STATE CROWDFUNDING AND THE INTRASTATE EXEMPTION UNDER FEDERAL SECURITIES LAWS—LESS THAN MEETS THE EYE?

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Introduction

Crowdfunding has become a popular term to describe a variety of vehicles for providing funding to companies or individuals.[1] Crowdfunding is most commonly understood to be "a means to raise money by enticing relatively small individual contributions from a large number of people."[2]

The rise in crowdfunding in large part has followed the spread of the Internet, with the concomitant ability of any individual or entity seeking funds to directly reach large numbers of potential contributors.[3] The securities laws, at the least on the federal level in the United States, have, however, largely acted as a brake on the ability of those seeking crowdfunding to issue stock or other securities in exchange for the funds raised. Specifically, because of the federal securities laws, the initial efforts in crowdfunding were limited to raising money in exchange for something that could not be construed as a security under those laws.[4] The contributors (the persons providing the funds) could not legally receive any form of equity in or debt issued by the company seeking the funds; rather they either received the psychic benefit of contributing to something they felt was worthwhile, or, in some cases, a

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[1] *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 14-27 (2012) (describing and analyzing each form of crowdfunding).

[2] Lori Schock, Director, Sec. & Exch. Comm'n Office of Investor Educ. & Advocacy, Outline of Dodd-Frank Act and JOBS Act (June 9, 2012), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1365171490596#.VN5S3lPF8TI, *archived at* http://perma.cc/9TF7-R3G4.

[3] *See infra* note 4.

[4] In the words of the Securities and Exchange Commission (the "SEC"): Crowdfunding is a term used to describe an evolving method of raising money through the Internet. For several years, this funding method has been used to generate financial support for such things as artistic endeavors like films and music recordings, typically through small individual contributions from a large number of people. While crowdfunding can be used to raise funds for many things, it generally has not been used as a means to offer and sell securities. That is because offering a share of the financial returns or profits from business activities could trigger the application of the federal securities laws, and an offer or sale of securities must be registered with the SEC unless an exemption is available. Press Release, Sec. & Exch. Comm'n, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.VN5VIlPF8TI, *archived at* http://perma.cc/G5R4-3M82.

benefit that was not to be linked to the financial performance of the recipient.[5] While some would scoff at the idea that funding in this form would work, it has turned out to be quite successful in many cases.[6]

Because of this success, it was felt that crowdfunding in exchange for the issuance of a security could be similarly beneficial to startup business entities seeking investors if the existing securities laws were amended.[7] Thus, on April 5, 2012, with much fanfare, President Obama signed the bipartisan Jumpstart Our Business Startups Act (known as the "JOBS Act").[8] In addition to changes in the initial public offering process, which are beyond the scope of this Article, the bill was intended to open up funding for smaller companies by reducing, subject to oversight by the U.S. Securities and Exchange Commission (the "SEC"), the existing prohibition of public advertising of the sale of unregistered securities.[9] Crowdfunding was one of two ways Congress chose to effectuate this purpose. President Obama's statement on the bill signing is indicative:

> And for start-ups and small businesses, this bill is a potential game changer. Right now, you can only turn to a limited group of investors—including banks and wealthy individuals—to get funding. Laws that are nearly eight decades old make it impossible for others to invest. But a lot has changed in 80 years, and it's time our laws did as well. Because of this bill, start-

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[5] *See supra* notes 93-97 and accompanying text.

[6] *See supra* note 104 and accompanying text.

[7] *See* Bradford, *supra* note 1, at 5-7; Karen Mills, *JOBS Act Creates Crowdfunding Opportunities, Eases IPO Rules*, The White House Blog (Apr. 5, 2012), https://www.whitehouse.gov/blog/2012/04/05/jobs-act-creates-crowdfunding-opportunities-eases-ipo-rules, *archived at* http://perma.cc/64N9-QX66

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

[9] *See infra* notes 16-17 and accompanying text. Section 401(a)(2) of the JOBS Act also required the SEC to adopt rules adding a class of securities exempt from registration under the Securities Act for offerings up to $50 million in a twelve-month period. JOBS Act § 401(a)(2), 15 U.S.C. § 77c(b)(2)(A) (2012). This section was implemented in Regulation A+, adopted by the SEC on April 20, 2015. *See generally* Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Securities Act Release No. 9741, Exchange Act Release No. 74578, 80 Fed. Reg. 21,806 (Apr. 20, 2015) (to be codified in scattered parts of 17 C.F.R.).

> ups and small business will now have access to a big, new pool of potential investors—namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.
>
> Of course, to make sure Americans don't get taken advantage of, the websites where folks will go to fund all these start-ups and small businesses will be subject to rigorous oversight. The SEC is going to play an important role in implementing this bill.[10]

The JOBS Act amended existing law to allow general public solicitation for two kinds of exempt securities offerings: (1) it permitted general solicitation and advertising for Rule 506 offerings if only accredited investors[11] purchase the security;[12] and (2) it provided a mechanism for crowdfunding.[13] The SEC was required to complete its regulation in the former area within ninety days after the enactment of

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[10] Barack Obama, President, United States, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012), *available at* http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing, *archived at* http://perma.cc/32BW-Q7M4.

[11] The term "accredited investor" was incorporated into the federal securities laws in 1980, when Congress amended the Securities Act of 1933 (the "'33 Act") to include that term in Section 2(a)(15), and left much of the definition to the SEC. *See* Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, § 603, 94 Stat. 2275 (codified as amended at 15 U.S.C. § 77b (2012)). Accredited investors were investors who essentially were deemed to have sufficient assets to be able to fend for themselves, as well as certain institutions. *Id.* In Securities Act Release No. 6389, the Commission adopted Regulation D ("Reg. D"), effective on April 15, 1982. Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11,251 (Mar. 16, 1982); *see also* Regulation D, 17 C.F.R. §§ 230.500-508 (2014). Reg. D created a number of safe harbors from the registration requirements of the Securities Act of 1933. *See infra* notes 58-79 and accompanying text. Most of these safe harbors depend to varying extent on the financial resources of the investors. *See infra* notes 60-79 and accompanying text.

[12] JOBS Act § 201 (codified as amended at 15 U.S.C. § 77d). Title II of the JOBS Act, in which Section 201 appears, is entitled "Access to Capital for Job Creators." JOBS Act, tit. II.

[13] The crowdfunding provisions contained in Title III of the JOBS Act are called the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012" or the "CROWDFUND Act." JOBS Act § 301.

the JOBS Act,[14] but in fact completed those regulations in July 2013, some fifteen months after the enactment.[15] These regulations for the first time permit advertising and general solicitation for an offering under Rule 506,[16] provided that only accredited investors actually invest.[17]

The "CROWDFUND Act," title III of the JOBS Act, which does not limit offerings to accredited investors, is the focus of this Article. The SEC has still not completed its regulations of this form of crowdfunding, despite the fact that the JOBS Act required such regulations to be issued 270 days after the enactment of the JOBS Act,[18] which would have been almost a year and a half before the date of the publishing of this Article.[19] As a consequence no crowdfunding of securities to non-accredited investors has been permissible under federal securities laws in the almost three years following the JOBS

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[14] JOBS Act § 201(a).

[15] 17 C.F.R. § 230.506(c) (codifying Eliminating the Prohibition Against General Solicitation and General
Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,804-05 (Jul. 24, 2013)).

[16] *Id.* § 230.506. Rule 506 has been one of the most important exemptions from Federal Securities laws, and is discussed in detail below. *See infra* note 17, notes 67-68 and accompanying text.

[17] Rule 506 under Reg. D was amended by the SEC to permit general solicitation and advertising, which includes use of the Internet, provided that the issuer identifies the offering as involving general solicitation and advertising in its filing of Form D, and provided that the issuer takes additional steps to verify the accredited status of investors. 17 C.F.R. § 230.506. Internet portals such as OneVest.com have begun to provide offerings under this safe harbor. *See generally* ONEVEST, https://onevest.com/ (last visited Feb. 18, 2015), *archived at* http://perma.cc/86AD-KJJN. Rule 506 largely preempts state securities laws' registration requirements. *See* 15 U.S.C. § 77r(b)(4)(E) (2012). Accordingly, issues under state law crowdfunding do not arise for such offerings.

[18] JOBS Act § 302(c).

[19] Indeed, the SEC's rulemaking agenda now indicates that the SEC does not anticipate considering its proposed rules until October 2015, which would mean they could not be effective until 2016. *Rules Governing the Offer and Sale of Securities Through Crowdfunding Under Section 4(a)(6) of the Securities Act*, OFFICE OF MGMT. & BUDGET, http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201404&RIN=3235-AL37 (last visited Mar. 16, 2015); *archived at* http://perma.cc/VZD3-68FP.

Act.[20] In the interim, a number of states have enacted state crowdfunding statutes or are considering such action.[21] This Article will examine the degree to which state crowdfunding initiatives are likely to prove meaningful supplements to or substitutes for the federal regime.

I. The Securities Laws

To remediate many of the conditions that caused the 1929 stock market crash and ensuing economic depression, beginning in 1933 the United States Congress enacted a series of laws regulating the issuance and trading of securities and establishing the SEC as the chief federal regulator in this area.[22] Several other federal securities laws,

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[20] One may be perhaps justified in concluding from this delay that the SEC's views of the "improvements" to the offering process in the JOBS Act are less fulsomely positive than that of the Congress. That view would certainly be supported by the regulations the SEC did promulgate with respect to Title II, "Access to Capital for Job Creators." *See* 17 C.F.R. § 230.506(c). The additional investigative process required by those regulations to verify accredited investor status in an advertised Rule 506 offering can be expected to be difficult and potentially time consuming and may deter some potential investors who do not wish to disclose the required personal financial information. *See* 17 C.F.R. § 230.506(c)(2)(ii). For traditional investor offerings under Rule 506, in which issuers were not permitted to use advertising or general solicitation, all that was and is required is a reasonable belief by the issuer that an investor meets the accredited investor requirements. 17 C.F.R. § 230.501(a) (2014). Under the new rules, if advertising or general solicitation is involved, "[t]he company [must take] reasonable steps to verify that its investors are accredited investors, which could include reviewing documentation, such as W-2s, tax returns, bank and brokerage statements, credit reports and the like." *Rule 506 of Regulation D*, SEC. & EXCH. COMM'N, http://www.sec.gov/answers/rule506.htm (last visited Feb. 18, 2015), *archived at* http://perma.cc/F9XZ-WVTV.

