target audience, it will likely have a positive impact on entrepreneurs and promote their ability to develop and market their products, and thereby bolster the American economy.

## **II. The Spark Behind the Initial Crowdfunding Revolution**

To obtain a complete understanding of the origins and goals of the crowdfunding movement, it is necessary to first understand why the federal securities laws govern the sale of all equity financing in the United States. Next, this Article will discuss the unique burdens on small businesses and start-up companies that largely prevent them from raising capital through equity offerings. Only then will the Article turn to the motivations of the parties behind the crowdfunding movement.

### **A. The Federal Securities Regime<sup>34</sup>**

The modern federal regulatory structure that governs the sale of securities in the United States was enacted shortly after the Great Depression in the early 1930's.<sup>35</sup> At that time, the average investor had limited access to information and

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34. This Article does not include or discuss a comprehensive list of the federal securities laws. For a list of federal securities laws, see *The Laws that Govern the Securities Industry*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/about/laws.shtml> (last updated Oct. 1, 2013).

35. *Securities Law History*, CORNELL UNIV. LAW SCH., LEGAL INFO. INST., [http://www.law.cornell.edu/wex/securities\\_law\\_history](http://www.law.cornell.edu/wex/securities_law_history) (last visited July 20, 2015).

generally was unable to verify the accuracy of the information he received.<sup>36</sup> Accordingly, “leading up to the stock market crash [in 1929], [many] companies issued stock and enthusiastically promoted the value of their company to induce investors to purchase those securities. Brokers in turn sold this stock to investors based on promises of large profits but with little disclosure of relevant information about the company.”<sup>37</sup> Some brokers operated on a wholly fraudulent basis, and were distributing information without any underlying support for their fantastic claims.<sup>38</sup> This created a “frenzy” in the stock market and led investors to purchase stocks at prices much higher than their actual value.<sup>39</sup> Ultimately, the exaggerated stock price was unsustainable and stock prices began to plummet in October 1929, creating a massive selloff, where brokers and investors sold their stock shares well below their purchase value.<sup>40</sup> In the space of a month, stock values across the market dropped by roughly forty percent, and sent the United States and ultimately, the World, into a massive economic depression.<sup>41</sup>

In response, the U.S. Congress and President Franklin D. Roosevelt passed the Securities Act of 1933 to prevent misinformation and speculative bubbles in the stock market.<sup>42</sup> The ultimate goals of the law were to provide company disclosure to investors and prevent fraud by stock promoters.<sup>43</sup> Congress also passed the Securities Exchange Act of 1934, which established the Securities Exchange Commission (the “SEC”) and granted it broad authority to regulate the stock market and related industries.<sup>44</sup> Finally, prior to the enactment of the federal securities laws, many, if not all, states had already established laws regulating the offering and selling of securities.<sup>45</sup> Typically, the state laws included “provisions for licensing brokers, registering securities, and formal approvals of the offerings by the appropriate government agencies.”<sup>46</sup> The state laws came to be known as “blue sky” laws, in reference to their goal of preventing the sale of securities that had the value of “hot air and blue sky.”<sup>47</sup>

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36. See 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, 982–83 (2013).

37. *Securities Law History*, *supra* note 35.

38. *See id.*

39. *See id.*

40. *See id.*

41. OXFORD UNIV. PRESS, OXFORD ENCYCLOPEDIA OF WORLD HISTORY 639 (Fran Alexander et al. eds., 1998).

42. *See Securities Law History*, *supra* note 35; *The Laws That Govern the Securities Industry*, *supra* note 34.

43. *The Laws That Govern the Securities Industry*, *supra* note 34.

44. *Id.*

45. See Jeffrey D. Chadwick, Comment, *Proving Preemption by Providing Exemption: The Quandry of the National Securities Market Improvement Act*, 43 U. RICH. L. REV. 765, 767 (2009).

46. BLACK'S LAW DICTIONARY 196 (9th ed. 2009).

47. *Lowell v. Illinois*, 131 Ill. App. 137, 139 (Ill. App. Ct. 1907); *see also* BLACK'S LAW DICTIONARY, *supra* note 46.

1. *The Securities Act of 1933*

The Securities Act of 1933 created a far reaching and comprehensive regulatory scheme requiring disclosure of information to investors and securities registration prior to the initial securities offerings to the public.<sup>48</sup> Additionally, the Act provides “broad private remedies for those investing in securities based upon a material misrepresentation [by the Securities issuer]. . . . These broad remedies sought to inspire, through fear of liability, broader disclosure and more careful marketing in connection with the sale of securities.”<sup>49</sup>

The Securities Act of 1933 regulates a “security” and defines that word broadly to include “any note, stock, . . . future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, . . . transferable share, investment contract, . . . or, in general, any interest or instrument commonly known as a ‘security’. . . .”<sup>50</sup> Federal courts, in interpreting the term “security”, have held that it is a “flexible rather than a static principle, [and] one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”<sup>51</sup>

Accordingly, any person or company who wants to sell an equity interest in a company in return for capital from an investor generally must first file a registration statement with the SEC.<sup>52</sup> Failure to register a security offering may result in substantial liability for the issuer, seller, or promoter.<sup>53</sup> The Securities Act of 1933 also grants the SEC broad authority to promulgate regulations requiring the disclosure of information.<sup>54</sup> After the securities are registered, the information disclosed with the securities offering becomes public and must be delivered to the SEC, with a goal to prevent the fraudulent sale of securities.<sup>55</sup>

But, a securities offering does not need to be registered with the SEC if the offering meets one of the 1933 Act’s exemptions from registration.<sup>56</sup> There are exemptions for specific types of securities and for securities sold in specific transactions.<sup>57</sup> Exemptions from registration<sup>58</sup> include, *inter alia*, transactions that

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48. Steven A. Ramirez, *The Virtues of Private Securities Litigation: An Historic and Macroeconomic Perspective*, 45 LOY. UNIV. CHI. L.J. 669, 680–81 (2014); *see generally* Securities Act of 1933, 15 U.S.C. §§ 77a-77mm (2012).

49. Ramirez, *supra* note 48, at 681.

50. Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2012).

51. U.S. Sec. & Exch. Comm’n v. W.J. Howey Co., 328 U.S. 293, 299 (1946).

52. *See* 15 U.S.C. § 77f.

53. *See id.* § 77e.

54. *See id.* § 77g.

55. *See id.* § 77f(d).

56. *See id.* §§ 77c–77d.

57. *See id.*

58. Securities Act of 1933, 15 U.S.C. §§ 77c–77d (2012) (providing other securities exemptions from registration).



## *Crowdfunding Regimes in Response to Inadequacy of JOBS Act Title III*

do not involve public offerings,<sup>59</sup> securities offered by the states and the federal government,<sup>60</sup> and securities sold to “accredited investors.”<sup>61</sup>

### *2. The Securities Exchange Act of 1934*

The Securities Exchange Act of 1934<sup>62</sup> “was designed principally to protect the investor against manipulation of stock prices through regulation of transactions upon securities exchanges and over-the-counter markets and to impose regular reporting requirements on companies whose stock is listed on a national securities exchange.”<sup>63</sup> It established the SEC and granted the agency comprehensive regulatory power to promulgate rules that would prevent fraud and protect investors.<sup>64</sup> Under this authority, the SEC has promulgated many rules to provide “safe harbors” for securities issuers; they provide specific requirements that if met, conclusively establish that a securities issuer has met a securities exemption in the 1933 Act, and insulates the issuer from liability for selling unregistered securities.<sup>65</sup>

### *3. State Blue Sky Laws*

Regulation of the securities market began at the state level. Decades before the enactment of the federal securities laws, states took action to regulate the sale of securities within their borders.<sup>66</sup> States were concerned with rampant fraud that was taking place within their jurisdictions and took action to protect their citizens from fraud.<sup>67</sup> At present, states generally require the registration of securities, the licensing of professionals who work in the securities industry, and provide civil and criminal penalties for conduct that is fraudulent or otherwise illegal.<sup>68</sup>

But, because the U.S. Congress has the power to regulate interstate commerce under the U.S. Constitution, federal securities law can preempt state regulation of securities. “While the federal government could have preempted the entire field of state securities regulation, it merely supplemented existing state law [where it conflicted with federal law] and created a dual system of regulatory enforcement.”<sup>69</sup> The Securities Exchange Act of 1934 states:

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59. *Id.* § 77d(a)(2).

60. *Id.* § 77c(a)(2).

61. *Id.* § 77d(a)(5).

62. *Id.* § 78a-78kk.

63. Notes and Comments, *Civil liability Under Section 10B and 10B-5: A Suggestion For Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 659 (1965).

64. *See id.* at 659–61.

65. *See* BLACK’S LAW DICTIONARY, *supra* note 46, at 1453 (defining a safe harbor as “[a] provision (as in a statute or [SEC] regulation) that affords protection from liability or penalty”).

66. Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 360–62 & n.60 (1991) (finding that “[b]y all accounts the inventor of blue sky legislation was the Kansas Commissioner of Banking, . . . J.N. Dolley” in 1911 and, in addition, around the year 1910, Rhode Island, California, and a “few other states” adopted legislation to address some aspects of the sale of securities).

67. *Id.* at 389–96.

68. *See, e.g.*, UTAH CODE ANN. §§ 61-1-1 to -108 (LexisNexis 2011) (setting out the contents of the Utah Uniform Securities Act).

69. Chadwick, *supra* note 45, at 767–68.

[T]he rights and remedies provided by [the Exchange Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity. . . . [N]othing in this [Act] shall affect the jurisdiction of the securities commission . . . of any State over any security or any person insofar as it does not conflict with the provisions of this [Act] or the rules and regulations thereunder.<sup>70</sup>

But, the National Securities Market Improvement Act<sup>71</sup> (“NSMIA”) prohibits the states from regulating any security “covered” by a federal securities law or regulation.<sup>72</sup> This includes some “transactions that are exempt from federal registration under the Securities Act.”<sup>73</sup>

Accordingly, state blue sky laws still apply to the sale of securities within a state insofar as they do not conflict with the federal securities laws. An individual can avoid the registration of securities under state and federal law only if they can find and qualify for separate exemptions under both state and federal law, or by having a federally-compliant “covered security” that is exempt from state law.

## B. The Difficulty of Raising Capital For Small Businesses and Start-up Companies

Small businesses and start-up companies who are looking to raise capital through an equity securities offering must also either register their offering with the SEC or meet one of the Securities Act’s exemptions from registration. For small businesses and start-up companies, “going public” by registering their securities offerings and engaging in an Initial Public Offering (“IPO”) is too costly and burdensome.<sup>74</sup> The cost of the IPO can amount to a significant part of the company’s securities offering, in some instances up to thirty-five percent of the offering.<sup>75</sup> For example, “[t]he Small Business Administration [found] the fees and expenses of going public” could reach into the hundreds of thousands, or millions of dollars in compliance and disclosure costs for an issuer.<sup>76</sup> According to other estimates, the average IPO costs \$2.5 million, while ongoing compliances costs roughly \$1.5 million per year for the average business.<sup>77</sup> Researchers at Oxford University found “U.S. investment banks managed to charge a 7 percent spread on IPOs in the past decade, about 3 percentage points higher than their European counterparts.”<sup>78</sup> Additionally, a securities registration with the SEC requires ongoing disclosures to update the

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70. Securities Act of 1933, 15 U.S.C. § 78bb(a) (2012).

71. *See, e.g.*, National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

72. Chadwick, *supra* note 45, at 771.

73. *Id.* at 771–72.

74. Mark A. Allebach, *Small Business, Equity Financing, and the Internet: The Evolution of a Solution?*, 4 VA. J. L. & TECH. 3, 27 (1999).

75. *Id.*

76. *The Ins and Outs of IPOs*, ENTREPRENEUR, <http://www.entrepreneur.com/article/52826> (last visited July 20, 2015).

77. Jamie Hopkins & Katie Hopkins, *Not All That Glitters is Gold—Limitations of Equity Crowdfunding Regulations*, 16 DUQ. BUS. L.J. 1, 6 (2013).

78. *Id.*

company's initial disclosures.<sup>79</sup> Ongoing disclosures include, among others, various types of quarterly, annual, and ongoing disclosures.<sup>80</sup>

Small businesses and start-up companies have difficulty raising capital under many, if not all, of the Securities Act of 1933's current exemptions from registration. Because of the sheer number and complexity of the exemptions from registration under the Securities Act of 1933, this Article will only briefly discuss a few relevant exemptions.<sup>81</sup> These businesses may attempt to rely on Rules 504, 505, and 506 of Regulation D, but because of the general ban on solicitation and advertising, are limited to a small pool of wealthy investors "with whom the issuer or its agents have a preexisting relationship."<sup>82</sup> Alternatively, a small business issuer may rely on Regulation A,<sup>83</sup> which allows a business to engage in "a public offering of less than \$5 million in a 12-month period."<sup>84</sup> While the registration and compliance requirements and costs are less than a traditional public offering, there are still substantial compliance requirements and an issuer may have to comply with blue sky laws "in all states in which the issuer intends to offer and sell securities."<sup>85</sup> This dual layered compliance can be costly, complex, and expensive. This is especially true if the company must comply with many different states' blue sky laws which often differ greatly.

Finally, the federal securities registration exemptions generally "allow 'private sales' to wealthy 'accredited investors' without registration. . . . [This] allows wealthy venture capitalists to angel invest, while [] barring middle-class investors [from engaging in unregistered securities offerings]."<sup>86</sup> Ultimately, the current landscape of the securities registration exemptions concentrates the overwhelming majority of legally-available equity funding in the hands of a few wealthy "accredited investors"<sup>87</sup> and limits an issuer's ability to raise capital from a diverse array of sources. Small businesses and start-up companies are especially affected by this phenomenon.<sup>88</sup>

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79. Allebach, *supra* note 74.

80. See *Forms List*, U.S. SEC. & EXCH. COMM'N, [http://www.sec.gov/forms#.VJDg7kKf\\_ww](http://www.sec.gov/forms#.VJDg7kKf_ww) (last visited July 20, 2015).

81. See, e.g., Natalia Delgado, *Using the Securities Registration Exemptions*, 43 PRAC. LAW. 59 (1997) (providing a more complete list of the multitude of securities registration exemptions).

82. Stuart R. Cohen & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J.L. & BUS. 1, 11 (2007).

83. Regulation "A-plus," which was enacted as part of the JOBS Act, allows an issuer to raise \$50 million in a securities offering, but also has substantial compliance costs. Thus, it is also not a viable capital-raising alternative for small businesses and start-up companies. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012); SEC Today, *Commissioner Aguilar Focuses on JOBS Act in Remarks to Hispanic Business Group*, WOLTERS KLUWER, May 23, 2013, 2013 WL 2252835.

84. Hopkins & Hopkins, *supra* note 77, at 7.

85. *Id.* at 7-8.

86. James J. Williamson, Comment, *The JOBS Act and Middle-Income Investors: Why It Doesn't Go Far Enough*, 122 YALE L.J. 2069, 2072 (2013) (footnotes omitted).

87. See *id.* at 2071-76.

88. See *id.*

### C. The Catalyst That Spurred the New Equity<sup>89</sup> Crowdfunding Revolution

Equity crowdfunding “offers investors a share of the profits or return of the business they are helping to fund.”<sup>90</sup> Proponents of equity crowdfunding have generally put forward five major policy justifications to support securities law crowdfunding exemptions at the state and federal level. First, they believe crowdfunding will democratize investing by making investing opportunities more readily available to the general public and to the average investor.<sup>91</sup> Second, they claim crowdfunding will avoid the concentration of investing profits in a select few and would spread investing wealth to a greater percentage of the U.S. population.<sup>92</sup> Third, they argue that crowdfunding will open new borrowing opportunities to businesses who would not otherwise receive funding.<sup>93</sup> Fourth, they believe society will reap benefits from the incorporation of social media in the securities industry.<sup>94</sup> In essence, they believe the “crowd” will regulate securities issuers and distinguish the good securities from the bad. Finally, they argue that equity crowdfunding will facilitate “social investing,” where individuals invest for purposes other than the consideration of potential profits alone, such as for artistic benefit or for the good of the community.<sup>95</sup>

#### 1. Democratize Investing

The venture capital and angel investing community, where new businesses generally must obtain funding, is remarkably homogenous.<sup>96</sup> According to one study, eighty-six percent of venture capital investors are male and they have an average age of fifty-seven.<sup>97</sup> Before the enactment of the CROWDFUND Act, equity investing in startup companies was generally only available to these wealthy investors.<sup>98</sup> For example, for “the first seven years of Facebook’s existence (2004-12), only friends, family, and wealthy (“accredited”) investors were offered, or allowed to buy, stock in the company.”<sup>99</sup> In other words, the average investor had no chance to invest in Facebook, or a similar company, because securities laws prohibited the average investor from individually investing in unregistered, private securities.<sup>100</sup>

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89. This Article only relates to one form of crowdfunding: equity crowdfunding. There are five principal types of crowdfunding: donation, reward model, pre-purchase, lending, and equity crowdfunding. See C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 14–27 (2012).