[21] Steven Davidoff Solomon, *S.E.C.'s Delay on Crowdfunding May Just Save It*, N.Y. TIMES DEALBOOK (Nov. 18, 2014, 2:56 PM), http://dealbook.nytimes.com/2014/11/18/s-e-c-s-delay-on-crowdfunding-may-just-save-it-2/.

[22] As the SEC itself has said:

> Often referred to as the "truth in securities" law, the Securities Act of 1933 has two basic objectives: . . . [to] require that investors receive financial and other significant information concerning securities being offered for public sale; and . . . [to] prohibit deceit, misrepresentations, and other fraud in the sale of securities. . . .

including the JOBS Act, were enacted more recently.[23] Of the federal securities laws, the ones that primarily regulate the capital formation process for issuers are the following:[24]

- The Securities Act of 1933 (the "'33 Act"),[25] which regulates the issuance of securities.
- The Securities Exchange Act of 1934 (the "'34 Act"),[26] which created the SEC and gave it sweeping authority to regulate the securities industry.[27] The '34 Act also regulates the trading of

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> With [the Securities Exchange Act of 1934], Congress created the Securities and Exchange Commission. The Act empowers the SEC with broad authority over all aspects of the securities industry. . . . The Act also identifies and prohibits certain types of conduct in the markets and provides the Commission with disciplinary powers over regulated entities and persons associated with them.

The Act also empowers the SEC to require periodic reporting of information by companies with publicly traded securities.*The Laws That Govern the Securities Industry*, SEC. & EXCH. COMM'N, http://www.sec.gov/about/laws.shtml#secact1933 (last visited Feb. 26, 2015), *archived at* http://perma.cc/C5JC-HAP8.

[23] *See supra* text accompanying note 8.

[24] Other statutes which touch on the capital formation process include the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (2012), which further regulates the public offering of debt instruments; the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-64 (2012), which regulates companies, such as mutual funds, who primary assets are securities and whose securities are in turn sold to the public; the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1-80b-21 (2012), which regulates entities and individuals who give investment advice; the Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.), enacted July 30, 2002, whose primary purposes were to fight corporate and accounting fraud through increased corporate responsibility and improved financial disclosure; and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (codified in scattered sections of the U.S.C.), enacted July 21, 2010, which affected such areas as financial products, consumer protection, trading, credit ratings, corporate governance and disclosure.

[25] Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2012).

[26] Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78pp (2012).

[27] 15 U.S.C. §§ 78b, 78d. The SEC is also charged with administering the other federal securities laws. *Id*.

securities and such things as public company corporate reporting, proxy statements, and tender offers.[28]

- The National Securities Markets Improvement Act of 1996 ("NSMIA"),[29] which, *inter alia*, preempted state regulation for offerings under Rule 506 of Regulation D.[30]
- The JOBS Act, previously described.[31]

Securities are also regulated on the state level by laws commonly known as blue sky laws.[32] The first of these state laws was enacted in Kansas in 1911.[33] Although many of them are patterned after the Uniform Sales of Securities Act of 1930 and its successors,[34] the state laws do vary from state to state, often overlapping federal laws principally in the regulation of the issuance and trading in securities.[35]

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[28] *See generally* 15 U.S.C. §§ 78a-78pp.

[29] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

[30] 15 U.S.C. § 77r.

[31] *See supra* notes 8-21 and accompanying text.

[32] The exact origin of the term "Blue Sky Law" itself has been lost in time. But its meaning was explained as early as 1917 in the decision in *Hall v. Geiger-Jones Co*., 242 U.S. 539, 550 (1917):It will be observed, therefore, that the law is a regulation of business, constrains conduct only to that end, the purpose being to protect the public against the imposition of unsubstantial schemes and the securities based upon them. Whatever prohibition there is, is a means to the same purpose, made necessary, it may be supposed, by the persistence of evil and its insidious forms and the experience of the inadequacy of penalties or other repressive measures. The name that is given to the law indicates the evil at which it is aimed; that is, to use the language of a cited case, "speculative schemes which have no more basis than so many feet of 'blue sky;'" or, as stated by counsel in another case, "to stop the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines, and other like fraudulent exploitations."

[33] Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 359-62 (1991).

[34] *Securities Act Summary*, UNIF. LAW COMM'N, http://www.uniformlaws.org/ActSummary.aspx?title=Securities%20Act (last visited Mar. 16, 2015), *archived at* http://perma.cc/3TY6-52JY; *see also* Adam J. Gana & Michael Villacres, *Blue Skies for America in the Securities Industry . . . Except for New York: New York's Martin Act and the Private Right of Action*, 19 FORDHAM J. CORP. & FIN. L. 587, 590-91 (2014).

[35] It should be noted that, since corporations and other entities are generally created under state law, state corporation law invariably provides certain basic operational requirements relating to the issuance of equity securities in such

Two themes pertaining to all blue sky laws, however, are relevant to this Article: all only pertain to activities subject to the jurisdiction of the state in question[36] and all are subject to preemption by federal law, although such preemption has been exercised sparingly.[37]

Returning to the federal laws, the overarching theme of these laws is to ensure that investors are given full, complete, and truthful disclosure of all material facts that a reasonable investor would need to assess the merits of the investment.[38] The various acts achieve this end in different ways: the '33 Act and the SEC regulations issued under it regulate the offering process and what information an issuer must give in the offering process,[39] the '34 Act and regulations regulate the trading process, proscribing such things as market manipulation and insider trading[40] and so on. Of all the federal acts and regulations, it is

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entities, such as the types and rights of such equity securities, what may be lawful consideration for such securities, the procedures for their issuance, what constitutes valid evidence of ownership of them and so on. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 151-174 (2011 & Supp. 2014). These basic provisions are beyond the scope of this Article.

[36] In the words of the United States Supreme Court, "The Court's rationale for upholding blue-sky laws was that they only regulated transactions within the regulating States." Edgar v. MITE Corp., 457 U.S. 624, 641 (1982); *see also* Sec. & Exch. Comm'n v. Bronson, 14 F. Supp. 3d 402, 415-16 (S.D.N.Y. 2014).

[37] Two examples of the exercise of preemption are the NSMIA preemption of state securities laws for Rule 506 offerings, except for notice filing requirements and fees in existence prior to NSMIA, 15 U.S.C. § 77r (2012), and Section 305 of the JOBS Act, which preempts state authority over registration, documentation, and offering requirements. JOBS Act, Pub. L. No. 112-106, § 305, 126 Stat. 306, 322 (2012). Both provisions preserve state authority to pursue enforcement actions. 15 U.S.C. § 77r (2012); JOBS Act, Pub. L. No. 112-106, § 305, 126 Stat. 306, 322 (2012). The new regulations for Regulation A+, adopted on April 20, 2015, also provide for preemption of state regulation for Tier 2 offerings (offerings of up to $50 million in a twelve-month period) under the new regulation. Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Securities Act Release No. 9741, Exchange Act Release No. 74,578, 80 Fed. Reg. 21,806, 21,807 (Apr. 20, 2015) (to be codified at 17 C.F.R. § 230.251(a)(2)). This preemption was objected to by many commenters on the proposed regulations, including the NASAA. *See id.* at 21,815 & n.122.

[38] *See The Laws That Govern the Securities Industry*, *supra* note 22.

[39] *Id.*

[40] *Id.*

the '33 Act, the regulations issued pursuant to it, and their interplay with the JOBS Act that are most pertinent to the discussion here.

The '33 Act generally requires that each sale of a security by an issuer in a public offering be pursuant to a currently effective registration statement, unless the transaction falls within one or more of the exemptions provided in the Act or the regulations the SEC has issued under it.[41] A common misunderstanding revolves around what must be registered under the '33 Act: each transaction must be registered or an exemption found, but the securities themselves are not registered.[42] It is thus somewhat of a misnomer to talk in terms of a registered security.[43]

The registration statement, and indeed the registration process as a whole, is burdensome, very expensive, and not useful for smaller

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[41] Section 5(a) of the '33 Act, 15 U.S.C. § 77e(a) (2012), for example, provides:

> Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly— (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

See also Section 3 of the '33 Act, 15 U.S.C. § 77c (2012), which exempts certain classes of securities from the registration process (for example, certain small issuances and interstate offerings), and Section 4(a) of the '33 Act, 15 U.S.C. § 77d(a) (2012), which provides: "The provisions of section 77e of this title shall not apply to—(1) transactions by any person other than an issuer, underwriter, or dealer [or] (2) transactions by an issuer not involving any public offering."

[42] 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 2.0 (2009).

[43] *Id.* This misunderstanding may be an outgrowth of the public offering process. In a public offering the securities are issued through public announcement and are available for purchase by the public without restriction as to whether or not the purchasers are accredited, but subject to a registration statement that includes a prospectus. *See id.* § 2.2[1][A]. Thereafter, the publicly sold securities are generally freely tradable on a public market—hence the wrong notion that the securities themselves are registered. *See id.* § 2.0. Rather, the correct view is that the later open market transactions are permitted because they fall within a specific exemption from registration, usually that in Section 4(a)(1) of the '33 Act, codified at 15 U.S.C. § 77d(a).

issuances.[44] But there is a succinct, oft-repeated statement of the law that there are only three ways to issue securities in the United States: first, by registration, second, under an exemption, or third, illegally.[45] Accordingly, the overwhelming majority of securities offerings by smaller entrepreneurial companies are made, if they are to be legal, through exemptions from the '33 Act.[46] Thus, these exemptions are of crucial importance to the entrepreneurial issuer, and to the lawyers who advise them.

There are a number of exemptions to the registration process.[47] Many apply to issuer offerings;[48] these include Reg. A,[49] Reg. D,[50]

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[44] The SEC itself has identified "the average cost of achieving initial regulatory compliance for an initial public offering is $2.5 million, followed by an ongoing compliance cost, once public, of $1.5 million per year. Hence for an issuer seeking to raise less than $1 million, a registered offering is not economically feasible . . . ." Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70741, 78 Fed. Reg. 66,428, 66,509 (proposed Nov. 5, 2013). Recognizing these concerns, the SEC has made some effort to provide less expensive and more user-friendly means of registration for small businesses, through use of forms SB-1 and SB-2 in lieu of the more burdensome requirements of a Form S-1. *See Small Business and the SEC: A Guide for Small Businesses on Raising Capital and Complying with the Federal Securities Laws*, SEC. & EXCH. COMM'N (Oct. 10, 2013), http://www.sec.gov/info/smallbus/qasbsec.htm, *archived at* http://perma.cc/97XQ-9JEZ.

[45] *See, e.g.*, HAZEN, *supra* note 42, § 4.1[1]. It should be noted that, even if the transaction is exempt from the registration process, it is not exempt from the antifraud provisions of the various federal securities laws. *See, e.g.*, Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2012). Also, almost all of the exemptions promulgated by the SEC also have provisions that prohibit "bad actors" from taking advantage of the exemption. *See, e.g.*, 17 C.F.R. 230.506(d) (2014). The proposed Regulation Crowdfunding would have a similar prohibition for both issuers and their principal players. Crowdfunding, 78 Fed. Reg. at 66,499-500.

[46] *See id.* at 66509.

[47] All of these exemptions are statute-based. *E.g.*, Securities Act of 1933 § 4(a), 15 U.S.C. § 77d(a). Many, however, also rest on regulations of the SEC issued pursuant to that statutory authority. *E.g.*, Regulation D, 17 C.F.R. §§ 230.500-508 (2014). Many of these rules, including Reg. D, are so-called "safe-harbor" exemptions, namely a regulation that, if complied with, provides an exemption from registration but which does not prevent non-complying offerings from being exempt if they otherwise qualify under the '33 Act. *See* HAZEN, *supra* note 42, § 4.24[1].

[48] As previously mentioned, some exemptions apply to resales of securities. *See supra* note 43. It is true that "transactions by any person other than an issuer, underwriter, or dealer" are exempt under Section 4(a)(1) of the '33 Act.

Rule 701,[51] and a statutory provision and interpretive safe harbor rule that exempt solely intrastate offerings.[52] Reg. D and Rule 701 have

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15 U.S.C. § 77d(a)(1); *see also supra* note 41. But most securities issued in private offerings, including those issued under Reg. D, "cannot be resold without [then] registration under the Act or an exemption therefrom." 17 C.F.R. § 230.502(d). Accordingly, a resale exemption important to startup enterprises is Rule 144, which establishes conditions for the resale into the public market after an initial public offering ("IPO") of securities bought privately under another exemption, such as Reg. D. 17 C.F.R. § 230.144 (2014). Rule 144 is only useful, however, if the issuer has gone through an IPO, which will not necessarily be the case. Rule 504 does provide that securities issued under Rule 504(b)(1), which are subject to state registration, are not restricted. 17 C.F.R. § 230.504(b)(1). However, Rule 504(b)(1) has certain limitations. *See infra* notes 64-65 and accompanying text. In contrast, the proposed crowdfunding regulations only limit sales during the one year period after purchase, and even during that year allow sales to the issuer, to an accredited investor, to a family member, or through a registered offering. Crowdfunding, 78 Fed. Reg. at 66,496.

[49] Regulation A, 17 C.F.R. §§ 230.251-263 (2014), was issued by the SEC pursuant to Section 3(b) of the '33 Act, the so-called small offering exemption. 15 U.S.C. § 77c(b) (2012). Section 3(b) permits the SEC to issue regulations providing a registration exempt for offering less than $5,000,000. *Id.* § 77c(b)(1). Reg. A allows issuance of securities into the public market but with a simpler process than a full public offering. *See generally* 17 C.F.R. §§ 230.251-263. Pursuant to Section 401 of the JOBS Act, which mandated rules exempting from registration offerings up to $50 million annually, the SEC adopted Regulation A+, which is intended to expand Regulation A offerings. *See generally* Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Securities Act Release No. 9741, Exchange Act Release No. 74578, 80 Fed. Reg. 21,806 (Apr. 20, 2015) (to be codified in scattered parts of 17 C.F.R.). Under these rules, which will become effective on June 19, 2015, *id.* at 21,806, there are two tiers of Regulation A+ offerings: Tier 1 for securities offerings up to $20 million and Tier 2 for securities offerings up to $50 million. *Id.* at 21,807 (to be codified at 17 C.F.R. § 230.251(a)). Tier 2 offerings will preempt state securities regulations for "qualified purchasers," which the SEC determined to be "any person to whom securities are offered or sold pursuant to a Tier 2 offering." *Id.* at 21,809 (to be codified at 17 C.F.R. § 230.256). Regulation A+ retains much of the mandated offering statement form previously contained in Regulation A. *See id.* at 21,820-21 (to be codified at 17 C.F.R. pt. 239).

[50] 17 C.F.R. §§ 230.500-508.

[51] Rule 701, provides for an "[e]xemption for offers and sales of securities pursuant to certain compensatory benefit plans and contracts relating to compensation." 17 C.F.R. § 230.701 (2014)

proved to be the most useful exemptions for startup enterprises; the other issuer exemptions have been much less so. Based on SEC filings, from 2009-12 there were 22,126 offerings under $1 million relying on Reg. D (of which 19,424 relied on Rule 506), as compared to 2 such offerings relying on Reg. A.[53] The exemptions that are most significant to the subject matter of this Article are in '33 Act Sections 4(a)(2)[54] and 3(b), on the one hand, and Section 3(a)(11)[55] on the other, and the regulations issued under them, namely Reg. D[56] and the intrastate exemption.[57]

A. Reg. D

Reg. D was issued by the SEC in part under Section 3(b) of the '33 Act[58] and in part under Section 4(a)(2) of that act.[59] Reg. D provides for exemption from registration for offerings depending on, among other things, the size of the offering, the number of purchasers, and whether or not the purchasers are sophisticated investors or accredited investors.[60] There are three exemptions under Reg. D, with

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[52] Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (2012); 17 C.F.R. § 230.147 (2012).
[53] Crowdfunding, 78 Fed. Reg. at 66,509-510.
[54] 15 U.S.C. § 77d(a)(2) (2012).
[55] 15 U.S.C. § 77c(a)(11).
[56] 17 C.F.R. §§ 230.500-508.
[57] 17 C.F.R. § 230.147.
[58] 15 U.S.C. § 77c(b); *see also* Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8828, Investment Company Act Release No. 27922, 72 Fed. Reg. 45,116, 45,116 (proposed Aug, 10, 2007) ("Regulation D, adopted in 1982, was designed to facilitate capital formation while protecting investors by simplifying and clarifying existing exemptions for private or limited offerings, expanding their availability, and providing more uniformity between federal and state exemptions.").
[59] 15 U.S.C. § 77d(a)(2).
[60] 17 C.F.R. §§ 230.500-508. The term "accredited investor" is defined in Rule 501 of Reg. D, 17 C.F.R. § 230.501(a), which provides:

> *Accredited investor* shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:
>
> (1) Any bank . . . or any savings and loan association . . . ; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any

varying qualifications and conditions, in Rules 504,[61] 505[62] and 506.[63] In short, Rule 504, sometimes referred to as the "seed capital"

> insurance company . . . ; any investment company . . . or a business development company . . . ; any Small Business Investment Company licensed by the U.S. Small Business Administration . . . ; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan . . . if the investment decision is made by a plan fiduciary, . . . which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;(2) Any private business development company . . . ;
>
> (3) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;
>
> (4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;
>
> (5) Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000 . . . ;
>
> (6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;
>
> (7) Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in §230.506(b)(2)(ii); and
>
> (8) Any entity in which all of the equity owners are accredited investors.

[61] 17 C.F.R § 230.504.
[62] 17 C.F.R § 230.505.
[63] 17 C.F.R § 230.506.

exemption,[64] covers offerings of up to $1,000,000 in any 12-month period with no restriction on the type of offeree;[65] Rule 505 covers offerings of up to $5,000,000 in any 12-month period to an unlimited number of accredited investors but only 35 non-accredited investors;[66] and Rule 506 covers offerings without limit on the amount.[67] Rule 506 offerings may be made to an unlimited number of accredited investors, and if there is no advertising or general solicitation may also be made to up to 35 non-accredited investors who must meet the sophistication condition proscribed in the Rule.[68]

There are varying other conditions applicable to each of the Reg. D exemptions. For example, Rule 506[69] exempts qualifying issuances from any otherwise applicable state blue sky laws other than, if required by applicable state law, filing a consent to service and paying certain fees.[70] As another example, a general qualification for Reg. D offerings is that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising,"[71] although this limitation does not apply to certain limited intrastate offerings pursuant to Rule 504(b),[72] or to qualified Rule 506(c) all-accredited investor offerings.[73] When the SEC rules applicable to crowdfunding become effective, those offerings will be exempt from that rule, although the Crowdfunding Regulation, as currently proposed, will regulate general solicitation.[74] There are also substantial differences in the form of disclosure among the various offerings under Regulation D, with issuers in Rule 505[75] offerings required to make disclosure in the form prescribed in detail in Rule

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[64] Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7644, 64 Fed. Reg. 11,090 (Mar. 8, 1999) (codified at 17 C.F.R § 230.504).
[65] 17 C.F.R § 230.504.
[66] 17 C.F.R § 230.505.
[67] 17 C.F.R § 230.506.
[68] *Id.*; *see also Rule 506 of Regulation D*, *supra* note 20.
[69] 17 C.F.R. § 230.506.
[70] This preemption was added in 1996 by the NSMIA. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290 § 102, 110 Stat. 3416, 3417-20 (codified at 15 U.S.C. § 77r (2012)).
[71] 17 C.F.R. § 230.502(c) (2014).
[72] 17 C.F.R. § 230.504(b) (2014).
[73] 17 CFR § 230.506(c); *see also supra* notes 11-12 and accompanying text.
[74] Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70741, 78 Fed. Reg. 66,428, 66,432 (proposed Nov. 5, 2013).
[75] 17 C.F.R § 230.505 (2014).