90. *Id.* at 24.

91. See *infra* Part II.C.1.

92. See *infra* Part II.C.2.

93. See *infra* Part II.C.3.

94. See *infra* Part II.C.4.

95. See *infra* Part II.C.5.

96. See Kevin Lawton, *The Crowdfunding Revolution Will Democratize Venture Investing*, HUFFINGTON POST BLOG (Dec. 8, 2010), [http://www.huffingtonpost.com/kevin-lawton/democratizing-venture-cap\\_b\\_792498.html](http://www.huffingtonpost.com/kevin-lawton/democratizing-venture-cap_b_792498.html).

97. *Id.*

98. See Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1473 (2013).

99. *Id.* at 1474.

100. See *id.* at 1473–74.

The average investor had to wait until Facebook went public and engaged in its IPO, and thus lost out on the potential for much larger profits from their investments.<sup>101</sup>

Relaxing the restrictions on investing for the average person will create new investing opportunities for the general public. In essence, it will level the playing field in investing and will allow both rich and poor to invest in all types of equity investments. As one proponent has stated, “Many . . . companies [will] fail. Returns may be much worse than in the stock market or elsewhere, but it seems only fair to give everyone, not only the wealthy and connected, the freedom to take their chances and invest in what they hope will be the next Facebook or Yelp.”<sup>102</sup> Ultimately, supporters believe the risk associated with the security should not be used to completely bar the average investor from investing in all non-public equity security offerings.

## *2. Spreading the Wealth*

Traditional investing opportunities are skewed to those who have money. Under the current federal securities regulatory regime, the more money one has, the less regulations one must comply with.<sup>103</sup> For example, individuals who make over \$200,000 individually or \$300,000 if they are married, or who have a net wealth of \$1 million or more (not including their primary residence) are designated “accredited investors,” and thus are able to invest in almost any security through reliance on several registration exemptions.<sup>104</sup> Accredited investors are able to invest in startups and new business and can potentially make significant profits.<sup>105</sup> The average investor is not afforded these same investment opportunities. And, “[t]he ultimate result of this closed community system is the concentration of wealth among a select few in limited geographic areas such as [New York,] Silicon Valley, Boston, Austin, and a few other[] [cities].”<sup>106</sup>

Proponents argue that crowdfunding will allow the average investor to engage in more risky ventures and reap the benefits if a business succeeds. Advocates believe this will be beneficial for society because it will give the average investor “the ability to invest and possibly strike it rich.”<sup>107</sup> For example, early investors in Facebook invested only hundreds of thousands of dollars and “saw their investments grow to be worth billions.”<sup>108</sup> In contrast, average investors, who were able to invest after Facebook’s IPO were offered the opportunity to purchase stock “at \$38 per share [and] the stock dropped below \$30 within days, and it soon dipped below \$20.”<sup>109</sup>

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101. *See id.* at 1474–75.

102. *Id.* at 1475.

103. *See Williamson, supra* note 86, at 2071–72.

104. *See id.* at 2072 & n.12–14; 17 C.F.R. § 230.501(a)(5)–(6) (2012); *see also* 17 C.F.R. § 230.506(a)–(b) (2012).

105. *See Pope, supra* note 36, at 984.

106. *Id.*

107. Andrea Rumbaugh, *Smaller Investors May Gain Better Crowdfunding Opportunities*, HOUSTON CHRONICLE (Oct. 21, 2014), <http://www.houstonchronicle.com/business/article/Rule-change-would-open-crowdfunding-opportunities-5838163.php>.

108. Schwartz, *supra* note 98, at 1474.

109. *Id.* at 1475.

While Facebook stock eventually gained value, the percent profit returned to an investor who purchased Facebook stock after its IPO was nowhere near a pre-IPO investor's rate of return.<sup>110</sup> Advocates claim crowdfunding will remove this type of heavy-handed paternalism and will give the average investor the opportunity to invest in start-up companies and determine which companies have the most potential to be successful and which do not.

### *3. Creating New Business Opportunities*

Capital is essential to business and job creation in the United States. It facilitates economic growth and provides business with the potential for expansion, growth, and development. Capital is especially important for small businesses, which provide a bulk of the job creation in the United States.<sup>111</sup> “[S]mall businesses’ demand for capital far outweighs supply in the United States.”<sup>112</sup> In 2011 alone, roughly 600,000 small businesses were unable to obtain any business funding or credit,<sup>113</sup> while another 800,000 small businesses needed additional capital to successfully run their business.<sup>114</sup>

Further, many individuals are willing to fund a start-up company or lend to a small business. According to one survey, “58 percent of all American adults maintain that they are willing to help fund a start-up or [a] expanding small business in pursuit of the American Dream.”<sup>115</sup> Advocates claim that loosening securities laws to allow for easier investing by average individuals will provide the funding that small businesses and start-up companies need. By one estimate, a \$300 billion infusion of capital into the United States economy would be created if Americans moved one percent of their “investable assets into crowdfunding.”<sup>116</sup> Accordingly, proponents argue that crowdfunding will close the gap between the lack of funding for new and small businesses and the average American’s desire to invest in start-up companies and small businesses.

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110. *Compare Facebook, Inc.*, MARKET WATCH, <http://www.marketwatch.com/investing/stock/fb> (last visited Feb. 25, 2015), and The Associated Press, *Prices of Facebook Stock since Long Awaited IPO*, HUFFINGTON POST (July 26, 2012), <http://www.huffingtonpost.com/huff-wires/20120726/us-earns-facebook-stock-prices/>, with Schwartz, *supra* note 98, at 1474–75 & n.104.

111. See Laurent Belsie, *Who Creates Jobs?*, NAT’L BUREAU ECON. RESEARCH, <http://www.nber.org/digest/feb11/w16300.html> (last visited July 20, 2015) (finding that young, start-up companies account for three percent of employment but twenty percent of job creation in the United States by “ramping up,” where a business “grow[s] faster than more mature companies, and creat[es] a disproportionate share of jobs relative to their size”); J.D. Harrison, *Who Actually Creates Jobs: Start-ups, Small Businesses or Big Corporations?*, WASH. POST (Apr. 25, 2013), [http://www.washingtonpost.com/business/on-small-business/who-actually-creates-jobs-start-ups-small-businesses-or-big-corporations/2013/04/24/d373ef08-ac2b-11e2-a8b9-2a63d75b5459\\_story.html](http://www.washingtonpost.com/business/on-small-business/who-actually-creates-jobs-start-ups-small-businesses-or-big-corporations/2013/04/24/d373ef08-ac2b-11e2-a8b9-2a63d75b5459_story.html) (“A growing contingency of economists believe start-ups are the most reliable job creators, pointing to studies that show new firms are responsible for nearly all of the nation’s net job growth every year (total job gains minus total job losses).”).

112. Saunders II, *supra* note 24, at 950.

113. *Id.*

114. *See id.*

115. *Id.* at 950–51.

116. *Id.* at 951.

## *Crowdfunding Regimes in Response to Inadequacy of JOBS Act Title III*

Proponents also claim that crowdfunding will reduce, or remove, the traditional costs associated with small business capital fundraising by: “(a) lowering agency costs associated with acceding to mandatory SEC and disclosure requirements; (b) lowering marketing and promotional costs traditionally correlating with issuing equity to the public; and (c) increasing the ease of obtaining equity capital by small businesses.”<sup>117</sup>

### *4. Incorporating Social Media in the Securities Industry*

Many crowdfunding proponents believe crowdfunding will increase the efficiency of investing by allowing the “crowd” to monitor and recommend securities.<sup>118</sup> Research seems to show online rating systems and signals “exert considerable influence over investment decisions.”<sup>119</sup> One CEO believes “new investment portals will [rely on social media links and] take [the] idea further, letting users ‘follow’ other investors with a proven record and pick up tips that help them sift through the mass of investment solicitations that are likely to flood the online platforms. . . .”<sup>120</sup> Additionally, proponents contend that “open” investment forums will limit fraud through “community ratings and the use of algorithms to detect illicit activity.”<sup>121</sup> Proponents point to the fact that these techniques have kept fraud below one percent of the total money raised on Indiegogo.<sup>122</sup> In effect, the proponents believe the incorporation of the “crowd” into equity investing will allow the quick and steady proliferation of successful businesses and investments and limit the harmful effect of failing or fraudulent investments.

### *5. Increasing “Social Investing”*

Finally, proponents and entrepreneurs argue that crowdfunding will increase an individual’s ability to invest in “social” projects, where the benefit provided by the investment is something other than simply a capital return. These nonmonetary benefits include producing social, environmental, and humanitarian benefits, among others. One proponent believes “[g]lobal awareness has been created around the need to effectuate change and deploy capital for good into sustainable commercial enterprises.”<sup>123</sup> Another stated, “Central to Crowdfunding’s rise is the idea of ‘enabling the individual through mass support’. The expected social impact is an expansion in community and social development projects, on both the small and large

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117. David Groshoff, *Kickstarter My Heart: Extraordinary Popular Delusions and the Madness of Crowdfunding Constraints and Bitcoin Bubbles*, 5 WM. & MARY BUS. L. REV. 489, 545 (2014).

118. See Saunders II, *supra* note 24, at 966.

119. *Id.* at 965.

120. Richard Walters, *Start-ups Seek the ‘Wisdom of the Crowds’*, FIN. TIMES (Apr. 3, 2012), <http://www.ft.com/cms/s/0/c1f1695c-7da8-11e1-9adc-00144feab49a.html#axzz3HDg47VMf>.

121. *Id.*

122. *Id.*

123. Devin Thorpe, *Crowdfunding Entrepreneurs Predict More Good in the World in 2014*, FORBES (Dec. 24, 2013), <http://www.forbes.com/sites/devinthorpe/2013/12/24/crowdfunding-entrepreneurs-predict-more-good-in-the-world-in-2014/>.

scale—local and global.”<sup>124</sup> While the promised results remain to be seen, the unprecedented investing taking place on Kickstarter and Kiva, all for non-investment purposes, shows the current potential for social investing.<sup>125</sup> Building on the success of social investing platforms like Kickstarter and Kiva, businesses could sell equity stakes in their companies, while also promising to provide socially-minded products.

### C. Connecting the Dots: How the Structure of the Federal Securities Laws Led to the Crowdfunding Revolution

The current securities regulatory regime that governs the offering and sale of securities in the United States was created to increase investor protection through the disclosure of relevant information about securities issuers.<sup>126</sup> In addition, the SEC has the power to enforce federal securities laws, including through the enforcement of anti-fraud provisions if a business includes untruthful information on their required disclosures.<sup>127</sup> But, in setting out this disclosure regime, federal securities laws create a regime that make it easier for businesses to sell securities to high-value and high-income individuals.<sup>128</sup> This regime was created because “the average investor needs the protection of the full panoply of securities regulations and thus should be limited to buying [fully] public securities.”<sup>129</sup> Ultimately, modern “[s]ecurities law’s dirty little secret is that that rich investors have access to special kinds of investments . . . that everyone else does not.”<sup>130</sup>

Discontent with current federal securities regime has steadily grown over time. Such discontent is largely motivated by the disparate treatment of average citizen-investors, compared to the relaxed rules for “status” individuals, those with high-wealth or income levels.<sup>131</sup> Average citizens are increasingly demanding a new securities regime that will give middle and low-income citizens the same opportunities to invest in a greater array of non-public securities offerings.<sup>132</sup> Advocates of crowdfunding claim that a crowdfunding exemption will inject new investments into an economy that consistently lacks sufficient capital to invest in start-up companies and small businesses.

### III. The CROWDFUND Act: An Exercise in Impracticality

The CROWDFUND Act and the proposed SEC regulations promulgated under the authority of the CROWDFUND Act have already been declared a dead letter by

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124. *Id.*

125. See Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOs*, 2015 UNIV. ILL. L. REV. 217, 222–24 (2015).

126. See Ramirez, *supra* note 48, at 681.

127. See, e.g. 17 C.F.R. 240.10b-5 (2012).

128. See Groshoff, *supra* note 117.

129. Usha Rodrigues, *Securities Law’s Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3389 (2013).

130. *Id.*

131. See *supra* Part II.B.

132. See *id.*



many commentators and legal scholars.<sup>133</sup> Professor Stuart Cohen argues that the CROWDFUND Act is “fraught with regulatory requirements that go beyond even existing exemptions and raise transaction costs and liability concerns that may substantially reduce the exemption’s utility for small capital-raising efforts.”<sup>134</sup> Because an entire book, let alone a law review article, could be written explaining the complexities of the CROWDFUND Act,<sup>135</sup> this Article will briefly examine the federal CROWDFUND Act, with an eye towards the Act’s implications for small businesses and start-up companies.

First, this Part will examine the broad prerequisites that an issuer must fulfill before the issuer may rely on the CROWDFUND Act to issue an equity capital offering. Second, it will turn to the Act’s compliance and disclosure requirements for issuers. Third, this Part will look at the compliance requirements for crowdfunding intermediaries, the brokers or funding portals that will facilitate the issuer’s crowdfunding transactions. Finally, after the Act’s introduction, this Part will address the Act’s flaws and shortfalls.

#### A. The Prerequisites of the CROWDFUND Act

The CROWDFUND Act exempts from registration, any securities sold as part of an offering that raises \$1 Million or less in any 12-month period.<sup>136</sup> The Act restricts the aggregate amount that may be sold to any individual investor to either: \$2,000 or ten percent of the investor’s annual income if the investor has an annual income of less than \$100,000; or ten percent of an investors income, “not to exceed a maximum aggregate amount sold of \$100,000 if either the annual income or net worth of the investor is equal to or more than \$100,000.”<sup>137</sup> In addition, the securities transaction must be “conducted through a broker or funding portal” that is in conformance with the CROWDFUND Act’s compliance and reporting requirements.<sup>138</sup> The Act also creates substantial disclosure and compliance requirements for crowdfunding securities issuers.<sup>139</sup> But, to the benefit of the securities issuer, the Act preempts state blue sky registration laws.<sup>140</sup> Accordingly, any securities offering sold under the Act can avoid registration with all state securities regulatory regimes.

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133. See, e.g., Charles Wilbanks, *For Crowdfunding, The Revolution Will Be Localized*, CBS MONEY WATCH (July 12, 2013), <http://www.cbsnews.com/news/for-crowdfunding-the-revolution-will-be-localized/>. “Opportunity knocked, but what began as a relatively straight-forward approach to assist small business capital-formation ended with a regulatory scheme laden with limitations, restrictions, obligations, transaction costs and innumerable liability traps. . . . The [CROWDFUND Act] is an opportunity missed. Small businesses and promotions needing to raise limited amounts of capital through equity or other forms of investment continue to lack meaningful registration exemptions.” Cohn, *supra* note 24, at 1445.

134. Cohn, *supra* note 24.

135. This is evidenced by the sheer length of the SEC’s proposed regulations under the CROWDFUND Act, which encompasses almost 200 pages of the federal register. See Crowdfunding, 78 Fed. Reg. 66428, 66428–66602 (proposed Nov. 5, 2013) (to be codified at 17 CFR pts. 200, 227, 232, 239, 240 and 249).

136. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(a)(6)(A), 126 Stat. 306 (2012).

137. *Id.* § 302(a)(6)(B).

138. *Id.* § 302(a)(6)(C).

139. *Id.* § 302(a)(6)(D).

140. *Id.* § 305.