502(b),[76] whereas issuers under Rule 506 have no specified form of disclosure unless there are non-accredited offerees,[77] and issuers under Rule 504 (except for certain offerings under state law) have no specified form of disclosure in any case.[78]

Although Rule 506 has historically been the exemption primarily used for issuances to investors by startups, the total disqualification prior to the JOBS Act of general solicitation and advertising and, to some extent, the requirement that most, if not, as a practical matter, all, purchasers be accredited have made it less than a perfect vehicle for such offerings. Also affecting Rule 506's usefulness is that the securities issued under Reg. D typically are restricted and cannot be freely resold.[79]

B. Section 3(a)(11)

Section 3(a)(11) of the '33 Act provides a statutory exemption for offerings that are wholly within one state.[80] It provides:

> (a) Exempted securities
>
> Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:
>
> . . .
>
> (11) Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.[81]

Unlike Rule 506 of Reg. D, Section 3(a)(11) does not displace state law and all requirements of any applicable blue sky law remain in

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[76] 17 C.F.R. § 502(b) (2014).
[77] 17 C.F.R. § 230.506(b)(1) (2014).
[78] 17 C.F.R. § 504(b)(1) (2014). For Rule 504 offerings made under state registration, disclosure must be "substantive" and comply with the applicable state disclosure law. *Id.*
[79] 17 C.F.R. § 230.502(d) (2014). Note that this is not the case for Rule 504 offerings made under state registration. 17 C.F.R. § 504(b)(1).
[80] 15 U.S.C. § 77c(a)(11) (2012).
[81] *Id.*

effect.[82] However, also unlike Reg. D, Section 3(a)(11) has no restrictions on the size of the offering, the number, nature, and sophistication of the purchasers, or whether there may be a public solicitation.[83]

Section 3(a)(11) has been less than useful for startup issuers. Firstly, since state law continues to apply to the issuers relying on this exemption, in many instances there is a substantial regulatory burden under state blue sky laws.[84] Moreover, both the courts and the SEC have interpreted Section 3(a)(11) narrowly.[85] They have required that all offerees, not just purchasers,[86] be residents of the state in question and have imposed geographic doing-business and other restrictions on the issuer.[87] The SEC issued Rule 147[88] in attempt to clarify these requirements, but in practice it has not materially expanded the statutory exemption and may even have narrowed it further in some respects. Among other things, under Section 3(a)(11) the issuer is required to be both resident and doing business within the state in question but Rule 147 does not ease this burden.[89] If anything the rule

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[82] *See* C. Steven Bradford, *Expanding the Non-Transactional Revolution: A New Approach to Securities Registration Exemptions*, 49 EMORY L.J. 437, 454 (2000) (explaining that one of the rationales for the intrastate exemption under "is that, because of the local nature of the offering, state regulation is adequate"); *see also supra* notes 61-70 and accompanying text.

[83] *See supra* note 60 and accompanying text.

[84] *See, e.g.*, William L. Powers & Don C. Reser, *Oil and Gas Programs and Broker-Dealer Securities Registration Ramifications*, 13 ST. MARY'S L.J. 803, 815-16 (1982).

[85] *See, e.g.*, Busch v. Carpenter, 827 F.2d 653, 656 (10th Cir. 1987); SEC v. McDonald Inv. Co., 343 F.Supp. 343, 346 (D.Minn. 1972); *see also* J. William Hicks, *Intrastate Offerings under Rule 147*, 72 MICH. L. REV. 463, 463-64 (1974).

[86] An offeree is anyone to whom an offer to purchase a security has been made, not just purchasers of the security.

[87] *See Busch*, 827 F.2d at 657-58; SEC v. Truckee Showboat, 157 F. Supp. 824, 825 (S.D. Cal. 1957) (holding that the Section 3(a)(11) exemption was not available despite the residency and geographic doing-business conditions being satisfied, because the proceeds of the offering were to be used to acquire and operate a business in another state); *see also* Hicks, *supra* note 85, at 479-83.

[88] 17 C.F.R. § 230.147 (2014).

[89] Rule 147(c) provides:

> (c) *Nature of the issuer*. The issuer of the securities shall at the time of any offers and the sales be a person resident and doing business within the state or territory in which all of the offers, offers to sell, offers for sale and sales are made.

is more restrictive than the statute. Nor does the rule eliminate the requirement that all offerees be resident of the state.[90] Rule 147 also adds integration rules that, at a minimum, increase the risk of a violation of the '33 Act if an issuer, relying on Rule 147, engages in any other financing, whether legal or not, that does not itself comply with Rule 147.[91] It also provides that 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 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."[92]

> (1) The issuer shall be deemed to be a resident of the state or territory in which: (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 organization that is not organized under any state or territorial law; (iii) His principal residence is located if an individual. (2) The issuer shall be deemed to be doing business within a state or territory if: (i) The issuer derived at least 80 percent of its gross revenues and those of its subsidiaries on a consolidated basis.
>
> . . . (ii) The issuer had at the end of its most recent semi-annual fiscal period prior to the first offer of any part of the issue, at least 80 percent of its assets and those of its subsidiaries on a consolidated basis located within such state or territory;(iii) The issuer intends to use and uses at least 80 percent of the net proceeds to the issuer from sales made pursuant to this rule 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 within such state or territory.

17 C.F.R. § 230.147(c).

[90] Rule 147(d) provides that "[o]ffers, offers to sell, offers for sale and sales of securities that are part of an issue shall be made only to persons resident within the state or territory of which the issuer is a resident." 17 C.F.R. § 230.147(d).

[91] 17 C.F.R. § 230.147 (Preliminary Notes).

[92] 17 C.F.R. § 230.147(d)(3).

II. Crowdfunding Efforts and the JOBS Act

As noted in the introduction, "crowdfunding is a means to raise money by enticing relatively small individual contributions from a large number of people."[93] The initial growth of crowdfunding was primarily donation-based or rewards-based.[94]

Donation-based funding is simply a straight contribution by the funding party with no expectation of any direct material benefit.[95] Examples of successful donation-based funding include purely charitable contributions or contributions simply because the funder wishes to see the project succeed.[96] A popular wrinkle on donation based funding is funding that offers some incentive to the donor that is neither cash nor a share in the ultimate profitability of the venture. These have ranged from a first case of beer to a far more elaborate sliding scale of prizes.[97] Early success of a variety of projects has led to an enormous growth of entities focused on fundraising from the general public and

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[93] Schock, *supra* note 2.

[94] *See* Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70741, 78 Fed. Reg. 66,428, 66,515 & n.878 (proposed Nov. 5, 2013).

[95] *Id.* at 66515.

[96] For example, Kickstarter, which limits itself to creative projects, claimed that "in 2013 3 million people had pledged $480 million to Kickstarter projects." *The Year in Kickstarter*, KICKSTARTER, https://www.kickstarter.com/year/2013/?ref=footer#1-people-dollars (last visited Feb. 12, 2015), *archived at* https://perma.cc/3K8A-T9KC.

[97] As an example Hendo Hoverboards, a for profit entity, which had raised over $493,000 as of December 13, 2014 (as against a goal of only $250,000) had over 3000 backers with 18 levels of incentives ranging from a social media mention for a $5 donation to receiving one of the first 10 hoverboards produced and additional VIP benefits for a $10,000 contribution. HENDO HOVER, *Hendo Hoverboards—World's First REAL Hoverboard*, KICKSTARTER, https://www.kickstarter.com/projects/142464853/hendo-hoverboards-worlds-first-real-hoverboard?ref=catego. All slots for the latter were subscribed. *Id.* It should be noted that if there is an element of chance in obtaining a reward or in the nature of such a reward, gaming or gambling laws may apply. *See, e.g.*, 31 U.S.C. § 5362 (2012) ("The term 'bet or wager'—(A) means the staking or risking by any person of something of value upon the outcome of a contest of others, a sporting event, or a game subject to chance, upon an agreement or understanding that the person or another person will receive something of value in the event of a certain outcome; [and] (B) includes the purchase of a chance or opportunity to win a lottery or other prize (which opportunity to win is predominantly subject to chance) . . . .").

on peer-to-peer lending.[98] Many of these sites differentiate themselves based on the type of participant. For example, Kickstarter allows only "creative projects";[99] GoFundMe provides for personal projects;[100] Funds for Causes only permits charitable and non-profit fundraising.[101] The common thread of all of these fundraising methods has been an Internet-based intermediary platform for connecting investors and recipients and for sharing information.[102] Typically the intermediary receives fees based on money raised, but is neither a lender nor a participant.[103]

Numerous sites have arisen to provide the intermediary function for crowdfunding and, while many projects receive scant funding, there are also numerous success stories.[104] All of these have operated outside the securities arena.[105]

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[98] For example, Lending Club Corporation went public in December 2014, and reported itself as having facilitated more than $6 billion in loans since 2007, primarily to individuals and small businesses. LendingClub Corp., Registration Statement (Form S-1, Amend. No. 4), at 1 (Dec. 8, 2014). Lending Club does not act as a lender but as a facilitator of such loans, typically under $100,000 and meeting pre-stated credit criteria. *Id.* at 52. It "rel[ies] on issuing banks to originate all loans and comply with various federal, state and other laws." *Id.* at 15.