Additionally, securities issued under the CROWDFUND Act are restricted and may not be transferred for one year after their purchase, unless they are sold in a new offering registered with the SEC, they are sold back to the issuer, or are sold to an accredited investor.<sup>141</sup> Further, the Act is not available to any issuer who is:

- 1) Organized under the laws of a foreign government, or not subject to the laws of a “State or territory of the United States or the District of Columbia;”
- 2) Subject to the filing requirements in section 13 or 15(d) of the Securities Act of 1934;
- 3) An investment company, as defined in the Investment Company Act of 1940;
- 4) Any other company excluded by the SEC.<sup>142</sup>

Many observations can be made about the CROWDFUND Act's initial structure. The caps on aggregate offering amounts and individual investments indicate that the SEC is concerned with the potential for fraud and loss of investment from risk-laden investments. Additionally, the limitation on so called “bad actor” issuers and the extensive compliance requirements for issuers and portals further indicate that fraud is a major concern for the SEC. “So much for the [Act’s] simple elements . . . . Now comes the [Act’s] heavy-handed additional requirements. . . .”<sup>143</sup> The bulk of the CROWDFUND Act’s requirements, and costs, are contained in the Act’s disclosure and compliance requirements.

#### B. The Issuer’s Disclosure and Compliance Requirements under the CROWDFUND Act

Issuers attempting to offer securities under the CROWDFUND Act must ensure they comply with a vast assortment of ongoing requirements. First, the investor must file a document with the SEC that comprehensively details the business’s relevant information. This document must include general information such as the name and legal status of the business, the directors, shareholders (who own over twenty percent of the company’s shares), and officers of the company, the anticipated business plan of the issuer, the target amount to be raised in the offering and the price of the securities, and a description of how the funds raised from the offering will be used.<sup>144</sup> The document must also include “a description of the ownership and capital structure of the issuer, including:” (1) the terms attached to the securities and how the terms may be modified in the future, as well as “how the rights of the securities being offered may be materially limited, diluted, or qualified by the rights of any other class of security of the issuer;” (2) potential negative impacts resulting from the ownership structure of the principal shareholders; (3) how the securities are being valued; (4) the risk to purchasers from minority ownership in the issuer and risks related to future company action; and (5) any other information required by the SEC.<sup>145</sup>

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141. *Id.* § 4A(e).

142. *Id.* § 4A(d).

143. Cohn, *supra* note 24, at 1438–39.

144. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 4A(b)(1), 126 Stat. 306 (2012).

145. *Id.* § 4A(b)(1)(H).

Additionally, the document must include a detailed description of the issuer's financial condition. The detail to which the issuer must report its financial condition varies by the amount the issuer wishes to raise. If the issuer wants to raise \$100,000 or less, it must provide income tax returns for the most recent year and financial statements, certified "to be true and complete in all material respects" by the principle executive officer of the issuer.<sup>146</sup> If the issuer wants to raise between \$100,000 and \$500,000, the financial statements must be reviewed by an independent public accountant "using professional standards and procedures established by the [SEC]."<sup>147</sup> Finally, if the issuer wants to raise between \$500,000 and \$1 Million, the issuer must include audited financial statements with its initial disclosure.<sup>148</sup>

Second, the issuer is prohibited from advertising its crowdfunding offering to any investor outside of the crowdfunding intermediary, either the portal or a broker.<sup>149</sup> Effectively, this means that issuers can only advertise and solicit their securities through a registered crowdfunding intermediary, and that intermediaries may not lure potential investors by advertising specific investment opportunities. Third, the issuer is prohibited from providing compensation to any individual unless they meet certain requirements created by the SEC.<sup>150</sup> Fourth, on at least an annual basis, the issuer must file and provide to investors reports, including "reports of the results of operations and financial statements of the issuer" and other information required by the SEC.<sup>151</sup> Finally, the Act creates liability for any "untrue statement of material fact or [a failure] to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading. . . ." <sup>152</sup> And, as a further deterrent, individuals harmed by an issuer's fraudulent statement are granted the power to bring private claims and act as a private attorney general to enforce the provisions of the CROWDFUND Act.<sup>153</sup>

### C. Killing the Messenger: Compliance Requirements For Crowdfunding Intermediaries

In addition to issuer obligations, the CROWDFUND Act also places numerous obligations on the intermediaries that facilitate crowdfunding transactions. The Act requires that all intermediaries register with the SEC, as a broker or as a funding portal (portal), and with all applicable self-regulatory organizations (SROs).<sup>154</sup> Implicit with the portal's registration with the SROs is the requirement that the portals comply with each SRO's individual requirements. One SRO that will regulate portals under the CROWDFUND Act is the Financial Industry Regulatory Authority

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146. *Id.* § 4A(b)(1)(D)(i).

147. *Id.* § 4A(b)(1)(D)(ii).

148. *Id.* § 4A(b)(1)(D)(iii).

149. *Id.* § 302(a)(6)(C), § 4A(b)(2).

150. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 4A(b)(3), 126 Stat. 306 (2012).

151. *Id.* § 4A(b)(2)-(4).

152. *Id.* § 4A(c)(2)(A).

153. *Id.* § 4A(c).

154. *Id.* § 4A(a)(1)-(2).

(FINRA).<sup>155</sup> FINRA has already promulgated fifty pages of proposed rules that would create new obligations for portals, in addition to those created by the CROWDFUND Act and the SEC's proposed rules.<sup>156</sup> Further, the CROWDFUND Act requires that portals provide disclosures to the SEC relating to "risks and other investor education materials" and any other information the SEC determines is appropriate for disclosure.<sup>157</sup> The portals are charged to ensure that all investors are investing in amounts within the limits of the CROWDFUND Act.<sup>158</sup> And, the portal may deliver funds to the issuer only after the aggregate capital raised meets the target-offering amount created by the issuer.<sup>159</sup>

Each portal must also take "measure[s] to reduce the risk of fraud" in crowdfunding investing, including establishing background checks and securities enforcement regulatory history checks "on each officer, director and person holding more than 20 percent of the outstanding equity of every issuer" who sells securities through the portal.<sup>160</sup> Further, the portal must ensure that each investor: reviews the relevant educational information; "positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss"; and understands the level of risk applicable to crowdfunding securities, including the risk of illiquidity and any other matter the SEC determines is appropriate.<sup>161</sup> The Act prevents portals from compensating any promoters, finders, or "lead generators" for discovering or locating potential investors.<sup>162</sup> Finally, portals must prohibit their directors, officers, partners, or others in a similar function or status from having any financial interest in any issuer or its services and portals must meet any other requirements established under the SEC's rulemaking authority.<sup>163</sup>

#### D. Criticism of the CROWDFUND Act and the SEC's Proposed Regulations

Many parts of the CROWDFUND Act provide necessary disclosures and create obligation for issuers and portals to prevent and reduce the impact of fraud and ensure investors have sufficient information regarding their potential investments. But, the Act's requirements, measured together, create a burden that far exceeds the potential benefits that may come from an issuer raising funds under the Act. The burden is especially great for small businesses and start-up companies because they

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155. See *Funding Portals*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/Industry/Issues/Crowdfunding/> (last visited July 20, 2015).

156. See *generally Funding Portal Notice – Attachment A*, FIN. INDUS. REGULATORY AUTH., available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/industry/p369763.pdf> (last visited July 20, 2015).

157. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 4A(a)(3), 126 Stat. 306 (2012).

158. *Id.* § 4A(a)(8).

159. *Id.* § 4A(a)(7).

160. *Id.* § 4A(a)(5).

161. *Id.* § 4A(a)(4).

162. *Id.* § 4A(a)(10).

163. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 4A(a)(11)–(12), 126 Stat. 306 (2012).

generally engage in smaller securities offerings and raise less money, as compared to larger, more established businesses.<sup>164</sup>

Congress has created a catch-22 for small businesses and start-up companies by passing the CROWDFUND Act. Crowdfunding is best fitted for those businesses that desperately need to raise small amounts of capital and who lack meaningful capital-raising alternatives. Start-up companies generally lack sufficient capital to finance their business and also have little or no past record of business performance, meaning they are generally unable to obtain business funding from traditional sources.<sup>165</sup> Without these alternatives, many entrepreneurs are turning to crowdfunding as a potential source to fund their business. But, the compliance and disclosure costs of the CROWDFUND Act effectively eliminate crowdfunding as a remedy for the capital raising plight of small businesses and start-up companies. As one commentator stated, “it is worth noting that the one million dollars allowable amount is considerably in excess of what many small entrepreneurs, artists and others raising capital might need.”<sup>166</sup> The CROWDFUND Act, despite what its sponsors touted, was not ultimately aimed at solving the crisis in small business and start-up company capital funding. “The problem with having selected one million dollars as the authorized amount is that Congress then felt impelled to surround the exemption with numerous requirements that might not have been necessary had an exemption been created for smaller offerings in lieu of or in addition to the one million dollar exemption.”<sup>167</sup>

First, the costs of the CROWDFUND Act are, to be blunt, immense. The Act’s compliance costs will inevitably be borne by the securities issuers and will cut into the potential profitability of a securities offering under the Act. The issuer must divert business funds or the funds it raises in its securities offering to ensure compliance with all of the Act’s requirements. Crowdfunding intermediaries, such as portals, must also register with the SEC and with any applicable SRO, including FINRA, in addition to their reporting and compliance requirements under the Act. This registration will likely entail many new obligations for the portals, such as procedures to prevent the laundering of money through securities offerings, and to “maintain fidelity bond[<sup>168</sup>] coverage.”<sup>169</sup> While each of these procedures will ultimately protect investors and provide some benefit, compliance with all of the CROWDFUND Act’s rules and procedures will amount to immense compliance costs for the portals. In conformance with basic notions of capitalism, the portals will

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164. See Am. Bar Ass’n, *The Impact of the 1992 Small Business Initiative*, 47 ADMIN. L. REV. 511, 512–13 (1995).

165. See *id.*

166. Cohn, *supra* note 24, at 1438.

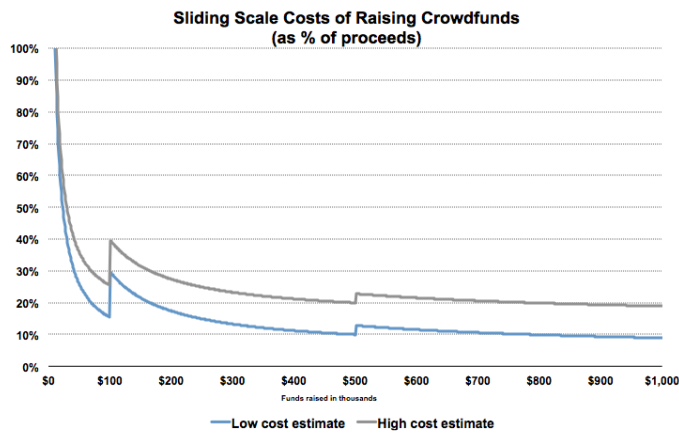
167. *Id.*

168. A fidelity bond is a “bond to indemnify an employer or business for loss due to embezzlement, larceny, or gross negligence by an employee or other person holding a position of trust.” BLACK’S LAW DICTIONARY, *supra* note 46, at 201.

169. See FIN. INDUS. REGULATORY AUTH., REGULATORY NOTICE: JUMPSTART OUR BUSINESS STARTUPS (JOBS) ACT 4 (Oct. 2013), available at <http://www.finra.org/sites/default/files/NoticeDocument/p370743.pdf>; see also *Anti-Money Laundering*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/Industry/Issues/AML/> (last visited July 30, 2015).

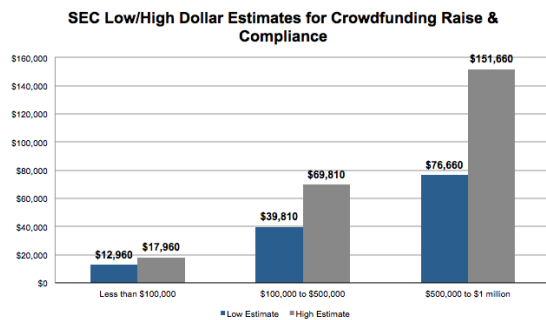
inevitably pass these regulatory costs onto the issuer. Ultimately, the potential for profitability of small-issue equity crowdfunding under the CROWDFUND Act will be greatly diluted by the enormous compliance costs. For example, “the SEC estimates portal and compliance fees will eat up between 12.9% and 39% of the money raised” in a securities issuing of less than \$100,000 under the CROWDFUND Act.<sup>170</sup> While securities issuings between \$100,000 and \$1 Million will likely average approximately eight percent.<sup>171</sup>

Second, the current version of the CROWDFUND Act favors those issuers who raise large amounts of money, near \$1 Million, the maximum annual amount an issuer may raise under the Act. If an issuer were to raise the maximum amount allowable under the Act, \$1 Million, the issuer would likely be able to justify the large compliance costs. As the issuer raises money, the compliance costs are reduced proportionally when compared to the amount of money raised under the crowdfunding securities issuing. For businesses who want to raise small amounts of money, say \$100,000, compliance costs can cost up to thirty to forty percent of the offering, and will likely make the CROWDFUND Act cost prohibitive.



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170. Sherwood Neiss, *It Might Cost You \$39K to Crowdfund \$100K under the SEC’s New Rules*, VENTURE BEAT (Jan. 2, 2014), <http://venturebeat.com/2014/01/02/it-might-cost-you-39k-to-crowdfund-100k-under-the-secs-new-rules/>.



*Id.* These visual graphs of the CROWDFUND Act’s estimated compliance costs show that the compliance costs decrease as a percentage of the offering as the issuer raises more funds in its securities offering. Thus, the Act will be of limited use to, and will be more costly for, small-capital securities issuers. *See id.*

171. *Id.*

172. *Id.*

Finally, the CROWDFUND Act's prohibition on the resale of securities for one year after their initial sale from the issuer will impair the security buyer's potential profitability and harm their ability to recoup money from their investments. A robust resale market for crowdfunding securities would provide greater liquidity to the securities and would increase the efficiency of the market in valuing crowdfunding securities. In effect, the suppression of a secondary market for the sales of crowdfunding securities will prevent the operation of the efficient market theory. "In an open market, like the market for publicly-traded securities, the market price is a built-in aggregator of the crowd's wisdom—i.e., the 'price discovery' mechanism—because it represents the price at which sellers and buyers are collectively willing to transact."<sup>173</sup> Whereas "the price of crowdfunded securities will not automatically reflect the collective judgment of all crowdfunding investors because there will only be one seller, the issuer, and pessimistic investors cannot balance optimistic investors in setting a market price."<sup>174</sup> Without an effective resale market, even one that is very limited in scope, there will only be a limited number of investors. Ultimately, this means that there will be fewer investors, and thus less capital for crowdfunding investments.

Proponents of the CROWDFUND Act's numerous compliance requirements may argue that a secondary market in crowdfunding securities will increase fraud and so-called "pump and dump" schemes, where "[s]hare prices are 'pumped' by building excitement through exaggerated statements and financials, often through cold calls, e-mail solicitations, and other internet media. Once shares reach a high enough price, they are sold, or 'dumped.' When the truth about the state of the company hits the market the shares become worthless leaving duped investors hanging."<sup>175</sup> It is certainly true that a secondary market will likely increase the potential for fraudulent schemes. But, there are many ways that the potential for fraud can be reduced. For example, "[t]he SEC can guard against fraud in the secondary markets . . . by allowing resales [only] to other members who are registered with complying funding portals. By doing this, the SEC would ensure that the investor pool in crowdfunding resale markets is educated."<sup>176</sup> Any resale market has risk, but the SEC has shown it has options to ensure investors have sufficient protection.

In conclusion, the CROWDFUND Act has been attacked because its compliance costs will likely remove much of the potential benefit for a business trying to raise less than \$250,000. In addition, the Act will most benefit those who are attempting to raise large sums of money under the Act (between \$500,000 and \$1 Million). The Act, as it stands, does not address the capital needs of small businesses. And, the Act's one-year prohibition on the resale of securities will prevent the creation of a secondary market that could promote capital raising under the Act and will harm

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173. John S. Wroldsen, *The CROWDFUND Act's Strange Bedfellows: Democracy and Start-up Company Investing*, 62 U. KAN. L. REV. 357, 379 (2013).