[99] KICKSTARTER, https://www.kickstarter.com/learn?ref=nav (last visited Feb. 12, 2015), *archived at* https://perma.cc/SWC5-39ME?type=live

[100] *About Us*, GOFUNDME, http://www.gofundme.com/about-us/ (last visited Feb. 20, 2015), *archived at* http://perma.cc/J93D-N8GB.

[101] FUNDS FOR CAUSES, https://www.fundsforcauses.com/org/raisemoney (last visited Feb. 20, 2015), *archived at* http://perma.cc/TCG7-WGZ9.

[102] *But see Teespring 101*, TEESPRING, http://teespring.com/about (last visited Feb. 12, 2015), archived at http://perma.cc/D63Z-XEN2. TeeSpring helps projects raise money by selling custom t-shirts. *See id.* While this is ultimately a form of donation-based funding, the site is directly involved in the sale of merchandise, and so is not a true crowdfunding site.

[103] *See About Us*, *supra* note 100 (explaining why GoFundMe charges a five percent fee).

[104] For example, Kickstarter reports that over 79,000 projects have been successfully funded on its site and that donors have pledged over $1,575,000,000. *Stats*, KICKSTARTER, https://www.kickstarter.com/help/stats?ref=footer (last visited Mar. 6, 2015), *archived at* http://perma.cc/8UFQ-4CUP. The incredible variety of successful fundraising efforts is illustrated by those projects Indiegogo identifies as among its more successful: Ubuntu Edge, developing a smartphone computer, which raised $12,814,216; "An Hour of Code for Every Student," an educational program, which raised $5,022,101; Axent Wear Cat Ear Headphones, which raised $3,335,566; Stone

One stated purpose of the JOBS Act was to allow similar crowdfunding of equity securities, particularly for startup entities.[106] Thus, the title of the JOBS Act is "An Act [t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."[107]

With respect to crowdfunding, the JOBS Act added to the '33 Act a new Section 4(a)(6) to exempt from the registration requirements of the '33 Act the sale of securities by an issuer provided that the aggregate amount of securities sold by the issuer to all investors during the 12 month period prior to the date of the transaction does not exceed $1 million.[108] All sales must take place through an intermediary that is

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Groundbreaking Collaborations (rare beers) which raised $2,532,180; and Lazer Team, a motion picture, which raised $2,480,334. INDIEGOGO, https://www.indiegogo.com/explore?filter_indiegogo_com=true&filter_quick=most_funded (last visited Mar. 6, 2015), *archived at* http://perma.cc/J22S-C6TM.

[105] To provide an analogously functional entity the JOBS Act added the concept of a "funding portal" to the securities laws as a new defined term describing intermediaries. JOBS Act § 304, 15 U.S.C. § 78c(a)(80) (2012). Section 3(a)(80) of the '34 Act now defines a funding portal to be:

> [A]ny person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to Section 4[a](6) of the ['33 Act] . . ., that does not—
>
> (A) offer investment advice or recommendations;
>
> (B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;
>
> (C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
>
> (D) hold, manage, possess, or otherwise handle investor funds or securities; or
>
> (E) engage in such other activities as the Commission, by rule, determines appropriate.

Id. Note that "[t]he JOBS Act inadvertently created two Sections 3(a)(80) of the Securities Exchange Act. Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70741, 78 Fed. Reg. 66,428, 66,458 n. 306 (proposed Nov. 5, 2013).

[106] *See* Sean M. O'Connor, *Crowdfunding's Impact on Start-Up IP Strategy*, 21 GEO. MASON L. REV. 895, 895 (2014); *see also supra* text accompanying note 10.

[107] JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 306 (2012).

[108] JOBS Act § 302(a), 15 U.S.C. § 77d(a)(6) (2012).

required to do some vetting of the issuer.[109] And the aggregate amount of funding by any individual investor is limited based on his or her income and net worth.[110]

The JOBS Act was not self-executing. The SEC was required to issue rules implementing Congress' intent within 270 days and no stock issuances based on the new crowdfunding provisions were permitted until the SEC rules became effective.[111] These SEC obligations were not met.[112] Although the JOBS Act became law on April 5, 2012,[113] the SEC first issued proposed crowdfunding regulations under the JOBS Act on November 5, 2013,[114] which commenced the notice and comment period required before final regulations could become effective.[115] As of March 2015, such regulations have still not become effective.[116] The SEC's release was some 585 double-spaced pages long,[117] and while the SEC said that it sought to strike a balance

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[109] *Id.* § 302(b), 15 U.S.C. § 77d-1 (2012).

[110] If the investor's annual income or net worth (excluding primary residence) is less than $100,000, the limit is "the greater of $2,000 or 5 percent of the annual income or net worth." *Id.* § 302(a), 15 U.S.C. § 77d(a)(6)(B)(i). If the investor's annual income or net worth is more than $100,000, the limit is "10 percent of the annual income or net worth" up to a maximum of $100,000. *Id.*, 15 U.S.C. § 77d(a)(6)(B)(ii).

[111] *Id.* § 302(c); *Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act*, SEC. & EXCH. COMM'N, http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm (last modified Apr. 23, 2012), *archived at* http://perma.cc/2LZS-QS48.

[112] *See supra* text accompanying note 18.

[113] *See supra* text accompanying note 8.

[114] Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70741, 78 Fed. Reg. 66,428, 66,428 (proposed Nov. 5, 2013).

[115] The regulations allowing general solicitation and advertising, mandated under the JOBS Act, became effective on July 24, 2013, although Congress had required them to be issued in 90 days. *See supra* notes 14-17 and accompanying text.

[116] *See* text accompanying note 18.

[117] The official version of the SEC's proposed crowdfunding regulations, published in the Federal Register and formatted into three single-spaced columns, is 176 pages long. *See generally* Crowdfunding, 78 Fed. Reg. 66,428. The unofficial version, which is available through the SEC's website, is double-spaced and formatted as one regular page-width column. *See generally* Crowdfunding, SEC. & EXCH. COMM'N, http://www.sec.gov/rules/proposed/2013/33-9470.pdf (last visited Mar. 16, 2015), *archived at* http://perma.cc/4SPV-MG2W. It appears on 585 pages due to its formatting. *Id*.

between providing flexibility to issuers and investor protection,[118] the rules will be fairly burdensome for the small issuers it is supposed to benefit.[119]

While the exact scope and effectiveness of the proposed rules is beyond the scope of this Article, there are several key points in the proposed regulations. Each offer must be made through a single portal.[120] All communications with prospective investors must be made on that portal in a publicly visible manner, so that potential investors get the benefit of the "wisdom of the crowd."[121] The issuer must make certain filings prior to the offer, including its business plan and financial statements.[122] Financial statements will have to be reviewed or audited by independent accountants for larger offerings[123] and issuers must also disclose directors and current principal shareowners.[124] Issuers must disclose their plan for the use of proceeds and update that information as funds are raised.[125] They will be required to show the risk factors applicable to the issuer and offering.[126] As long as any of the crowdfunded securities are outstanding, issuers will also be required to file annual reports and update much of the original filing material.[127] Finally there are extensive requirements for the portal as

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[118] Crowdfunding, 78 Fed. Reg. at 66,430 ("We understand that these proposed rules, if adopted, could significantly affect the viability of crowdfunding as a capital-raising method for startups and small businesses. Rules that are unduly burdensome could discourage participation in crowdfunding. Rules that are too permissive, however, may increase the risks for individual investors, thereby undermining the facilitation of capital raising for startups and small businesses.").

[119] Indeed, the SEC conservatively estimates that the cost of a $750,000 crowdfunding capital raise under the new rules will be between $77,260 and $152,260. *Id*. at 66,521 & n.918.

[120] *Id.* at 66435-36.

[121] *Id.* at 66437.

[122] *Id.* at 66437-38. There must be a business plan. *Id.* at 66437. Companies without a business plan would not be eligible for crowdfunding under the proposed rules. *Id.*

[123] *Id.* at 66443-44.

[124] *Id.* at 66438. Even apparently small items, like setting forth the number of employees (required by proposed Rule 201(e)) may pose concerns for many startups which operate virtually and may have no full time employees. *Id.* at 66442 & n.137.

[125] *Id.* at 66440-41, 66449-50.

[126] *Id.* at 66442 & n.138.

[127] *Id.* at 66450-52.

well.[128] Although not as burdensome as a full blown registration statement, the hurdles and expense to an issuer for raising money through crowdfunding under the proposed rules are far from trivial. It also remains to be seen whether venture capitalists or other institutional investors will be willing to invest in entities that have previously done equity crowdfunding.[129]

III. State Crowdfunding Efforts

The long delay in the adoption by the SEC of crowdfunding rules, and perhaps the burden associated with the proposed rules, has resulted in the adoption by a number of states of crowdfunding statutes and rules of their own.[130] These state laws attempt to provide a vehicle for small entity crowdfunding entirely apart from the SEC's rules, and have been touted by some as a significant opportunity for small entities.[131]

As of the end of 2014, at least twenty-seven jurisdictions had considered or were considering legislation or regulation authorizing

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[128] *Id.* at 66458-96. The extensive nature of the requirements on the intermediaries is indicated by the new Form Funding Portal mandated by the proposed regulations, which is 32 pages long. *Id.* at 66566.

[129] *See infra* note 197 and accompanying text. Among the concerns institutional investors have expressed to the authors anecdotally is that traditional angel investors and institutional investors understand the risks of an entrepreneurial venture and are far less likely to bring lawsuits than a large number of unsophisticated investors whose expectation of financial return may be unrealistic, and that the administration of a company with a large number of small investors will add unnecessary complexity to its operations. Note that if the number of nonaccredited investors reaches 500, the issuer will also be subject to full reporting requirements. *See* 15 U.S.C. § 78l(g)(1)(A)(ii) (2012).