174. *Id.* at 379–80.

175. Sherief Morsy, *The Jobs Act and Crowdfunding*, 79 BROOK. L. REV. 1373, 1382 (2014) (citation and quotation marks omitted).

176. *Id.* (footnotes omitted).

those investors who decide to invest their funds in a crowdfunding company by preventing the ready resale of their securities. While there is the potential for fraud in a secondary market, general fraud prevention such as monitoring, education, daily transfer limits, and reasonable restriction of the pool of potential securities purchasers and sellers could prevent much of the fraudulent activity.

#### **IV. State-Enacted Intrastate Crowdfunding Laws under Section 3(a)(11) of the Securities Act of 1933, SEC Rule 147, and SEC Rule 504**

In the last two years, many states have enacted new laws to grant in-state businesses the ability to raise capital through crowdfunding solicitations to state residents.<sup>177</sup> This movement has largely grown out of the widespread beliefs that (i) the final regulations that will eventually be promulgated by the SEC under the CROWDFUND Act will be too costly for the average small business; and (ii) the SEC has delayed the implementation of the CROWDFUND Act's final regulations. As mentioned previously, the United States has the constitutional power to regulate the sale of securities and may preempt state law that is contrary to federal law. And, Congress chose to exercise its power to regulate securities when it enacted the Securities Act of 1933 and the Securities Exchange Act of 1934 and subsequent amendments and related laws. Because the states are preempted from enacting securities laws that would conflict with federal securities laws, states are required to enact their crowdfunding regimes within a federal securities exemption contained in the Securities Act of 1933. To do so, the states have largely opted to rely on section 3(a)(11) of the Securities Act of 1933 and SEC Rule 147—the safe harbor provision promulgated by the SEC under section 3(a)(11).<sup>178</sup> In addition, at least one state (California) has proposed an intrastate crowdfunding regime relying on the security registration exemption in SEC Rule 504.<sup>179</sup>

First, this Part will discuss section 3(a)(11), Rule 147 and Rule 504 and each Rule's benefits and impediments to an intrastate crowdfunding regime. Second, it will survey the intrastate crowdfunding laws currently enacted or proposed by many states. Third, this Part will survey the practical effect of the enacted intrastate crowdfunding laws to determine if they are being used by businesses to raise capital.

##### **A. Capital Raising Under Section 3(a)(11), SEC Rule 147 and SEC Rule 504: Walking a Camel through the Eye of a Needle**

Section 3(a)(11), the intrastate securities exemption, and Rule 147, the intrastate securities safe harbor, effectively exempt from registration any security

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177. See *infra* Part V.B.

178. See Anthony J. Zeoli, *State of the States- List of Current Active and Proposed Intrastate Crowdfunding Exemptions*, CROWDFUNDINGLEGALHUB.COM (June, 25, 2014), <http://crowdfundinglegalhub.com/2014/06/25/state-of-the-states-list-of-current-active-and-proposed-intrastate-exemptions/>.

179. See *AB-2096 Securities Transactions: Qualification: Notification: Small Company*, CAL. LEGISLATIVE INFO., [http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill\\_id=201320140AB2096](http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201320140AB2096) (last visited Sept. 9, 2015).



that is offered and sold wholly within a single state.<sup>180</sup> Rule 504, one of the three safe harbor exemptions in Regulation D, exempts securities offerings that raise \$1,000,000 or less, so long as the offerings meet certain criteria.<sup>181</sup> Both Rule 147 and Rule 504 contain major impediments for securities offerors attempting to raise capital within their state's boundaries.

*1. Section 3(a)(11) of the Securities Act of 1933 and SEC Rule 147—an Intrastate Crowdfunding Safe Harbor*

The intrastate securities exemption contained in section 3(a)(11) of the Securities Act of 1933<sup>182</sup> and the safe harbor contained in SEC Rule 147<sup>183</sup> are the most natural fit for a state's creation of an intrastate crowdfunding exemption. The exemption frees securities offerings from federal registration if: (i) the securities are solicited and the funds are raised wholly within one state; and (ii) the issuer and the investors are all residents of the same state.<sup>184</sup> It is "intended to apply when local industries seek financing from local investors."<sup>185</sup> The SEC believes the rule was created so that "a company with operations restricted to one area . . . [can] to offer a limited amount of its securities to investors in the immediate vicinity without having to register the securities with a federal agency."<sup>186</sup> In enacting section 3(a)(11), Congress believed that federal protection of investors was unnecessary because "the investors would be protected both by their proximity to the issuer and by state regulation. [The SEC crafted] Rule 147 [to] reflect[] this Congressional intent and [has] limited . . . its application to transactions where state regulation will be most effective."<sup>187</sup>

First, this Part will examine the requirements of section 3(a)(11) and Rule 147. Next, it will consider the impediments to raising capital under intrastate securities exemptions that rely on section 3(a)(11), Rule 147, or both.

a. The Requirements of Section 3(a)(11)

Section 3(a)(11) of the Securities Act of 1933 is the main federal exemption from registration for intrastate securities offerings. A securities offeror may rely on section 3(a)(11) alone as a registration exemption, so long as it fulfills all of the section's requirements.<sup>188</sup> However, an offeror relying on section 3(a)(11) will be wading into vague and uncharted territory because of the brief and imprecise nature of the statute. The entire statute consists of only a single sentence and contains

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180. *See infra* Part IV.A.1.

181. *See infra* Part IV.A.2.

182. 15 U.S.C. § 77c(a)(11) (2012).

183. 17 C.F.R. § 230.147 (2012).

184. *See* 15 U.S.C. § 77c(a)(11).

185. J. William Hicks, *Intrastate Offerings under Rule 147*, 72 MICH. L. REV. 463, 463 (1974).

186. *Id.* at 499.

187. *Id.* at 505 (footnote omitted).

188. *See* James A. Askew, *A New Approach to the Interstate Exemption: Rule 147 vs. Section 3(a)(11)*, 62 CALIF. L. REV. 195, 196–99 (1974).

requirements that are open to varying interpretation and the subject of considerable debate.<sup>189</sup>

Section 3(a)(11) exempts any security from federal registration, if (1) the securities are “offered and sold only to persons resident within a single State or Territory,” and (2) the issuer of the securities “is a person resident and doing business within or, if a corporation, [is] incorporated by and doing business within, such State or Territory.”<sup>190</sup> While many parts of section 3(a)(11) are fairly clear, such as being incorporated or residing in a state, “doing business” in the state is subject to many diverging interpretations. “Doing business” may simply mean that the business in fact has some sort of business activity in the state, no matter how small the business activity is. At the other extreme, it may mean that the business has all of its business operations within the state. Or, it may mean something in between, authorizing a business to raise capital where it does a substantial amount of business within the state. The SEC seems to have chosen the last interpretation, though it has only given vague direction in interpreting “doing business.”<sup>191</sup>

To qualify under section 3(a)(11) the SEC has stated the business must “carry out a significant amount of its business in” the state.<sup>192</sup> Also, if a business “holds some of its assets outside the state, or derives a substantial portion of its revenues outside the state where it proposes to offer its securities, it may also have difficulty qualifying for the exemption.”<sup>193</sup>

In conclusion, while a state may rely on the plain language of section 3(a)(11), the business may open itself up to immense potential liability by doing so. Section 3(a)(11) is written in short, vague language that is subject to varying interpretation. Unless a securities issuer is able to obtain a no action letter from the SEC, the issuer will not know if it is in compliance with section 3(a)(11). Because of this uncertainty, it is often worthwhile for a business to rely on the intrastate offering safe harbor contained in SEC Rule 147.

#### b. SEC Rule 147: A Safe Harbor under Section 3(a)(11)

Rule 147 was promulgated by the SEC to create a safe harbor for section 3(a)(11), a set of requirements that guarantees a securities issuer is acting within the legal boundaries of section 3(a)(11). The SEC enacted Rule 147 as “an effort to publicize administrative and judicial interpretations of the [intrastate] exemption, to protect investors, and to provide more certainty in determining the parameters of section 3(a)(11). . . .”<sup>194</sup> If a securities issuer complies with the requirements of Rule 147, the SEC guarantees that the securities issuer has complied with the securities exemption in section 3(a)(11) of the Securities Act of 1933. The SEC has made clear

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189. See 15 U.S.C. § 77c(a)(11) (2012).

190. *Id.*

191. See *Small Business and the SEC*, U.S. SEC. & EXCH. COMM’N (Oct. 10, 2013), <http://www.sec.gov/info/smallbus/qasbsec.htm>.

192. *Id.*

193. *Id.*

194. Hicks, *supra* note 185, at 464.

that Rule 147 is merely one means of complying with section 3(a)(11) and is not the exclusive means.<sup>195</sup>

The SEC expounded on the purpose of section 3(a)(11) as a justification for the specific requirements of Rule 147. It stated, “The legislative history of [section] 3(a)(11) suggests that the exemption [applies] only to issues genuinely local in character, which in reality represent local financing by local industries, carried out through local investment. Rule 147 is intended to provide more objective standards [to those raising capital under] section 3(a)(11).”<sup>196</sup>

Rule 147 has five major sections: (i) the transactions covered by the Rule;<sup>197</sup> (ii) the scope of the securities issuances covered by Rule 147;<sup>198</sup> (iii) the requirements the issuer must meet;<sup>199</sup> (iv) who may be an offeree and purchaser of the securities;<sup>200</sup> and (v) the Rule’s temporary prohibition on the resale of intrastate securities after their purchase and the actions that must be taken by the issuer to prevent interstate offers and sales.<sup>201</sup>

First, Rule 147 states, “Offers, offers to sell . . . and sales by an issuer of its securities made in accordance with all [aspects] of this rule shall be deemed to be part of an issue offered and sold” in compliance with all parts of the intrastate exemption contained in section 3(a)(11) of the Securities Act of 1933.<sup>202</sup> Second, the Rule requires that all securities of the issuer, which are part of the same issuance, must be “offered for sale or sold in accordance with all of the terms and conditions of” Rule 147.<sup>203</sup> Effectively, this requires that all parts of the issuer’s then-current securities offering meet Rule 147. An issuer may not sell some securities based on Rule 147, while at the same time sell securities that do not meet Rule 147. A broker-dealer may distribute securities “in an intrastate offering made” under Rule 147, “without jeopardizing the federal exemption.”<sup>204</sup>

Third, Rule 147 contains a substantial list of requirements that the issuer must meet before it is eligible to rely on Rule 147 for an intrastate securities offering. The issuer must “at the time of any offers and the sales be a person resident and doing business” in the state where the offers and sales are made.<sup>205</sup> An issuer will be considered a resident of the state where:

- (i) It is incorporated or organized, if a corporation, limited partnership, trust or other form of business organization that is organized under state or territorial law;
- (ii) Its principal office is located, if a general partnership or other form of business

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195. *See id.* at 465.

196. 17 C.F.R. § 230.147 (2012).

197. *Id.* § 230.147(a).

198. *Id.* § 230.147(b).

199. *Id.* § 230.147(c).

200. *Id.* § 230.147(d).

201. *Id.* § 230.147(e)–(f).

202. 17 C.F.R. § 230.147(a) (2012).

203. *Id.* § 230.147(b)(1).

204. *Compliance and Disclosure Interpretations: Securities Act Rules, Question 141.02*, U.S. SEC. & EXCH. COMM’N (Jan. 26, 2009), <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.

205. 17 C.F.R. § 230.147(c).

organization that is not organized under any state or territorial law; (iii) His principal residence is located if an individual.<sup>206</sup>

An issuer is “deemed to be doing business” in a state when: (i) “the issuer derived at least 80 percent of its gross revenues and those of its subsidiaries on a consolidated basis [from within the state];” (ii) the issuer has at least “80 percent of its assets and those of its subsidiaries on a consolidated basis located [in the state];” (iii) “the issuer intends to use and uses at least 80 percent of the net proceeds . . . in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory;” and (iv) “the principal office of the issuer is located [in the state].”<sup>207</sup>

Fourth, offers and sales of securities may be made “only to persons resident within the state or territory of which the issuer is a resident.”<sup>208</sup> Rule 147 does not contain any outright prohibition on general advertising or solicitation, but does substantially restrict where the advertising or solicitation can take place.<sup>209</sup> Advertising and solicitations “must be conducted in a manner consistent with the requirement that offers . . . be made only to persons resident within the state or territory of which the issuer is a resident.”<sup>210</sup> Advertising make take place under any medium, so long as the advertising is restricted to a single state or territory. The Internet may be used to advertise and solicit so long as “the [advertiser] implements adequate measures so that offers of securities are made only to persons resident in the relevant state or territory.”<sup>211</sup> This includes “at a minimum, disclaimers and restrictive legends making it clear that the offering is limited to residents of the relevant state . . . and limiting access to information about [the] investment opportunities to persons who confirm they are residents of the relevant state.”<sup>212</sup> In practice, this has been interpreted to allow general information about intrastate offerings to be included on a website that is accessible by out of state individuals, so long as detailed information about an intrastate security offering is not freely available on a website that is accessible to individuals outside the state.<sup>213</sup> Rather, the information can be available only after the individual “logs in” to the website, and proves the residency requirements.<sup>214</sup> The issuer cannot use a website or social media presence to advertise or solicit their securities offering because it would “likely involve offers to residents outside the particular state in which the issuer did business.”<sup>215</sup> Social media sites such as Facebook and Twitter are not naturally

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206. *Id.* § 230.147(c)(1).

207. *Id.* § 230.147(c)(2).

208. *Id.* § 230.147(d).

209. *Compliance and Disclosure Interpretations: Securities Act Rules, Question 141.03*, U.S. SEC. & EXCH. COMM’N (Apr. 10, 2014), <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.

210. *Id.*

211. *Compliance and Disclosure Interpretations: Securities Act Rules, Question 141.04*, U.S. SEC. & EXCH. COMM’N (Apr. 10, 2014), <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.

212. *Id.*

213. *See id.*; *see, e.g., Discover Investments, LOCALSTAKE*, [https://localstake.com/discover\\_investments?tab=discover](https://localstake.com/discover_investments?tab=discover) (last visited July 20, 2015).

214. *See, e.g., Discover Investments, supra* note 213.

215. *Compliance and Disclosure Interpretations: Securities Act Rules, Question 141.05*, U.S. SEC. & EXCH. COMM’N (Apr. 10, 2014), <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.

restricted to members of a single state and members often have “friends” or “followers” that cross state lines. But, to the extent the social media device or website restricts access to those within a single state, it is likely the advertising or solicitation would not violate the provisions of Rule 147.<sup>216</sup>

The residence of an offeree is determined based on the type of person. If the person is:

- (1) A corporation, partnership, trust or other form of business organization[, they] shall be deemed to be a resident of a state or territory if, at the time of the offer and sale to it, it has its principal office within such state or territory[;]
- (2) An individual, [they] shall be deemed to be a resident of a state or territory if such individual has, at the time of the offer and sale to him, his principal residence in the state or territory[;]
- (3) A corporation, partnership, trust or other form of business organization which is organized for the specific purpose of acquiring part of an issue offered pursuant to this rule[, they] shall be deemed not to be a resident of a state or territory unless all of the beneficial owners of such organization are residents of such state or territory.<sup>217</sup>

The SEC has said that an issuer may sell securities to a person “whose principal residence is in [the] state but who resides temporarily out of state” under Rule 147.<sup>218</sup> The issuer must “obtain a written representation from each purchaser” evidencing their proof of residence within the state.<sup>219</sup>

Fifth, all securities sold under Rule 147 are subject to a limitation on resale “for a period of nine months from the date of the last sale by the issuer of such securities.”<sup>220</sup> The limitation on resale requires that all resales of securities originally sold under Rule 147 be sold “only to persons resident within [the] state or territory” for the nine-month period.<sup>221</sup> The issuer must also place a restrictive legend on the certificate or similar document “evidencing the security stating that the securities have not been registered under the [Securities Act of 1933] and [must set] forth the limitations on resale” for the security.<sup>222</sup> The issuer must give stop transfer instructions to its applicable transfer agent, or “if the issuer transfers its own securities make a notation in the appropriate records of the issuer.”<sup>223</sup> Finally, the issuer must in connection with any offer or sales, “disclose, in writing, the limitations on resale” and the information contained on the security’s restrictive legend.<sup>224</sup>

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216. *See id.*

217. 17 C.F.R. § 230.147(d)(1)–(3) (2012).

218. *Compliance and Disclosure Interpretations: Securities Act Rules, Question 141.01*, U.S. SEC. & EXCH. COMM’N (Jan. 26, 2009), <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.

219. 17 C.F.R. § 230.147(f)(1)(iii) (2012).

220. *Id.* § 230.147(e).

221. *Id.*

222. *Id.* § 230.147(f)(1)(i).

223. *Id.* § 230.147(f)(1)(ii).

224. *Id.* § 230.147(f)(3).

c. Section 3(a)(11) and SEC Rule 147's Impediments to Raising  
Capital in Intrastate Crowdfunding Offerings

While it is possible that an issuer could successfully use an intrastate crowdfunding regime to raise equity funding, section 3(a)(11) and Rule 147 contain major impediments that affect an issuer's equity offering. First, they contain major restrictions on a business's ability to reach large population centers by restricting capital sales to a single state. Second, Rule 147 narrowly defines which businesses are able to raise funds under the Rule's terms.

Section 3(a)(11) and Rule 147's requirement that a securities offering be offered and sold only to residents of a single state or territory<sup>225</sup> is problematic because this requirement severely restricts the modern issuer's ability to find investors for its securities. Restricting an issuer's potential investor pool to a single state hampers its investment opportunities by removing a vast majority of the investing public from their investments. The largest state by population, California, has 38.8 million residents.<sup>226</sup> Forty-five states have populations ranging from 500,000 to 12 million people.<sup>227</sup> A single state's population is small compared to the overall United States population of roughly 320 million, especially for many of the states with small populations.<sup>228</sup> Limiting the sale of securities to a single state limits the number of investors available to a securities issuer and removes most large population centers—the investment capitals of the United States—as investment opportunities for many issuers. Possibly as a result of this, states that have enacted intrastate crowdfunding laws have found that only a limited number of businesses are using the intrastate crowdfunding laws as capital raising tools.<sup>229</sup> Such a result may partially be due to a small investor pool within many of the states.

In addition, the eligibility restrictions are problematic for crowdfunding securities issuers because only a narrow category of businesses can rely on Rule 147 to raise funds under an intrastate securities exemption. To rely on Rule 147, an issuer must: (1) derive eighty percent of their revenues (including subsidiaries income) from within the state; (2) have eighty percent of its assets and those of its subsidiaries in the state; (3) must intend and actually use eighty percent of the proceeds from the securities offering in the state; and (4) have their principal offices within the state.<sup>230</sup> The eighty percent standard is a strict standard to determine which entities are “doing business” in a state. In many parts of the United States, where cities straddle state lines or where businesses regularly operate across state borders, this requirement likely eliminates many businesses' ability to rely on the intrastate exemption, despite having substantial business operations within a state. Removing

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225. 17 C.F.R. § 230.147(d) (2012); 15 U.S.C. 77c(a)(11) (2012).

226. *Florida Passes New York to Become the Nation's Third Most Populous State*, Census Bureau Reports, U.S. CENSUS BUREAU (Dec. 23, 2014), available at <http://www.census.gov/newsroom/press-releases/2014/cb14-232.html>.

227. *See State Population by Rank, 2014*, INFOPLEASE, <http://www.infoplease.com/us/states/population-by-rank.html> (last visited Sept. 9, 2015).

228. *See id.*

229. *See infra* Part IV.D.–E.

230. 17 C.F.R. § 230.147(c)(2) (2012).

an issuer's ability to rely on Rule 147 in this manner is especially harmful because most issuers will not rely on section 3(a)(11) alone because of that section's considerable ambiguity.

In conclusion, section 3(a)(11) and Rule 147 have the potential to be effective channels of funding for small businesses and start-up companies. However despite this potential, many issuers are restricted from raising capital under Rule 147, despite conducting substantial business in the state. In addition, those who do qualify for an exemption are subject to advertising restrictions that can severely limit their ability to advertise, and ultimately sell, their securities.

## *2. SEC Rule 504: Regulation D's \$1,000,000 Securities Offering*

Regulation D was promulgated by the SEC in 1982, and created three securities offering exemptions for securities issuers.<sup>231</sup> In adopting the regulation, the SEC attempted to strike a proper balance between ensuring investor protection and providing investor capital to businesses.<sup>232</sup> "Regulation D, therefore, offered issuers a stair-step approach through its three exemptions—Rule 504, Rule 505 and Rule 506—requiring more investor protections as the size of the offering increased."<sup>233</sup> The exemption with the smallest annual cap on capital-raising, Rule 504, has been proposed as an avenue for the creation of a state-law intrastate crowdfunding regime.<sup>234</sup> Current evidence suggests "that small issuers raising small amounts of capital now overwhelmingly abandon Rule 504" as a means of obtaining equity funding.<sup>235</sup> State intrastate crowdfunding regimes operating under Rule 504 may provide a new lifeline for the otherwise underused and possibly obsolete rule.

First, this Part will set out Rule 504's requirements. Second, it will describe the practical difficulties and drawbacks of using Rule 504 as a vehicle for an intrastate securities regime.

### a. Rule 504's Requirements

Rule 504 creates an exemption for "limited offerings and sales of securities not exceeding \$1,000,000 [in any twelve month period]."<sup>236</sup> To rely on Rule 504, a business may not be: (1) Subject to the reporting requirements of section 13 or 15(d) of the [Securities] Exchange Act; (2) An investment company; or (3) A development stage company that either has no specific business plan or purpose or" intends to engage "in a merger or acquisition with an unidentified . . . entity or person."<sup>237</sup> Second, all sales which are "part of the same Regulation D offering must meet all of

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231. See Rutherford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 287, 288 (2012); 17 C.F.R. §§ 230.501–508 (2012).

232. Campbell, Jr., *supra* note 231.

233. *Id.* at 289.

234. See *infra* Part IV.B.4.

235. See Campbell, *supra* note 231, at 290.

236. 17 C.F.R. § 230.504 (2012).

237. *Id.* § 230.504(a).

the terms and conditions” of the applicable Regulation D section.<sup>238</sup> Third, the issuer must file with the SEC a Form D for “each new offering of securities no later than 15 days after the first sale of securities in the offering. . . .”<sup>239</sup> Additionally, the Form D must be amended as the information provided on the initial Form D becomes inaccurate.<sup>240</sup>

Fourth, Rule 504 generally requires that offerings relying on the rule be subject to advertising and resale restrictions.<sup>241</sup> It requires the following:

[N]either the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following: (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.”<sup>242</sup>

Additionally, it states that securities acquired under Rule 504 have the “status of securities acquired in a transaction under section 4(2) of the [Securities Act of 1933] and cannot be resold without registration.”<sup>243</sup> Lastly, Rule 504 generally requires the issuer to:

exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of section 2(11) of the Act, which reasonable care may be demonstrated by the following: (1) Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons; (2) Written disclosure to each purchaser prior to sale that the securities have not been registered under the Act and, therefore, cannot be resold unless they are registered under the Act or unless an exemption from registration is available; and (3) Placement of a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities.<sup>244</sup>

But, the advertising and resale restrictions just outlined, and required by Rule 504 will not apply if a securities offering meets one of three separate provisions. First, where the securities are offered and sold “[e]xclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and [the sales] are made in accordance with those state provisions.”<sup>245</sup> Second, where the securities are offered and sold in a state with no securities registration provisions, “if the securities have been registered in at least one state that provides for such registration, public filing

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238. *Id.* § 230.502(a). Offerings will not be considered part of the same Regulation D offering if they are made at least six months before or after the completion of the Regulation D offering, “so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D. . . .” *Id.*

239. *Id.* § 230.503(a)(1).

240. *Id.* § 230.503(a)(3)–(4).

241. *See id.* § 230.504(b)(1); *id.* § 230.502(c)–(d).

242. 17 C.F.R. § 230.502(c) (2012).

243. *Id.* § 230.502(d).

244. *Id.* This is a non-exclusive list, other actions may satisfy the reasonable care requirement. *See id.*

245. *Id.* § 230.504(b)(1)(i).



and delivery before sale, offers and sales are made in that state in accordance” those provisions and the disclosure document is delivered to the purchasers prior to the sale of the securities.<sup>246</sup> And, finally, where the securities are offered and sold exclusively under state law registration exemptions which authorize general solicitation and advertising, so long as the securities are sold to only “accredited investors’ as defined in [17 C.F.R.] § 230.501(a).”<sup>247</sup>

In conclusion, Rule 504 is a federal securities exemption that allows an issuer to raise up to \$1,000,000 in a securities offering. But, the Rule places restrictions on the offering’s ability to advertise and solicit sales of the securities and restricts the resale of the offering’s securities. An offering may avoid the advertising and resale restrictions if the issuer sells the securities in a state requiring substantive disclosures or where the securities are sold only to accredited investors.

b. The Drawback of an Intrastate Crowdfunding Regime under Rule 504

While Rule 504 presents a unique platform for the creation of an intrastate crowdfunding regime under state law, the rule’s state registration requirements will make it too costly to be used by small businesses that need to raise capital. First, “[r]ule 504 requires issuers to register under state blue sky law, sell only to accredited investors, or comply with the general solicitation and resale restrictions of Regulation D.”<sup>248</sup> Registering a securities offering under a state’s blue sky laws can be costly, especially for a business that is small and likely has minimal resources or for a new venture that is still in the business-development stage. If a state chooses not to register its securities, then a business’s only option is either to sell only to accredited investors, which would effectively remove the underlying purpose of an intrastate crowdfunding regime, or the business would have to sell its crowdfunding securities without general solicitation, which, because of their small clientele, would be difficult, if not impossible, for the average business. This effectively puts the issuers that would benefit the most from an intrastate crowdfunding regime between a preverbal rock and a hard place. Either the issuer must file and disclose a state’s “substantive disclosure document,” which will cost thousands of dollars, or the issuer must comply with Rule 504’s terms, which will restrict the business’s ability to accept investments from an average person and require they not engage in the general advertising or solicitations of their securities. The prohibitive costs of this registration and the administrative difficulties of complying with a crowdfunding regime relying on Rule 504 will likely cause most small issuers to avoid the use of a state crowdfunding regimes established under Rule 504.

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246. *Id.* § 230.504(b)(1)(ii).

247. *Id.* § 230.504(b)(1)(iii).

248. C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case For an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 16 (2001).

## B. Rule 147 and Rule 504's Interaction with Registration under State Blue Sky Laws

Rule 147 and Rule 504 provide an exemption from registration for securities at the federal level, but these rules do not necessarily provide an exemption from registration under state blue sky laws. An issuer's compliance with Rules 147 or 504 only exempts them from registration with the federal government. Issuers relying on these rules must also determine whether they are required to register under any applicable state securities laws.

In passing the National Securities Markets Improvement Act of 1996<sup>249</sup> (NSMIA), Congress preempted state blue sky laws from governing securities that meet certain federal securities exemptions in the Securities Act of 1933.<sup>250</sup> Under NSMIA, if a security meets an applicable federal exemption from registration, the security will also be exempt from registering under a state's blue sky law.<sup>251</sup>

NSMIA's exemption from state registration does not apply to any securities offering that is relying on the intrastate securities exemption contained in section 3(a)(11) of the Securities Act of 1933, including Rule 147, promulgated under section 3(a)(11).<sup>252</sup> Securities offerings that are relying on section 3(a)(11) or Rule 147 must either register under the applicable state blue sky law or must meet one of the state's exemptions from securities registration.<sup>253</sup> The intrastate securities exemption was "premised on the theory that investors in such securities will be protected by state regulation and their proximity to the issuer. [Accordingly,] [l]ocal transactions and sales of securities that meet the conditions of section 3(a)(11) are left to state regulation, which continues to vary from state to state."<sup>254</sup>

Additionally, under Rule 504 a securities issuer must generally submit a "watered down" registration document with the applicable state securities agencies. As mentioned previously, an issuer selling securities in reliance on Rule 504 must file a "substantive disclosure document" with the proper state securities agency or authority if it wants to advertise and solicit securities to the general public.<sup>255</sup> The limited clientele and contacts of small businesses will mean that most will be unable to raise a sufficient amount of capital through a non-public securities offering. As a result, most businesses raising capital under Rule 504 must complete a limited securities registration with all applicable state agencies.

In conclusion, a securities issuer who is relying on section 3(a)(11) or Rule 147 and most issuers under Rule 504 must register their securities under the applicable state blue sky laws before they may solicit and issue their securities. To alleviate the state registration requirements that would otherwise be imposed on the securities

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249. *See, e.g.*, National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

250. *See Brown v. Earthboard Sports USA, Inc.*, 481 F.3d 901, 909-12 (6th Cir. 2007).

251. *See* 15 U.S.C.A. § 77r(a)-(b).

252. *See id.* § 77r(b)(4)(D).

253. *See, e.g.*, UTAH CODE ANN. § 61-1-14 (2011).

254. Askew, *supra* note 188, at 198.

255. *Id.* § 230.504(b)(1)(i).

issuers, some states have passed exemptions from securities registration for wholly intrastate securities offerings.

### C. The States' Use of SEC Rule 147 and Rule 504 to Create Intrastate Crowdfunding Exemptions

The first states to enact crowdfunding legislation by relying on Rule 147 were Kansas and Georgia.<sup>256</sup> Since then, and as of September 2015, Alabama, Arizona, Colorado, the District of Columbia, Florida, Idaho, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, Mississippi, Montana, Nebraska, New Mexico, Oregon, South Carolina, Tennessee, Texas, Vermont, Virginia, Washington, and Wisconsin have enacted crowdfunding regimes through either legislation or agency rulemaking power.<sup>257</sup> In addition, California, by relying on Rule 504, and dozens of other states have proposed legislation to enact intrastate crowdfunding regimes.<sup>258</sup>

First, this Section will examine intrastate crowdfunding laws that operate under section 3(a)(11) of the Securities Act of 1933 and Rule 147. Next, this Section will turn to intrastate crowdfunding laws that rely on Rule 504 of Regulation D.

#### *1. Intrastate Crowdfunding Laws under Section 3(a)(11) and Rule 147*

In total, twenty-four states and the District of Columbia have enacted intrastate crowdfunding regimes by relying upon section 3(a)(11) of the Securities Act of 1933 or SEC Rule 147, or both. These laws have many of the same general characteristics, but vary significantly in their detail. Because it would be tedious to detail each of the laws, this subsection will highlight the major provisions of the laws and will discuss where the laws tend to deviate from each other. Further, this subsection will highlight the unique and innovative aspects of many of the laws. This Section will only review the general details of most intrastate securities regimes. Each particular law will likely not contain everything reviewed in this section. For more detailed and state specific information on each state regime, the reader should review the applicable state laws referenced below.

The states that have enacted intrastate crowdfunding regimes have taken differing routes to create their new security exemptions. The legislatures of

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256. Tom Sharbaugh, *Some States Are Sidestepping the JOBS Act's Burdensome Crowdfunding Rules*, CROWDFUND INSIDER (May 16, 2014), <http://www.crowdfundinsider.com/2014/05/38730-states-sidestepping-jobs-acts-burdensome-crowdfunding-rules/>.

257. *Intrastate Crowdfunding Directory*, N. AM. SEC. ADM'RS. ASS'N, <http://www.nasaa.org/industry-resources/corporation-finance/intrastate-crowdfunding-resource-center/intrastate-crowdfunding-directory/> (last visited Sept. 10, 2015).