[130] *See* text accompanying notes 20-21.

[131] *See, e.g.*, Alan McGlade, *5 Reasons Why States Should Seize the Initiative On Crowdfunding*, FORBES (March 14, 2014, 12:02 P.M.), http://www.forbes.com/sites/alanmcglade/2014/03/13/5-reasons-why-states-should-seize-the-initiative-on-crowdfunding/; Solomon, *supra* note 21. *But see generally* Letter from Russ Iuculano, Exec. Dir., N. Am. Sec. Adm'rs Ass'n, Inc., to William T. Pound, Nat'l Conference of State Legislatures (Jan. 17, 2014), *available at* http://www.nasaa.org/wp-content/uploads/2011/08/NASAA-Letter-to-NCSL-on-State-Crowdfunding-Bills-1-17-14.pdf, *archived at* http://perma.cc/625V-WHS2 (pointing out some of the important concerns in state crowdfunding activity).

intrastate state crowdfunding.[132] These laws or regulations had been finally adopted in at least Alabama,[133] the District of Columbia,[134] Georgia,[135] Idaho,[136] Indiana,[137] Kansas,[138] Maine,[139] Maryland,[140] Michigan,[141] Nebraska,[142] Oregon,[143] Tennessee,[144] Texas,[145] Vermont,[146] Washington,[147] and Wisconsin.[148]

Unlike federal securities regulation, most states require a minimum number of purchasers before their registration rules apply at all, so offerings to fewer than that number of purchasers can be made without registration and without the need to use the applicable state crowdfunding rules.[149] These exclusions vary widely[150] and each state's

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[132] *See generally Intrastate Crowdfunding Legislation*, N. AM. SEC. ADM'RS ASS'N (Dec. 30, 2014), http://www.nasaa.org/wp-content/uploads/2014/01/NASAA-Crowdfunding-Index-12-30-2014.pdf, *archived at* http://perma.cc/BS4Y-GRR3.

[133] ALA. CODE § 8-6-11(a)(14) (2014).

[134] D.C. MUN. REGS. tit. 26, § 250 (2015).

[135] GA. COMP. R. & REGS. 590-4-2-.08 (2014).

[136] *See generally* Treasure Valley Angel Fund, LLC, Docket No. 2012-7-02 (Idaho Dep't of Fin. Jan. 20, 2012), *available at* http://www.finance.idaho.gov/securities/Actions/Administrative/2012/2012-7-02.pdf, *archived at* http://perma.cc/QK4D-Z66P.

[137] IND. CODE § 23-19-2-2(24q) (2014).

[138] KAN. ADMIN. REGS. § 81-5-21 (2014); *see also* Special Order—Authorizing Certain Modifications of Conditions for the Invest Kansas Exemption, "IKE", Under K.A.R. 81-5-21, Docket No. 13E024 (Kan. Sec. Comm'r June 21, 2013), *available at* http://ksc.ks.gov/DocumentCenter/View/227, *archived at* http://perma.cc/EM9K-MVVV. That order adds a requirement that "all persons responsible for the management of the operations or property of the issuer are residents of Kansas," which means that even offers which would be deemed intrastate under Rule 147 might not qualify if a single manager of the issuer lived in another state—even if she commuted to Kansas. Special Order—Authorizing Certain Modifications of Conditions for the Invest Kansas Exemption, *supra*.

[139] 02-032-523 ME. CODE R. §§ 1-8 (LexisNexis 2015).

[140] MD. CODE ANN., CORPS. & ASS'NS § 11-601(16) (LexisNexis 2014).

[141] MICH. COMP. LAWS § 451.2202a (2014).

[142] NEB. REV. STAT. § 8-1111(23) (2014).

[143] OR. ADMIN. R. 441-035-0070 to -0230 (2014).

[144] TENN. CODE ANN. §§ 48-1-103(a)(13)(A) (2014).

[145] 7 TEX. ADMIN. CODE § 139.25 (2014).

[146] 21-030-007 VT. CODE R. § S-2014-1 (2014).

[147] WASH. REV. CODE § 21.20.880 (2015).

[148] WIS. STAT. § 551.202(26) (2014).

[149] *See infra* note 150.

law must be examined to determine whether it covers a particular offering, whether registration would be required, and then whether an available crowdfunding provision would apply. As in federal securities regulation,[151] in all cases states retain the overarching liability of issuers for securities fraud even for transactions exempt from registration.[152]

Like the minimum-number-of-purchasers exemption, there is considerable variation among the state crowdfunding rules which have been adopted. Table 1 at the end of this Article summarizes several of the important variations. These include caps on the total amount that may be raised, caps on the size of individual investments, filing and audit requirements, and requirements applicable to portals or other intermediaries.[153]

IV. The Interplay of State Crowdfunding Laws and the Federal Securities Laws

As mentioned above, the regulatory scheme applicable to securities is at both the state and federal levels, subject to preemption of state law in the few cases where Congress has chosen to exercise its

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[150] For example, Massachusetts exempts any offer to less than 25 Massachusetts offerees if the seller believes they are purchasing for investment. MASS. GEN. LAWS ch. 110A, § 402(b)(9) (2011). New Jersey exempts sales to no more than 10 New Jersey purchasers. N.J. STAT. ANN. § 49:3-50(b)(9) (West 2001). Illinois exempts any offer as long as there are not more than $1 million in sales to not more than 35 Illinois residents in a 12-month period and there has been no advertising or general solicitation. 815 ILL. COMP. STAT. 5/4(G) (2008). North Carolina exempts transactions where there are not more than 25 offerees in the state over 12 consecutive months, if the seller reasonably believes they are purchasing for investment. N.C. GEN. STAT. § 78A-17 (2013). In each case, there are also general overriding conditions that will determine if an offering is permissible without registration and whether the exemptions are self-executing or require filing or approval.

[151] *See Small Business and the SEC: A Guide for Small Businesses on Raising Capital and Complying with the Federal Securities Laws*, *supra* note 44 ("[A]ll securities transactions, even exempt transactions, are subject to the antifraud provisions of the federal securities laws. This means that you and your company will be responsible for false or misleading statements that you or others on your behalf make regarding your company, the securities offered, or the offering. You and your company are responsible for any such statements, whether made by your company or on behalf of the company, and regardless of whether they are made orally or in writing.").

[152] *E.g.*, 21-030-007 VT. CODE R. § S-2014-1 (2014).

[153] *See infra* Table 1.

preemptive powers .[154] Such preemption is most notably contained in Rule 506 of Reg. D, the exemption relied upon in much small entity fundraising.[155] But the reverse is not the case. Complying with state requirements does not provide automatic exemption from federal securities laws.[156] Only if there is a specific federal exemption is the offering governed only by state blue sky laws.[157]

Accordingly, almost all of these state provisions expressly or implicitly require that crowdfunded offerings covered by their laws be exempt under Section 3(a)(11) of the '33 Act and Rule 147.[158] This suggests that noncompliance with Rule 147 defines the maximum scope of the exemption in these states, whereas the nature of a safe harbor rule is normally that it is possible to comply with the statute even if there is not compliance with rule.[159] One state, Maine, has taken a different approach, relying in its statute on Rule 504 of Reg. D.[160] The remainder of this Article will address the pros and cons of these two different approaches and the degree to which either can be expected to meet the goals espoused for them.

A. The Intrastate Exemption

The intrastate exemption is a relatively thin reed. In the words of the SEC, "[t]he legislative history of [Section 3(a)(11)] suggests that the exemption was intended to apply only to issues genuinely local in character, which in reality represent local financing by local industries, carried out through local investment."[161]

As noted previously, Section 3(a)(11) only provides an exemption from registration for "[a]ny security which is a part of an issue *offered and sold only to persons resident within a single State or Territory*, where the *issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing*

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[154] *See supra* text accompanying notes 22-37.
[155] 17 C.F.R. § 230.506 (2014).
[156] Except, of course, where the state statute specifically requires compliance with the federal exemption provision.
[157] *See supra* notes 80-82 and accompanying text.
[158] *E.g.*, GA. COMP. R. & REGS. 590-4-2-.08(1)(b) (2014).
[159] *See supra* text accompanying notes 58-83. Among the effects of this construction would be the requirement that the issuer comply with the eighty percent provisions of the rule rather than the more general "doing business" aspects of the statute. *See infra* notes 162-65.
[160] *See* ME. REV. STAT. tit. 32, §16304(6-A) (2014).
[161] 17 C.F.R. § 230.147 (2014) (Preliminary Notes).

business within, such State or Territory."[162] Accordingly, the exemption applies narrowly and only does so if: (1) all the purchasers are from the state in question; (2) all the offerees are from the state in question; and (3) the issuer is a resident of and doing business within the state in question.[163] Moreover, under Rule 147, for the issuer to be deemed a resident of and doing business within the state in question it must: (1) be incorporated[164] in that state; (2) have its principal place of business in the state, as evidenced by the fact that at least 80% of its assets and at least 80% of its revenues are in-state; and (3) use at least 80% of the proceeds of the issue within the state.[165] In addition, depending on the circumstances, different offerings may be "integrated" and counted as one offering for the purpose of the exemption[166] and

> 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 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.[167]

Because of the narrowness of the intrastate exemption, and because offerings that are exempt under Section 3(a)(11) would still be subject to state blue sky regulation, historically the intrastate exemption has not proved to be a significant tool for facilitating financing of small businesses.[168] How then would it work for crowdfunding under state crowdfunding statutes?