258. See Zeoli, *supra* note 178.

Alabama,<sup>259</sup> Arizona,<sup>260</sup> Colorado,<sup>261</sup> Florida,<sup>262</sup> Illinois,<sup>263</sup> Indiana,<sup>264</sup> Maryland,<sup>265</sup> Michigan,<sup>266</sup> Montana,<sup>267</sup> Nebraska,<sup>268</sup> Tennessee,<sup>269</sup> Virginia,<sup>270</sup> Washington,<sup>271</sup> and Wisconsin<sup>272</sup> have enacted crowdfunding exemptions. In contrast, the District of Columbia,<sup>273</sup> Georgia,<sup>274</sup> Kansas,<sup>275</sup> Kentucky,<sup>276</sup> Massachusetts,<sup>277</sup> Mississippi,<sup>278</sup> New Mexico,<sup>279</sup> Oregon,<sup>280</sup> South Carolina,<sup>281</sup> Vermont,<sup>282</sup> and Texas<sup>283</sup> have enacted intrastate crowdfunding regimes through administrative regulation. The state regulatory agencies in these states have created the intrastate crowdfunding rules by relying on catch-all statutes that create securities exemptions for “any security, transaction, or offer,” made pursuant to a “rule adopted or order issued” by the state securities commissioner.<sup>284</sup> Finally, Idaho has taken a unique stance in the enactment of its intrastate crowdfunding exemption. Idaho exempts intrastate crowdfunding offerings from state registration on a case-by-case basis.<sup>285</sup> To date, Idaho has exempted at least three intrastate crowdfunding offerings from state registration.<sup>286</sup> It is unclear whether Idaho is strict in granting applications for its intrastate crowdfunding, or if it only has had a few applications for the exemption.

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259. See ALA. CODE § 8-6-11(a)(14) (Supp. 2014).

260. See ARIZ. REV. STAT. ANN. § 44-1844(D).

261. See COLO. REV. STAT. ANN. § 11-51-304(6) (LexisNexis 2015).

262. The Florida legislature passed an intrastate crowdfunding exemption into law on June 16, 2015. See H.B. 275, 2015 Leg., Gen. Sess. (Fla. 2015), available at <https://legiscan.com/FL/text/H0275/id/1220744>.

263. The Illinois legislature passed an intrastate crowdfunding exemption into law on July 29, 2015. See H.B. 3429, 99th Gen. Assembly, Gen. Sess. (Ill. 2015), available at <https://legiscan.com/IL/text/HB3429/id/1257029>.

264. See IND. CODE § 23-19-2-2(27).

265. See MD. CODE ANN., CORPS. & ASS'NS § 11-601(16).

266. See MICH. COMP. LAWS § 451.2202a.

267. See MONT. CODE ANN. § 30-10-105(22).

268. The Nebraska legislature passed an intrastate crowdfunding exemption into law on May 27, 2015. See L.B. 226, 104th Leg., Gen. Sess. (Neb. 2015), available at <https://legiscan.com/NE/text/LB226/id/1238622>.

269. See TENN. CODE ANN. § 48-1-103(a).

270. See VA. CODE ANN. § 13.1-514(B)(21).

271. See WASH. REV. CODE § 21.20.880.

272. See WIS. STAT. § 551.202(26) (2013–14).

273. See D.C. MUN. REGS. Tit. 26, §§ B249–56, 299.

274. See GA. COMP. R. & REGS. § 590-4-2-.08.

275. See KAN. ADMIN. REGS. § 81-5-21(a).

276. See KY. REV. STAT. ANN. § 292.411.

277. See 950 MASS. CODE REGS. 14.402(B)(13)(o) (2015).

278. See 1-14 MISS. CODE R. § 7.21 (2015), available at <http://www.sos.ms.gov/Securities/Documents/Part%2014%20Rule%207%2021.pdf>.

279. See N.M. CODE R. § 12.11.1.7 (LexisNexis 2015).

280. See ORE. ADMIN. R. 141-035-0070 to -0230 (2015), available at [http://www.dfcs.oregon.gov/rules\\_statutes/new\\_legislation/441-035-0070.pdf](http://www.dfcs.oregon.gov/rules_statutes/new_legislation/441-035-0070.pdf).

281. See S.C. CODE ANN. REGS. 13-206 (2015).

282. See 21-30 VT. CODE R. § S-2014-1, available at <http://www.dfr.vermont.gov/sites/default/files/Final%20Securities%20Regulation%20%28VSBOE%20%29.pdf>.

283. See Tit. 7 TEX. ADMIN. CODE § 193.25 (2014).

284. See, e.g., KAN. STAT. ANN. § 17-12a203 (2007).

285. See IDAHO CODE ANN. § 30-14-203; Treasure Valley Angel Fund, LLC, Docket No. 2012-7-02 (Dep't of Fin. of State of Idaho 2012).

286. See Treasure Valley Angel Fund, LLC, Docket No. 2012-7-02 (Dep't of Fin. of Idaho 2012); In re Idaho's Bounty Co-op, Inc., Docket NO. 2015-7-05 (Dep't of Fin. of Idaho 2015); In re GDE Corp. d/b/a UNIBURR, Docket NO. 2014-7-06 (Dep't of Fin. of Idaho 2014).

Regardless, the fact that the state has granted exemptions to at least three businesses in the last two years shows, at a minimum, that it is possible a sufficiently qualified business may be granted an exemption.

The intrastate crowdfunding regimes can be broken into three segments: (a) general rules, (b) requirements and obligations imposed on the issuers, and (c) disclosures that must be made by the issuer to the investors.

a. General Rules

The general rules focus on the requirements that an offering must meet in order to be exempt from state registration. First, all of the state laws require that each issuer be a business or organization formed under the applicable state laws and be registered with the applicable state agency—generally, the state’s secretary of state.<sup>287</sup> Some states, such as Kansas, require “all persons responsible for management of the operations or property of the issuer” be residents of the same state.<sup>288</sup> Second, to align the subject state’s laws with the applicable requirements in section 3(a)(11) of the Securities Act of 1933, “no issuer may be an investment company as defined in section 3 of the Investment Company Act of 1940 . . . , or subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934.”<sup>289</sup>

Under the Alabama law, an issuer cannot raise funds in reliance on the law if the issuer is an investment advisor, as defined by Alabama law,<sup>290</sup> or a person who provides investment advice “as a service or for a fee.”<sup>291</sup> Alabama and many other states take their issuer requirements one step further and prevent an issuer from relying on the intrastate crowdfunding exemption if “the issuer, or any [of] its officers, controlling people or promoters[, are] subject to a” disqualifying provision under the state’s securities act.<sup>292</sup> Acts that disqualify an issuer include, *inter alia*: being convicted of any felony or misdemeanor crime related to the purchase or sale of a security; a judgment, order, or a decree from any court of law related to the purchase or sale of a security; a pending SEC proceeding regarding registration statement or other securities related matter;<sup>293</sup> the issuer having no specific business plan, or a plan “to engage in a merger or acquisition with an unidentified company or companies, or other entity or person”: or if the issuer, issuer’s predecessors, any owner, officer, director, partner, ten percent or more equity holder, promoter, or underwriter (1) is subject to a “currently effective registration stop order” by a state agency or the SEC; (2) has been convicted “within the last five years of any criminal offense in connection with the offer, purchase, or sale of any security, or involving

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287. See, e.g., KAN. ADMIN. REGS. § 81-5-21(a)(1).

288. See Modifications of “IKE”, the Invest Kansas Exemption under K.A.R. 81-5-21, Docket No. 13E024 (Sec. Comm’r of Kan. June 21, 2013), <http://ksc.ks.gov/DocumentCenter/View/227>.

289. See, e.g., GA. COMP. R. & REGS. § 590-4-2-.08(1)(g).

290. ALA. CODE § 8-6-2(18) (2002).

291. *Id.*

292. See, e.g., *id.* § 8-6-11(a)(14)b (Supp. 2014).

293. See, e.g., GA. COMP. R. & REGS. § 590-4-2.06.

fraud or deceit;" (3) "is subject to any current state or federal administrative enforcement order or judgment, entered within the last five years, finding fraud or deceit in connection with the purchase or sale of any security;" or (4) is subject to any judgment, decree, or order of any court that restrains or enjoins the party from engaging in or continuing to engage in any conduct or practice involving fraud or deceit in connection with the purchase or sale of any security."<sup>294</sup> In some states, an issuer may overcome a disqualifying event under certain conditions.<sup>295</sup>

Third, most states have explicit catch-all provisions that require all offerings relying on the intrastate crowdfunding regime comply with section 3(a)(11) of the Securities Act of 1933, SEC Rule 147, or both.<sup>296</sup> Fourth, while it might seem implicit in the law, states require all funds raised "be used in accordance with representations made to investors."<sup>297</sup> Fifth, payments delivered from the sale of securities must be deposited in an escrow account at a bank or depository institution in the applicable state.<sup>298</sup> In addition, the institution generally must hold the funds raised until "the aggregate capital raised from all purchasers is equal to or greater than the minimum target offering amount specified in the disclosure statement as necessary to implement the business plan."<sup>299</sup> If the target offering amount is not raised by the target date, the money must be returned to the investors.<sup>300</sup> Sixth, some states require the issuer notify the proper state authority that the issuer is selling securities under the intrastate crowdfunding exemption before the general solicitation of the securities or before the "twenty-fifth sale of the security, whichever occurs first."<sup>301</sup>

Seventh, all states set a maximum amount of capital that an issuer may raise within any twelve-month period and restrict the maximum investment that an individual can invest in crowdfunding securities in any twelve-month period.<sup>302</sup> In Kansas, an issuer can raise up to \$1,000,000 and up to \$5,000 from any non-accredited investor, or an unlimited amount from an accredited investor.<sup>303</sup> In Georgia, an issuer can raise up to \$1,000,000 and up to \$10,000 from any individual investor.<sup>304</sup> Colorado allows crowdfunding offerings of up to \$5,000,000 in any twelve-month period.<sup>305</sup> In Idaho, which authorizes crowdfunding on a case-by-case basis,

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294. *See e.g.*, KAN. ADMIN. REGS. § 81-5-13(c).

295. *See id.*

296. *See, e.g., id.* § 81-5-21(a)(2).

297. *See, e.g.*, KAN. ADMIN. REGS. § 81-5-21(a)(5).

298. *See, e.g.*, Tit. 7 TEX. ADMIN. CODE § 139.25(f) (2014).

299. *Id.*

300. *Id.*

301. *See, e.g.*, KAN. ADMIN. REGS. § 81-5-21(a)(7).

302. *See, e.g., id.* (authorizing securities exemptions for offerings up to \$1,000,000 in any twelve-month period); VA. CODE ANN. § 13.1-514(B)(21)(c) (authorizing securities offerings up to \$2,000,000 in any twelve-month period); MONT. CODE ANN. § 30-10-105(22)(b)(i) (authorizing securities offerings of up to \$1,000,000 in any twelve-month period); ARIZ. REV. STAT. ANN. § 44-1844(D)(3) (authorizing securities offerings of up to \$1,000,000 and \$2,500,000 in any twelve-month period, depending on certain issuer qualifications).

303. *Id.* § 81-5-21(a)(3)–(4). While the original cap for non-accredited investors was \$1,000, it was subsequently changed to \$5,000 in 2013 by a Special Order of the Kansas Securities Commissioner. *See* Modifications of "IKE", the Invest Kansas Exemption under K.A.R. 81-5-21, Docket No. 13E024 (Sec. Comm'r of Kan. June 21, 2013), <http://ksc.ks.gov/DocumentCenter/View/227>.

304. GA. COMP. R. & REGS. § 590-4-2-.08(1)(c)–(d).

305. COLO. REV. STAT. ANN. § 11-51-304(6) (LexisNexis 2015).

the Director of Finance has previously allowed an issuer to raise up to \$2,000,000 in the aggregate, with no more than \$2,500 contributed from any single investor, unless the investor is an accredited investor as defined by SEC Rule 504.<sup>306</sup> In Indiana, an issuer may raise \$1,000,000 if the issuer has not had a financial audit in the last fiscal year, or \$2,000,000 if the issuer has had a financial audit in the last fiscal year and makes it available to each prospective investor.<sup>307</sup> Maryland has created a micro-crowdfunding law, where an issuer may raise up to \$100,000 in increments of \$100 from each investor.<sup>308</sup>

Eighth, any website or other entity acting as a crowdfunding “portal”—a website that facilitates the sale of crowdfunding securities—must restrict “access to securities offerings on the website” and offers and sales of the securities appearing on the website are limited to persons that “are residents of the applicable state.”<sup>309</sup> In Texas, as in many other states, the portal must obtain an “affirmative representation by a visitor to the Internet website that the visitor is a resident of Texas is required before the visitor can view securities-related offering materials on the website.”<sup>310</sup> Michigan requires any website selling intrastate crowdfunding securities to register with the state.<sup>311</sup> Further, the securities issuer must have evidence that the website is organized in Michigan and is authorized to do business in the state.<sup>312</sup> The website must give annual written notice to the state that it is facilitating the sale of crowdfunding securities and is authorized to do business in the state.<sup>313</sup> Further, “[t]he issuer and the website [must] keep and maintain records of the offers and sales of securities made through the website and provide ready access to the records to the administrator on request [at any time].”<sup>314</sup>

Ninth, most states have created restrictions on the transferability of intrastate crowdfunding securities.<sup>315</sup> For example, Washington restricts the transferability of crowdfunding securities for one year after the date of the securities purchase, unless the sale meets one of four exemptions.<sup>316</sup> The securities may only be sold within one year if they are sold: “(a) To the issuer of the securities; (b) To an accredited investor; (c) As part of a registered offering; or (d) To a member of the family of the purchaser or the equivalent, or in connection with the death or divorce or other similar circumstances, in the discretion of the director.”<sup>317</sup>

Finally, at any time, Alabama grants the Alabama Securities Commission power to “deny or revoke the exemption specified in this section” if the Commission

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306. See *Treasure Valley Angel Fund*, § (A)(3)–(4), LLC, Docket No. 2012-7-02 (Dep’t of Fin. of Idaho 2012).

307. IND. CODE § 23-19-2-2(27)(C).

308. MD. CODE ANN., CORPS. & ASS’NS § 11-601(16)(iii)–(iv).

309. See, e.g., Tit. 7 TEX. ADMIN. CODE § 139.25(h)(1)(A) (2014).

310. *Id.* § 139.25(h)(1)(B).

311. MICH. COMP. LAWS § 451.2202a(j).

312. *Id.* § 451.2202a(j)(i).

313. *Id.* § 451.2202a(j)(iii).

314. *Id.* § 451.2202a(j)(iv).

315. See, e.g., H.B. 275, 2015 Leg., Gen. Sess. (Fla. 2015), § 517.0611(13)(b), available at <https://legiscan.com/FL/text/H0275/id/1220744>.

316. WASH. REV. CODE § 21.20.880(4).

317. *Id.*

“finds the sale of such security would work or tend to work a fraud upon the purchasers.”<sup>318</sup> Many other states have similar provisions.<sup>319</sup>

### b. Issuer Obligations

Intrastate crowdfunding laws also place affirmative obligations on the securities issuers. First, prospective issuers must file a notice with the applicable state regulatory authority. Generally, the notice serves to register the issuer with the state and puts the state on notice that the business may issue securities in reliance on a crowdfunding exemption in the future. In Indiana, the issuer must file a Form D<sup>320</sup> with the state securities division to fulfill the notice requirement.<sup>321</sup> In contrast, Georgia has created its own filing form that is similar to the Form D, but requires less information from the issuer.<sup>322</sup>

Second, the issuer may not pay a commission or remuneration “for any person’s participation in the offer or sale of securities for the issuer unless the person is registered as a broker-dealer or agent under the act.”<sup>323</sup> Third, in Texas, an issuer may not rely on the intrastate crowdfunding exemption if the issuer or any “control person” of the security has made another securities offering within the last twelve months, or is currently offering securities in Texas.<sup>324</sup> Effectively, this means the issuer or control person may rely on the intrastate crowdfunding regime only if they are not engaged in, or have not recently been engaged in, any other securities offering. Fourth, most states impose a fee that must be paid by the securities issuer. For example, Alabama charges a \$150 filing fee.<sup>325</sup> Fifth, prior to any sale of a security, the securities issuer must obtain documentary evidence from each investor, evidencing the investor’s residence in the state. In Texas:

[at] least one of the following would be considered sufficient evidence that the individual is a resident of this state: (i) a valid Texas driver license or official personal identification card issued by the State of Texas; (ii) a current Texas voter registration; or (iii) general property tax records showing the individual owns and occupies property in this state as his or her principal residence. . . .<sup>326</sup>

Alabama has a more discretionary standard, requiring that the issuer obtain “documentary evidence[,]” from each investor, that creates a “reasonable basis to believe [each] investor is a resident of the State of Alabama.”<sup>327</sup>

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318. ALA. CODE § 8-6-11(b) (Supp. 2014).

319. COLO. REV. STAT. ANN. § 11-51-304(6) (LexisNexis 2015).

320. Form D is a short filing document created by the SEC that contains relevant information about the issuer of securities. *See Form D*, U.S. SEC. & EXCH. COMM’N, available at <https://www.sec.gov/about/forms/formd.pdf> (last visited July 25, 2015).

321. IND. CODE § 23-19-2-2(27)(F).

322. *See Form GA-1*, STATE OF GA.: OFFICE OF THE SEC’Y OF STATE COMM’R OF SEC., [http://sos.ga.gov/admin/files/Invest\\_Georgia\\_Exemption\\_-\\_Form\\_GA-1.pdf](http://sos.ga.gov/admin/files/Invest_Georgia_Exemption_-_Form_GA-1.pdf) (last visited July 25, 2015).

323. *See, e.g.*, KAN. ADMIN. REGS. § 81-5-21(a)(5).

324. Tit. 7 TEX ADMIN. CODE § 139.25(m)(4) (2014).

325. ALA. CODE § 8-6-11(a)(14)n (Supp. 2014).

326. Tit. 7 TEX ADMIN. CODE § 139.25(h)(1)(C) (2014).

327. ALA. CODE § 8-6-11(a)(14)b (Supp. 2014).



Some states require that an individual register with the state if he or she “offer[s] investment advice or recommendations,” solicits “purchases, sales, or offers to purchase” crowdfunding securities, compensates “employees, agents, or other persons for the solicitation of purchases, sales, or offers to purchase” crowdfunding securities, or takes “custody of investor funds or securities.”<sup>328</sup> Fifth, a few states, including Washington, require that “[t]he issuer reasonably believe[] that all purchasers are purchasing for investment and not for sale in connection with a distribution of the security.”<sup>329</sup> Finally, most states require that “[t]he issuer [] place a legend on the certificate or other document evidencing that the securities have not been registered and setting forth the limitations on resale contained in Rule 147(e), including that for a period of nine months from the date of last sale by the issuer of the securities in the offering, all resales by any person, shall be made only to [the state’s] residents.”<sup>330</sup>

### c. Disclosures to Investors

Finally, the intrastate crowdfunding laws require extensive disclosures by the issuer to potential and actual investors. First, the issuer must provide investors and the applicable securities agency with a disclosure statement. Texas requires:

A disclosure statement . . . be made readily available and accessible to each prospective purchaser at the time the offer of securities is made to the prospective purchaser on the Internet website. The disclosure statement must contain all of the following:

(1) Material information and risk factors. All information material to the offering, including, where appropriate, a discussion of significant factors that make the offering speculative or risky. . . . Topics to be addressed include, but are not limited to:

- (A) general description of the issuer's business;
- (B) history of the issuer's operations and organization;
- (C) management of the company and principal stockholders;
- (D) how the proceeds from the offering will be used;
- (E) financial information about the issuer;
- (F) description of the securities being offered; and
- (G) litigation and legal proceedings.<sup>331</sup>

Some states also require the disclosure of relevant financial information, including current financial statements.<sup>332</sup> Washington requires that all crowdfunding issuers create a quarterly report of the business and requires the issuer make the report available to all security-holders.<sup>333</sup>

Second, the issuer must disclose information relevant to the risk and illiquidity of the securities sold under the intrastate crowdfunding regime. In Texas, the issuer must disclose that:

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328. GA. COMP. R. & REGS. § 590-4-2-.08(5).

329. WASH. REV. CODE § 21.20.880(1)(h)(i).

330. Tit. 7 TEX. ADMIN. CODE § 139.25(k) (2014).

331. *Id.* § 139.25(h)(i)(1).

332. *See, e.g., id.* § 139.25(h)(i)(3).

333. WASH. REV. CODE § 21.20.880(j)(3).

(A) There is no ready market for the sale of the securities acquired from this offering; it may be difficult or impossible for an investor to sell or otherwise dispose of this investment. An investor may be required to hold and bear the financial risks of this investment indefinitely;

(B) The securities have not been registered under federal or state securities laws and, therefore, cannot be resold unless the securities are registered or qualify for an exemption from registration under federal and state law.

(C) In making an investment decision, investors must rely on their own examination of the issuer and the terms of the offering, including the merits and risks involved; and

(D) No federal or state securities commission or regulatory authority has confirmed the accuracy or determined the adequacy of the disclosure statement or any other information on this Internet website.<sup>334</sup>

Finally, a handful of states require a specific set of disclosures and require that all issuers obtain signed documentation that each potential investor has read, understood, acknowledged, and signed the applicable disclosure forms. The first disclosure, which must be placed on the securities legend generally states:

IN MAKING AN INVESTMENT DECISION, INVESTORS MUST RELY ON THEIR OWN EXAMINATION OF THE ISSUER AND THE TERMS OF THE OFFERING, INCLUDING THE MERITS AND RISKS INVOLVED. THESE SECURITIES HAVE NOT BEEN RECOMMENDED BY ANY FEDERAL OR STATE SECURITIES COMMISSION OR DIVISION OR OTHER REGULATORY AUTHORITY. FURTHERMORE, THE FOREGOING AUTHORITIES HAVE NOT CONFIRMED THE ACCURACY OR DETERMINED THE ADEQUACY OF THIS DOCUMENT. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE. THESE SECURITIES ARE SUBJECT TO RESTRICTIONS ON TRANSFERABILITY AND RESALE AND MAY NOT BE TRANSFERRED OR RESOLD EXCEPT AS PERMITTED BY SUBSECTION (e) OF SEC RULE 147 (17 CFR 230.147(e)) AS PROMULGATED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, AND THE APPLICABLE STATE SECURITIES LAWS, PURSUANT TO REGISTRATION OR EXEMPTION THEREFROM. INVESTORS SHOULD BE AWARE THAT THEY WILL BE REQUIRED TO BEAR THE FINANCIAL RISKS OF THIS INVESTMENT FOR AN INDEFINITE PERIOD OF TIME.<sup>335</sup>

Second, each purchaser generally must certify a document that states:

I UNDERSTAND AND ACKNOWLEDGE THAT I am investing in a high-risk, speculative business venture. I may lose all of my investment, or under some circumstances more than my investment, and I can afford this loss. This offering has not been reviewed or approved by any state or federal securities commission or division or other regulatory authority and no such person or authority has confirmed the accuracy or determined the adequacy of any disclosure made to me relating to this offering. The securities I am acquiring in this offering are illiquid, there is no ready market for the sale of such securities, it may be difficult or impossible for me to sell or otherwise dispose of this investment, and, accordingly, I may be required to hold this investment indefinitely. I may be subject to tax on my share of the taxable income and losses of the company, whether or not I have sold or otherwise disposed of my investment or received any dividends or other distributions from the company.<sup>336</sup>

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334. Tit. 7 TEX. ADMIN. CODE § 139.25(h)(i)(2) (2014).

335. See, e.g., IND. CODE § 23-19-2-2(27)(H) (capitalization original).

336. See, e.g., *id.* § 23-19-2-2(27)(i).

These documents ensure that the investor knows the investments he is making consists of risky and illiquid assets. They operate as a last warning for the investor to ensure the investor fully appreciates all of the implications of the action about to be taken.

## *2. Intrastate Crowdfunding Laws under Rule 504 of Regulation D*

A California legislator proposed legislation, and Maine has enacted, through regulation, an intrastate crowdfunding exemption based on Rule 504 of Regulation D.

### a. California Assembly Bill 2096

On February 20, 2014, Assembly Member Albert Muratsuchi introduced Assembly Bill No. 2096 to the California State Assembly.<sup>337</sup> The bill would create an intrastate crowdfunding exemption by relying on the federal exemption from registration contained in SEC Rule 504 of Regulation D.<sup>338</sup> The bill was subsequently passed by the California Assembly by a vote of seventy-five for, and zero against.<sup>339</sup> As of September 12, 2015, the bill is currently awaiting passage in the California Senate, after passing out of the Appropriations Committee.<sup>340</sup>

Securities offerings under Assembly Bill 2096 must meet all of the requirements contained in SEC Rule 504 of Regulation D.<sup>341</sup> The business may raise up to \$1,000,000 in any twelve-month period and may raise up to \$5,000 per investor per year, unless the investor is an accredited investor under Rule 501 of Regulation D, in which case the investor does not have any statutorily proscribed investing limit.<sup>342</sup>

The issuer must make disclosures to investors and potential investors, and file a copy of the disclosures with the California Securities Commission. The issuer also must disclose “[a] Small Company Offering Registration disclosure document<sup>343</sup> . . . as adopted by the North American Securities Administrators Association.”<sup>344</sup> The proposed law contains staggered issuer disclosure requirements, based on the amount of money to be raised by the issuer. If the issuer raises \$100,000 or less in any twelve-month period, the issuer must disclose: (1) income tax returns for the most recent year; and (2) financial statements certified by the principal executive officer of the business to be “true and complete in all material respects.”<sup>345</sup> If the issuer raises an

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337. See *AB-2096 Securities Transactions*, *supra* note 179.

338. See *id.*

339. *Id.*

340. See *id.*

341. See 17 C.F.R. § 230.504 (2012).

342. See A.B. 2096, § 25112(a)(2)(A)–(B), 2013-2014 Gen. Sess. (Ca. 2014).

343. See *SCOR Forms*, N. AM. SEC. ADM’RS ASS’N, <http://www.nasaa.org/industry-resources/corporation-finance/scor-overview/scor-forms/> (last visited July 26, 2015).

344. A.B. 2096, § 25112(a)(2)(D)(i), 2013-2014 Gen. Sess. (Ca. 2014).

345. *Id.* § 25112(a)(2)(D)(ii).

amount between \$100,000 and \$500,000, “all financial statements [must be] reviewed by a public accountant who is independent of the issuer, [and who uses] professional standards and procedures. . . .”<sup>346</sup> Finally, if the issuer raises more than \$500,000, the business’s financial statements must be audited by a Certified Public Accountant.<sup>347</sup>

The issuer must set aside, in a third-party escrow account, all funds raised in the crowdfunding offering until the business’s minimum offering amount is reached.<sup>348</sup> If the minimum offering amount is not reached within one year, the issuer must return the funds to the investors.<sup>349</sup> Additionally, if an employee, officer, or person associated with the business has been “disqualified as a ‘bad actor’ under subdivision (d) of [Rule 506 of Regulation D],” the business may not utilize the crowdfunding provisions.<sup>350</sup>

#### b. Maine’s Act to Increase Funding for Start-ups

In 2014, the Maine Legislature enacted an intrastate crowdfunding exemption without the Governor’s signature when the Maine Senate and Maine House voted to pass an “Act to Increase Funding for Start-Ups,” with the latter voting overwhelmingly in favor by a vote of 129-1.<sup>351</sup> According to the Act’s preamble, the “legislation will provide immediate access to capital and [will] streamline regulations for Maine small businesses without diminishing the regulatory protections for investors.”<sup>352</sup>

Maine’s crowdfunding law largely tracks the requirements of California’s proposed crowdfunding bill and the federal CROWDFUND Act, including filing financial statements that are more onerous depending on the amount raised.<sup>353</sup> A securities issuer may file a “short form registration statement,” for offerings that are selling intrastate crowdfunding securities. The registration requirements are less burdensome than a full registration under Maine’s general securities registration law.

The Maine Act requires the business to have its principal place of business in Maine and be registered with the Maine Secretary of State “as an entity formed under the laws of [Maine] or authorized to transact business within [Maine.]”<sup>354</sup> An issuer may raise up to \$1 Million in any twelve-month period and may raise up to \$5,000 from an individual in any twelve-month period. If the purchaser is an “accredited

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346. *Id.* § 25112(a)(2)(D)(iii).

347. *See id.* § 25112(a)(2)(D)(iv).

348. *See id.* § 25112(a)(2)(E).

349. *See id.*

350. *See* A.B. 2096, § 25112(a)(2)(F), 2013-2014 Gen. Sess. (Ca. 2014).

351. *Summary of LD 1512*, STATE OF ME. LEGISLATURE, <http://legislature.maine.gov/LawMakerWeb/summary.asp?ID=280048971> (last visited July 25, 2015).

352. L.D. 1512, 126th Leg., Gen. Sess. (Me. 2014), *available at* <http://www.mainelegislature.org/legis/bills/getPDF.asp?paper=SP0568&item=3&num=126>.

353. *See* ME. REV. STAT. tit. 32, § 16304, sub-§6-A(E)(5) (requiring, among other things, income tax returns for those raising less than \$100,000, financial statements reviewed by a public accountant for issuers raising between \$100,000 and \$500,000, and audited financial statements for those issuers raising over \$500,000).

354. *Id.* § 16304, sub-§6-A(A).

investor,” there is no limit on the amount that can be invested from the purchaser.<sup>355</sup> The Act has a catchall provision requiring complete compliance with Rule 504.<sup>356</sup>

The Act also requires extensive disclosure to the Maine Office of Securities and the potential securities purchasers.<sup>357</sup> Lastly, of note, the Act vests the Maine securities administrator with the power to “provide by rule that a short-form registration statement filed under [the Act, becoming either] immediately effective upon filing or becomes effective within some other stated period after filing, conditionally or otherwise.”<sup>358</sup>

#### D. Are the State Laws Working? State Crowdfunding Laws in Action

As of December of 2014, there is only limited evidence of crowdfunding laws in action. The relative newness of the intrastate crowdfunding laws has limited the use and media coverage of businesses who have raised funds under state crowdfunding laws. Further, there has not been sufficient time to determine whether those few businesses that have raised funds through an intrastate crowdfunding offering will be successful in their business pursuits. For example, “[i]n Kansas, the first state in the country to legalize equity crowdfunding within its borders in 2011, fewer than 10 companies had utilized the exemption as of the end of April 2014. In other states, the changes are so recent that it remains unclear as to what extent entrepreneurs are informed and poised to raise capital in this manner.”<sup>359</sup>

Overall, the majority of accessible crowdfunding schemes have a few similar characteristics. First, the businesses tend to raise small amounts of money, generally between \$100,000 and \$200,000. Second, the businesses tend to be focused in small, niche markets such as small craft breweries and distilleries. These businesses are “typically smaller in size and scope than those envisioned by the federal crowdfunding provisions, which entrepreneurs and economic development officials alike have heralded as a new mechanism for businesses to raise capital needed for expansion.”<sup>360</sup> Third, the businesses tend to be focused in geographic areas and economic sectors that are not serviced by angel investors and venture capital investors. As one commentator stated, equity crowdfunding “‘is really an extended friends and family round’ for small, local shops and restaurants that aren’t likely to seek or receive professional angel or venture capital investments.”<sup>361</sup>

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355. *Id.* § 16304, sub-§6-A(B)–(C).

356. *Id.* § 16304, sub-§6-A(D).

357. *Id.* § 16304, sub-§6-A(E)–(F).

358. *Id.* § 16304, sub-§6-A.

359. Dane Stangler, *State Equity Crowdfunding Policies Hold Promise*, FORBES (May 28, 2014), <http://www.forbes.com/sites/kauffman/2014/05/28/state-equity-crowdfunding-policies-hold-promise/>.

360. Steven Overly, *As Federal Regulators Move Slowly on Equity Crowdfunding, States Adopt Their Own Rules*, WASH. POST (Aug. 24, 2014), [http://www.washingtonpost.com/business/capitalbusiness/as-federal-regulators-move-slowly-on-equity-crowdfunding-states-adopt-their-own-rules/2014/08/22/81c6da54-2942-11e4-958c-268a320a60ce\\_story.html](http://www.washingtonpost.com/business/capitalbusiness/as-federal-regulators-move-slowly-on-equity-crowdfunding-states-adopt-their-own-rules/2014/08/22/81c6da54-2942-11e4-958c-268a320a60ce_story.html).

361. Ruth Simon & Angus Loten, *‘Crowdfunding’ Gets State-Level Test Run*, WALL ST. J. (Dec. 4, 2013), <http://www.wsj.com/articles/SB10001424052702303722104579237862928397316>.