For a crowdfunded offering, the intrastate exemption is generally far less useful than might appear. An examination of each of

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[162] 15 U.S.C. § 77c(a)(11) (2012) (emphasis added).
[163] *Id.*
[164] The SEC has by regulation also applied this requirement to LLC's and other non-corporate entities. 17 C.F.R. § 230.147(c)(1) (2014).
[165] 17 C.F.R. § 230.147(c)(2) (2014).
[166] 17 C.F.R. § 230.147 (Preliminary Notes); *see also infra* note 192 and accompanying text.
[167] 17 C.F.R. § 230.147(d)(3) (2014).
[168] *See supra* text accompanying notes 84-87. In fact, it is probable that many financings that historically would qualify as intrastate offerings under Section 3(a)(11) would also have not been deemed to be public offerings, and therefore also exempt under Section 4(a)(2), 15 U.S.C. § 77d(a)(2) (2012).

the requirements shows why that is so. Although some of the requirements of Section 3(a)(11) and Rule 147 should not prove to be too troublesome to those seeking to do an intrastate crowdfunded offering, others will be substantially harder, if not impossible, to meet. This later group includes the offeree, purchaser, and issuer requirements as well as the integration rules, the number of possible purchasers, and the rules applicable to portals. We will discuss each in turn.

B. Offeree Requirements

An intrastate offering requires that not only every purchaser, but every offeree, be resident in the state in question.[169] This precludes any financing where funding is sought, even if perhaps unintentionally, from out-of-state investors.[170] Indeed, if there is a single *offeree* outside the issuer's state, whether or not the offeree actually invests, the intrastate offering exemption does not apply.[171] "Offer" is defined broadly in the '33 Act as including "*every* attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."[172]

The SEC staff has given an interpretation that appears helpful to intrastate crowdfunding, stating that use of a third party Internet portal in accordance with a state statute or regulation would be permissible as an intrastate offering, but with critical provisos.[173] There must be adequate measures to assure that the *offer* is not made to persons outside the state, it must be in accordance with a state statute or regulation, and it must comply in all other aspects with Rule 147.[174]

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[169] *See supra* note 86 and accompanying text.
[170] *See supra* note 86 and accompanying text.
[171] 15 U.S.C. § 77c(a)(11) (2012).
[172] 15 U.S.C. § 77b(a)(3) (2012) (emphasis added).
[173] *Securities Act Rules: Questions and Answers of General Applicability*, SEC. & EXCH. COMM'N (last updated Jan. 23, 2015), http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm#141-04, *archived at* http://perma.cc/7SNG-8US7.
[174] According to the SEC staff:

> Question: An issuer plans to use a third-party Internet portal to promote an offering to residents of a single state in accordance with a state statute or regulation intended to enable securities crowdfunding within that state. Assuming the issuer met the other conditions of Rule 147, could it rely on Rule 147 for an exemption from Securities Act registration for the offering, or would use of an Internet portal

But even this administrative interpretation, which is less authoritative than action by the SEC or a court, leaves many unanswered questions, particularly in light of the broad definition of an offer under the '33 Act.[175]

The very nature of a crowdfunded offering—that is an offering posted on the Internet— raises real questions as to whether it does, or possibly could, comply with such a limiting restriction. Would allowing geographically unscreened access to a portal which includes pages for specific offerings be deemed an "offer?" Or would it be deemed sufficient to screen access[176] only to specific pages for a particular intrastate offering? What, if any, means of verification must a portal use to determine if a browsing party, likely to be deemed an offeree, complies with other Rule 147 requirements?[177]

> necessarily entail making offers to persons outside the relevant state or territory?
>
> Answer: Use of the Internet would not be incompatible with a claim of exemption under Rule 147 if the portal implements adequate measures so that offers of securities are made only to persons resident in the relevant state or territory. In the context of an offering conducted in accordance with state crowdfunding requirements, such measures would include, at a minimum, disclaimers and restrictive legends making it clear that the offering is limited to residents of the relevant state under applicable law, and limiting access to information about specific investment opportunities to persons who confirm they are residents of the relevant state (for example, by providing a representation as to residence or in-state residence information, such as a zip code or residence address). Of course, any issuer seeking to rely on Rule 147 for the offering also would have to meet all the other conditions of Rule 147.

Id.

[175] *See supra* note 172 and accompanying text.

[176] Presumably such screening could be done either by the viewer's IP address, a location question directed to the viewer, or both. *See supra* note 174. But the former is by no means a perfect screen—for example, it is not able to screen users of public or semi-public Wi-Fi systems, and it only tells the location of the device on which the viewing is done, not the residence of the viewer. Both methods may also raise user privacy concerns.

[177] Note that if the offeree is an entity, then if it is organized for the specific purpose of investing in the issue, all beneficial owners must be residents of the state to qualify it as a resident for purposes of Rule 147. *See supra* note 167 and accompanying text.

C. Purchaser Requirements

In addition to offerees, every purchaser must be a resident of the state in question for the offering to qualify for the intrastate exemption.[178] But what is the standard used to determine if there is an improper sale? Traditional exempt sales under Reg. D only required that the issuer have a reasonable belief that a purchaser was an accredited investor and thus eligible for the exemption.[179] But the SEC has substantially tightened the verification requirements for "exempt" offerings under Reg. D that use advertising or general solicitation.[180] In the case of an intrastate crowdfunded offering under Rule 147, what steps must an issuer take to verify the residence of the purchaser? There is no SEC rule directly on point, but the analogous provision under Reg. D for all-accredited investor Rule 506 offerings that use general solicitation requires a fairly detailed verification process with relatively intrusive information requirements.[181] Even if one assumes that the verification requirements for an intrastate crowdfunding would not be as onerous, an assumption which may or may not bear out in reality, it is easily foreseeable that prospective investors on a crowdfunding site may be reluctant to comply with even a modestly intrusive information requirement.

The analysis is even more complex if the purchaser is an entity, because in the case of an entity organized for the specific purpose of investing in the issue, all beneficial owners must be residents of the state to qualify it as a resident for purposes of Rule 147.[182] And, what are the consequences if the issuer can be reasonably certain of the verification steps to take and takes such steps, but then turns out to be wrong? Is there strict liability?

The limitation that all purchasers be residents of the state in question may also pose an important practical hurdle. Especially in less populous or less prosperous states, a startup may be far less likely

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[178] *See supra* note 86 and accompanying text. As noted earlier, states may impose standards that are even stricter. *See, e.g.*, *supra* note 138. Kansas, for example, in its intrastate crowdfunding rule requires "all persons responsible for management of the operations or property of the issuer are residents of Kansas." *See supra* note 138.

[179] 17 C.F.R. § 230.506(b)(2)(ii) (2014); *see also supra* 20.

[180] 17 C.F.R. § 230.506(c)(2)(ii) (2014; *see also supra* 20.

[181] *Id.*

[182] *See supra* note 167 and accompanying text.

to meet its initial financing goals if it can only seek to raise money from residents of its home state.

D. Issuer Requirements

To qualify under Section 3(a)(11), an issuer must be a resident of and doing business in the state in question.[183] Rule 147 further interprets this requirement such that an issuer is only resident in a state if that state is (1) the state of issuer's incorporation, (2) the location of 80% of its revenues, (3) the location of 80% of its assets, *and* (4) the state where 80% of the proceeds of the investment will be used.[184] Taken separately, each of these criteria may be sufficient to make the intrastate exemption unavailable for a typical startup that might use crowdfunding. Taken together they severely narrow the possible use of the intrastate exemption.

It is not uncommon for a startup to be incorporated in a state other than where it is physically located. Regardless of where they may have their places of business, Delaware is a common state of incorporation for startups.[185] The reasons for this are many and include that Delaware is perceived as being a good state in which to incorporate,[186] that Delaware corporate law is in fact advantageous and easy to use,[187] that many venture capital funds will only invest in Delaware corporations,[188] and that other states have provisions which inhibit the startup process.[189] Intrastate crowdfunding would be unavailable to any startup incorporated in Delaware but located

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[183] *See supra* notes 162-63 and accompanying text.

[184] 17 C.F.R. § 230.147(c)(2) (2014); *see also supra* note 87, notes 164-65 and accompanying text.

[185] *See generally* LEWIS S. BLACK, WHY CORPORATIONS CHOOSE DELAWARE (2007), *available at* http://corp.delaware.gov/pdfs/whycorporations_english.pdf, *archived at* http://perma.cc/5SSF-FSH2.

[186] *See id.* at 1.

[187] *See id.* at 2-3.

[188] *See* Christopher W. Cole, *Financing an Entrepreneurial Venture: Navigating the Maze of Corporate, Securities, and Tax Law*, 78 UMKC L. REV. 473, 500-01 (2009).

[189] *See, e.g.*, N.Y. BUS. CORP. LAW § 630 (McKinney 2014) (imposing liability under certain circumstances for employee wages on the ten largest shareholders of a corporation); *see also* Depperman v. Chenango Valley Pet Foods, Inc., 201 A.D.2d 936, 936 (N.Y. App. Div. 1994); THERESE H. MAYNARD & DANA M. WARREN, BUSINESS PLANNING: FINANCING THE START-UP BUSINESS AND VENTURE CAPITAL FINANCING 269-70 (2d ed. 2014).

elsewhere.[190] Whether or not this would be an insuperable obstacle, as it could be argued that the availability of financing might be enough to persuade some startups to incorporate in their home state, is possibly open to debate. But it would surely preclude a fairly large number of startups from utilizing the intrastate exemption.

The percentage of assets, revenues, and use of proceeds requirements will also be difficult, or impossible, for most startups to meet. While very local companies[191] may meet these standards, the most attractive and successful startups, and those likely to provide substantial employment, are those with large market potential, and it is far less likely that 80% of any such market would be in one state. Except at the pre-revenue stage, it is highly improbable that a startup will have 80% of its revenues within its home state and keep 80% of its assets there. This is particularly true of Internet, mobile device applications, and other computer related startups, but it is also true of those in medical and other fields as well. Moreover, the requirement that 80% of the proceeds be spent in the domicile state is similarly unrealistic for many startups that today may well be virtual or partially virtual companies with employees and contractors geographically scattered.