Tecumseh Brewing Company (Tecumseh) is one example of a business that has successfully raised equity in an intrastate securities offering. Tecumseh was founded by Kyle Dewitt and Tim Schmidt, and will be a brewpub and craft brewery in Michigan.<sup>362</sup> Tecumseh used Michigan's intrastate crowdfunding exemption to raise \$175,000.<sup>363</sup> The pair are using the capital to cover the cost of renovating new business space and purchasing brewery equipment. To raise the funds, Tecumseh used Localstake.com, an online investment service in Michigan, where investors "invest in local businesses" through intrastate crowdfunding laws.<sup>364</sup> As of December 22, 2014, Tecumseh had completed its crowdfunding offering and had raised \$175,000, the full amount of their initial offering amount.<sup>365</sup>

Similar to Tecumseh, MobCraft Inc. was the first company to use Wisconsin's intrastate crowdfunding law in an equity offering. MobCraft "is a small craft brewery that makes custom craft beer. It produces small batches of 'custom craft beers' based on submitted recipes."<sup>366</sup> The company used CraftFund as a crowdfunding portal to solicit and advertise its securities.<sup>367</sup> It is unclear how much the company raised in its crowdfunding offering.

Other businesses that have engaged in equity crowdfunding offerings under intrastate securities laws include: Moody's Butcher Shops, a "farm-to-fork local food system" in Indianapolis, Indiana that raised \$220,000; Biologics Modular, a company that "produces pre-built, transportable manufacturing facilities," located in Brownsburg, Indiana that raised \$400,000; Cardinal Spirits, a local distillery in Bloomington, Indiana that raised \$850,000; Unity Vibration Living Kombucha Tea LLC, the "Makers of award-winning, healthy, gluten-free kombucha tea and beer" in Ypsilanti, Michigan that raised \$136,000; Bearface Instructional Technologies, which "provides unique learning [] assessment technology for higher education," located in Indianapolis, Indiana and raised \$348,000;<sup>368</sup> and Bohemian Guitars LLC, a Marietta, Georgia company making specialty guitars that raised \$131,000 on SparkMarket, a crowdfunding portal.<sup>369</sup>

The relative novelty of the intrastate crowdfunding regimes makes it difficult, if not impossible to determine how many businesses are currently raising capital. More systematic analysis will need to be conducted in the future to determine the economic success of the new slate of businesses that are raising capital in intrastate crowdfunding regimes. This is especially true given the large increase in state

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362. David Frownfelder, *Tecumseh Brewing Co. First Customer of New Crowdfunding Law*, LENCONNECT.COM (Mar. 21, 2014), <http://www.lenconnect.com/article/20140321/News/140329823>.

363. *Id.*

364. *See Invest Local*, LOCALSTAKE.COM, <https://localstake.com/> (last visited July 25, 2015).

365. *See Discover Investments*, *supra* note 213.

366. Samantha Hurst, *Brewery Becomes First Wisconsin Company to Use Equity Crowdfunding Platform*, CROWDFUND INSIDER (June 6, 2014), <http://www.crowdfundinsider.com/2014/06/41255-brewery-becomes-first-wisconsin-company-use-equity-crowdfunding-platform/>.

367. *Id.*

368. *See Discover Investments*, *supra* note 213.

369. *How It Works*, SPARK MARKET GA., <https://www.sparkmarket.com/how-it-works> (last visited Dec. 22, 2014); *Bohemian Guitars LLC*, SPARK MARKET GA., <https://www.sparkmarket.com/campaigns/bohemian-guitars-llc/overview> (last visited Dec. 22, 2014).

enactments of intrastate crowdfunding exemptions in 2015.<sup>370</sup> Overall, the new intrastate crowdfunding regimes are creating a new set of businesses that are benefiting from this new capital funding source. Without the intrastate crowdfunding laws, many, if not all, of these businesses would not have received funding for their business ventures.

#### E. Conclusion

This Section has analyzed intrastate crowdfunding regimes enacted under section 3(a)(11) of the Securities Act of 1933, Rule 147 promulgated thereunder, and Rule 504 to provide federal securities registration exemptions. First, the Section analyzed the requirements that an issuer must fulfill before they can meet an exemption from registration in section 3(a)(11), Rule 147, and Rule 504. Additionally, the Section examined the practical difficulties that an issuer will face in attempting to meet one of the exemptions today. Second, the Section discussed these exemptions' interactions with state blue sky laws and how they operate to govern securities that meet an exemption from federal registration. Third, the Section chronicled currently enacted state exemptions from registration under section 3(a)(11), Rule 147, and Rule 504. Finally, the Section analyzed whether the currently enacted intrastate crowdfunding laws are fostering investment in small businesses and start-up companies. Ultimately, it is too early to determine whether the state securities exemptions are creating a burgeoning market for intrastate crowdfund investing. While there are many businesses that have taken advantage of the exemptions, the numbers of securities issuers are quite small. But, many businesses that have engaged in securities offerings under intrastate crowdfunding exemptions have raised their full asking amount and met their initial offering amount. This may suggest that there is a significant market of idle investors who are looking for new ways to invest their money. The practical difficulties of an intrastate securities exemption, including the advertising restrictions and significant compliance costs may be hampering the ability of businesses to rely on the intrastate securities exemptions. What may be needed most is a new federal crowdfunding exemption that preempts state blue sky laws and that is specifically targeted at supporting the capital needs of small businesses.

#### **V. A New Federal Crowdfunding Exemption for Small Businesses**

To remedy the many problems hampering small businesses and start-up issuers' ability to raise capital in an equity crowdfunding offering, this Article proposes that the federal government create a new exemption targeted and made for small businesses. This exemption will not be a one size fits all exemption that lumps together many different sizes of businesses. Rather, the exemption would be available only to small businesses and start-up companies. The new exemption would be called the "Small Business Crowdfunding exemption." The Small Business Crowdfunding

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370. See *supra* Part IV.C.1.

exemption would have two major components. First, the exemption would create a new national crowdfunding exemption for small businesses and would preempt any blue sky registration. Second, the law would authorize a secondary market for the securities to provide liquidity for the investors of the crowdfunding securities.

#### A. A Federal Small Business Crowdfunding Exemption

The Small Business Crowdfunding exemption would be restricted to securities offerings of \$500,000 or less in any twelve-month period. Further, an investor would be able to invest up to \$1,000 annually or up to \$3,000 from any single household annually. This small capital amount and strict individual limit will reduce the effects of potential fraud under the Small Business Crowdfunding exemption. And, if there is less risk overall, and to each individual investor, then there is less need for a robust regulatory and disclosure regime.

To register a Small Business Crowdfunding offering, the securities issuer would need to file a simple form with the SEC, declaring their intent to issue Small Business Crowdfunding securities and showing they are in compliance with the laws' requirements. This form could be similar to the Form D that is currently used by the SEC. To be eligible for an offering, an issuer must have less than \$25 Million in annual profits and must have a specific business plan that incorporates the use of the funds raised. Any statements made to the SEC that were untrue or fraudulent would result in substantial civil and criminal penalties. In addition, no issuer, owner, officer, director of the company may have a past criminal record,<sup>371</sup> or bankruptcy within the last seven years. Further, an issuer may not use the Small Business Crowdfunding exemption if they own or otherwise control a subsidiary business. This requirement will avoid the administrative difficulty of a business using the Small Business Crowdfunding exemption multiple times through the ownership of subsidiaries. The issuer must certify that they are raising the funds to be used for a legitimate business purpose, that their owners, directors, and officers do not have a criminal conviction. The issuer must disclose to the investors and potential investors that they are engaging in high risk investments which may lose all of their value, that neither the SEC or any state agency has reviewed the securities or issuers, and that there is a limited resale market for the securities they are investing in.

Other than these requirements, Small Business Crowdfunding issuers would not have any registration, disclosure, or compliance requirements. The issuers and its officers, directors, and owners would still be subject to criminal and civil liability, under both federal and state law for any fraud or misrepresentation committed during a securities offering. This exemption would not have any geographical restrictions and an issuer could raise funds from any individual across the United States and its territories.

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371. Less serious criminal convictions, such as most misdemeanor charges would not count in this requirement. Though a significant amount of misdemeanor crimes could be enough to disqualify an issuer. Most felony convictions would result in automatic disqualification.



The Small Business Crowdfunding exemption would also authorize Small Business Portal status for those online websites that facilitate the Small Business Crowdfunding securities. These businesses would be required to register with the SEC and their only regulatory task should be to ensure that each business that attempts to solicit their securities on the portal does not have any bankruptcies or criminal history. The portal would also be required to ensure that the funds are properly transferred from the investor to the issuer and that the issuer properly issues the securities. The portals would not have any other regulatory, compliance or oversight duties. Further, to protect both the investor and the issuer, the SEC should restrict the amount a portal can charge for acting as an intermediary between the issuer and investor. The SEC could restrict the amount charged to a dollar amount, such as \$250-\$1000 per issuance, or could make the restriction based on a percentage of the offering.

This new exemption will allow small businesses, single location restaurants, and new business ventures, to obtain capital through the issuing of crowdfunding equity. Risk to the overall market and to investors will be limited, despite the lack of disclosure and oversight because of the limited amount that may be raised. In essence, most individuals willing to commit fraud would likely not use the Small Business Crowdfunding exemption because they would only be able to raise a small amount of money, compared to other securities offerings, and would be subject to substantial criminal and civil liability for their actions. Small businesses will be attracted to this form of borrowing because of the minimal compliance costs. Rather than having to spend up to twenty percent of the capital raised on compliance, it is likely that compliance with this exemption would be limited to two percent of the amount raised, or even less. The most expensive part will be reaching the investor to facilitate the offering and sale of securities. Businesses who outgrow the qualifications of the Small Business Crowdfunding exemption, or who need to raise more than \$500,000 could rely on another exemption, such as the CROWDFUND Act.

#### B. A Small Business Crowdfunding Resale Market

The Small Business Crowdfunding exemption would also authorize the resale of Small Business Crowdfunding securities immediately after their initial sale. The immediate resale market would be restricted to those investors who do not have a controlling stake of the crowdfunding issuer or who are not directors, officers, or employees of the issuer. Removing controlling stakeholders and officers, directors, or employees from the resale market will prevent some attempts at so called “pump and dump” schemes where the securities issuers pump up the price of a security and then sell their shares at a overinflated rate, before the market price of the security crashes, leaving the security holder with a worthless stock. To further prevent “pump and dump” schemes, the resale market should have restrictions on the amount of securities that can be sold within a given period. For example, the SEC could restrict an individual’s resales to a set amount, such as two percent of the outstanding securities. Further, the SEC could restrict the overall sale of a business’s security to

a certain percent of the issued securities, such as a daily or weekly transfer restriction limiting the sale to between two to five percent of the issued securities. This would make it much harder for an individual to unduly influence the price of the security and would prevent many fraudulent schemes.

A resale market would have many benefits for the investors. A resale market would increase the liquidity of the Small Business Crowdfunding securities. The liquidity of a stock has two major effects on a securities issuance. First, liquidity allows the stockholder/investor to get out of his or her investment at any time. If the stockholder, at any point, becomes concerned about the financial or economic direction of the company, they can sell their shares. This means that an investor can recover some of his or her initial investment should the business begin down the path of insolvency, rather than the issuer having to simply accept a full, 100% loss of his or her initial investments. Second, the increased liquidity makes the officers and directors of the company more beholden to the company's stockholders. As the economist Murray N. Rothbard stated, in a liquid market, "[t]he managers are hired agents of the stockholders and subject to the alters' dictation. Any individual stockholder not satisfied with the decisions of the majority of owners can dispose of his ownership share."<sup>372</sup> In a liquid stock market, the investor who holds on to a security "permits the managers to continue their present course; the fundamental control, however, is still his, and he has absolute control over his agents."<sup>373</sup> If at any point the stockholder becomes dissatisfied with the company, the stockholder can sell his or her securities. The sale of securities will have the overall effect of decreasing the price of the securities and will require the managers of the corporation to change the course of their management or have the value of their securities reduced, and reduce the possibility of a successful future securities offering.

In conclusion, a Small Business Crowdfunding exemption should be created by the United States Congress and should target the capital needs of small businesses. The exemption should be limited to true small businesses and start-up companies and should set a maximum investment cap on each individual investor. Doing so will reduce the risk of fraud for the overall market and to each individual investor. Further, the Small Business Crowdfunding exemption should authorize an immediate resale market for Small Business Crowdfunding securities to further protect the investors through increased liquidity in the securities, to facilitate investing, and to increase investors control over the managers and the company's overall decision making.

## VI. Conclusion

During the signing ceremony of the JOBS Act, President Obama called the JOBS Act a "potential game changer" for startups and small businesses.<sup>374</sup> He said,

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372. MURRAY N. ROTHBARD, *MAN, ECONOMY, AND STATE WITH POWER AND MARKET: SCHOLAR'S EDITION* 434 (2d ed. 2009).

373. *Id.* at 434–35.

374. Kim Hart, *Obama: JOBS Act a 'Game Changer'*, POLITICO (Apr. 5, 2014), <http://www.politico.com/news/stories/0412/74882.html>.

“This is a country that has always been on the cutting edge and the reason is because America has always had the most daring entrepreneurs in the world[.]”<sup>375</sup> “When their ideas take root we get inventions that can change the way we live. And when their businesses take off, more people become employed because, overall, new businesses account for almost every new job that’s created in America.”<sup>376</sup> Two and a half years later, the JOBS Act’s goal to improve investment in small and new businesses has yet to come to pass, though great strides have been made as a result. The passage of the JOBS Act, in particular Title III, the CROWDFUND Act created a new federal exemption from registration for crowdfund investing. Despite the delay in the implementation of the final regulations, which as of September 12, 2015 have yet to be enacted, the CROWDFUND Act sparked a national conversation about the future of small and new business investing through the utilization of technology and the crowd. After the federal CROWDFUND Act stalled and when major criticism surfaced about the Act’s inability to provide a meaningful capital-raising tool for small businesses and start-up companies, the states took matters into their own hands.

States, beginning with Kansas and Georgia in 2011, created new state level exemptions from registration for intrastate securities offerings that met a federal exemption from registration under section 3(a)(11) of the Securities Act and SEC Rule 147. Many states saw the potential for business and economic growth and followed Kansas and Georgia’s lead. Maine took a new path towards the creation of an intrastate crowdfunding regime by relying on SEC Rule 504 for a federal exemption from registration. While these new intrastate crowdfunding regimes furthered the goal of providing a new avenue for investing in small businesses and start-up companies, they suffer from major impediments that may prevent them from becoming a long-term fix for those businesses capital needs. Among other things, the state crowdfunding regimes are generally restricted to a single states boundary and many businesses may not be able to comply with Rule 147’s residency requirements. The intrastate requirements greatly restrict a business’s ability to reach out to potential investors.

Ultimately, this Article proposes a new federal crowdfunding exemption that targets the capital needs of small businesses and start-up companies. The new exemption would require minimal disclosure and, to counter the increased risk, a small company or start-up business will be limited to raising \$500,000 in any twelve-month period and would limit investments by a single individual to \$2,000 (or \$5,000 per family) in any twelve-month period. Further, the new exemption would create a secondary market to promote the growth of small business investing. While there is increased risk in the creation of a secondary market, the SEC could implement regulations that prevent pump and dump schemes, while promoting investor protection.

In the words of the great centrist president, Theodore Roosevelt: “Rhetoric is a poor substitute for action, and we have trusted only to rhetoric. If we are really to be

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375. *Id.*

376. *Id.*

a great nation, we must not merely talk; we must act big.”<sup>377</sup> The time for talking has passed, while other proposals have been touted as the solution for the ailments of small business funding and investment, they have all failed to rise to the occasion. The time has come for a federal Small Business Crowdfunding exemption that will provide meaningful, long-term relief to the capital-plight that is afflicting small businesses and start-up companies. Crowdfunding is here to stay, it is time to put its capital distributing potential to the test for small businesses and start-up companies, those businesses that stand to benefit the most from the crowdfunding revolution.

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377. *Theodore Roosevelt Quotes*, BRAINY QUOTES, [http://www.brainyquote.com/quotes/authors/t/theodore\\_roosevelt\\_3.html#6UiXqglTzmryWJEd.99](http://www.brainyquote.com/quotes/authors/t/theodore_roosevelt_3.html#6UiXqglTzmryWJEd.99) (last visited July 25, 2015).