E. Integration rules

Rule 147 contains strict rules on integration of offerings.[192] Under these rules, an offering cannot qualify for the Rule 147 safe

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[190] *See supra* note 87, notes 164-65 and accompanying text.

[191] The companies most likely to benefit from this provision are those of such a nature that it is relatively unlikely that they would be candidates for a successful liquidity event (such as an acquisition or initial public offering). These types of companies are unattractive investment vehicles as investors have little or no means of realizing a return on their investment. Among other things, it is unlikely that there will be a readily available market for their shares.

[192] Rule 147 provides in pertinent part :

> All offers, offers to sell, offers for sale, and sales which are part of the same issue must meet all of the conditions of Rule 147 for the rule to be available. The determination whether offers, offers to sell, offers for sale and sales of securities are part of the same issue (i.e., are deemed to be integrated) will continue to be a question of fact and will depend on the particular circumstances. See Securities Act of 1933 Release No. 4434 (December 6, 1961) (26 FR

harbor if it is deemed integrated with any non-qualifying offer.[193] This is a factual question which considers various factors, such as whether both of the "offerings" are part of the same "plan of financing," occur at the same general time, and occur "for the same general purpose."[194]

This integration provision can prove problematic for a startup company. If there are sales of the same kind of security (e.g., common stock) to an out-of-state purchaser, does it preclude crowdfunding under the intrastate exemption for the next six months? If there is a crowdfunding for cash for working capital, does that mean that the issuer cannot seek to raise working capital for at least six months after the completion of the crowdfunding unless it is intrastate? Would the other transaction be deemed integrated even if it qualified under a different exemption from federal securities laws, such as Rule 506? In the area of securities laws, uncertainty makes both issuers and investors

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> 9158). Securities Act Release No. 4434 indicated that in determining whether offers and sales should be regarded as part of the same issue and thus should be integrated *any one* or more *of the following factors may be determinative*:
>
> (i) Are the offerings part of a single plan of financing;
>
> (ii) Do the offerings involve issuance of the same class of securities;
>
> (iii) Are the offerings made at or about the same time;
>
> (iv) Is the same type of consideration to be received; and
>
> (v) Are the offerings made for the same general purpose.

17 C.F.R. § 230.147 (2014) (Preliminary Notes) (emphasis added).
The only issuances that expressly are not so integrated are those which are part of

> offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemption provided by section 3 or section 4(a)(2) of the ['33] Act or pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, offers for sale or sales pursuant to this rule [147], Provided, That, there are during either of said six month periods no offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

17 C.F.R. § 230.147(a)(3) (2014).

[193] *See supra* note 192.

[194] 17 C.F.R. § 230.147 (Preliminary Notes).

reluctant to rely on a process that might subject them to liability or risk, and uncertainties such as those mentioned certainly qualify.[195]

F. The number of possible purchasers

Intrastate crowdfunding may produce a large number of shareholders. This may be because there is a relatively small cap on the amount each investor can invest.[196] It may also occur when, because of the requirement that all offerees and purchasers are restricted to one state, the issuer is unable to find a sufficient number of investors willing to invest at the cap and must look to many more smaller investors.

Obviously, a large number of shareholders is unattractive administratively for a startup. Such things as investor relations, management of the stock ledger, shareholder action and meetings, and so on increase in cost and effort as the number of shareholders increases. It may also discourage subsequent investors, particularly venture capital funds.[197]

If the number of purchasers is large enough, it also raises an issue of compliance with the '34 Act. Unlike the proposed Regulation Crowdfunding,[198] Rule 147[199] makes clear that neither it nor Section 3(a)(11) provides any exemption at all from Section 12(g) of the '34 Act, 15 U.S.C. § 78l(g) (2012). Section 12(g)(1)(A)(ii) of the '34 Act, 15 U.S.C. § 78l(g)(1)(A)(ii), requires any issuer with more than 499 non-accredited shareholders and more than $10,000,000 in assets to comply with federal reporting requirements.[200] In essence, a company

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[195] *Cf.* Cole, *supra* note 188, at 500-01 (explaining that one of the reasons that venture capital firms prefer to invest in companies organized in Delaware is the "high certainty level surrounding corporate governance" in that state).

[196] *See* JOBS Act § 302(a), 15 U.S.C. 77d(a)(6) (2012).

[197] *See* Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOs*, 2015 U. ILL. L. REV. 217, 258 (2015).

[198] Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70741, 78 Fed. Reg. 66,428, 66,497-98 (proposed Nov. 5, 2013).

[199] 17 C.F.R. § 230.147 (Preliminary Notes).

[200] Reporting requirements are also triggered when the total number of shareholders of any class of security reaches 2000, regardless of whether they are accredited. 15 U.S.C. § 78l(g)(1)(A)(i). It should be noted that under the JOBS Act this provision is modified to exclude purchasers in a federal crowdfunding offer from the shareholder cap. *See* JOBS Act § 303(a), 15 U.S.C. § 78l(g)(6). However, this provision will only become effective when the SEC issues implementing regulations. *See id*. Nonetheless, even when

meeting those requirements becomes a public company without having an initial public offering. We have previously noted the great cost of compliance after an initial public offering, estimated by the SEC to be $1.5 million per year.[201] The potential for this to happen by accident, and to occur without the benefit of an underwriter supported public market for the shares, may well be reasonably perceived by the issuer, not to mention larger investors, as very undesirable.

G. Intermediaries

The proposed federal crowdfunding regulation requires the use of a portal.[202] State rules vary as to what, if any, intermediary is required.[203] While the federal rule preemptively addresses the status of such an intermediary as a broker-dealer,[204] the state rule cannot do so, since the status of an intermediary will remain governed by federal law. The question is thus presented: if an intermediary is used (either voluntarily or under state law requirement), must the intermediary be a registered broker-dealer under either or both of federal and state law?[205]

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effective, this exemption applies only to sales made under new Section 4(a)(6), and would not apply to sales under state crowdfunding. *See id.*

[201] *See supra* note 44.

[202] *See supra* note 105, text accompanying notes 120-121.

[203] *See infra* Table 1.

[204] JOBS Act § 304(a), 15 U.S.C. § 78c(h) (2012).

[205] Only registered broker-dealers may "effect" a securities transaction. *See* 15 U.S.C. §78c(a)(4) (2012). For SEC purposes, almost anything more than providing contact information can be considered as effecting a securities transaction. For example any of the following activities are considered to require the intermediary to register: recommending a company or the purchase of its securities; negotiating the terms of a transaction or involvement in such negotiations; attending meetings where the merits are discussed; providing valuations or estimates of value; or performing or accommodating due diligence efforts. *See, e.g.*, May-Pac Management Co., SEC No-Action Letter, 1973 WL 10806 (Dec. 20, 1973). In particular, the intermediary receiving transaction-based compensation has been identified as a critical measure of whether registration is required. *See* Richard S. Appel, SEC No-Action Letter, 1983 WL 30911 (Feb. 14, 1983); AM. BAR ASS'N, REPORT AND RECOMMENDATIONS OF THE TASK FORCE ON PRIVATE PLACEMENT BROKER-DEALERS 29-30 (2007). These rules have not been tested in an otherwise wholly intrastate transaction or in the context of the crowdfunding regulations, although the SEC describes the intrastate exemption for broker-dealers as "very narrow." *See infra* note 209.

The scope of activities that is required of the intermediary under the proposed SEC crowdfunding regulations would almost certainly be enough to subject the portal to registration as a broker-dealer under current broker-dealer rules.[206] If a state requires similar activity by the intermediary, it would almost certainly thereby subject the intermediary to required SEC registration.[207] Even if not required by state law, a portal whose activities fell within those of a broker-dealer under federal law similarly would be subject to SEC registration.[208]

While the SEC has recognized an intrastate exemption for broker-dealers, it characterizes the exception as "very narrow," and in any event, the intermediary might well have to register under state rules.[209] And state mandated rules for intermediaries that were comparable to those under the JOBS Act would likely subject those intermediaries to full broker-dealer registration, without the benefit of the "tailoring" that the SEC has proposed for crowdfunding portals.[210]

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[206] "Because a funding portal would be engaged in the business of effecting securities transactions for the accounts of others through crowdfunding, it would meet the Exchange Act definition of broker." Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70741, 78 Fed. Reg. 66,428, 66,458 (proposed Nov. 5, 2013). Nonetheless, the proposed regulations impose requirements on a portal that the SEC has characterized as "tailored to the limited brokerage activities in which funding portals may engage." *Id.* at 66458 n.309.

[207] *See supra* note 205.

[208] *See supra* note 204.

[209] "A broker-dealer that conducts all of its business in one state does not have to register with the SEC. (State registration is another matter. . . .) The exception provided for intrastate broker-dealer activity is very narrow. To qualify, *all aspects of all transactions* must be done within the borders of one state. This means that, without SEC registration, a broker-dealer cannot participate in any transaction executed on a national securities exchange or Nasdaq. Also, information posted on the Internet that is accessible by persons in another state would be considered an interstate offer of securities or investment services that would require Federal broker-dealer registration." *Guide to Broker-Dealer Registration*, SEC. & EXCH. COMM'N (April 2008), http://www.sec.gov/divisions/marketreg/bdguide.htm (emphasis added), *archived at* http://perma.cc/U3QU-H3S4.

[210] *See supra* note 206.

H. The Maine Approach

Uniquely thus far, Maine has based its crowdfunding approach on an entirely different basis from other states. Rather than rely on the intrastate exemption, Maine bases its crowdfunding rules on the exemption provided by Rule 504 under Regulation D.[211] Rule 504 exempts the offer and sale of up to $1,000,000 of securities in a 12-month period.[212] There are no specific disclosure requirements[213] and offerees need not meet the standards of financial sophistication or accredited status required under other parts of Reg. D. Key restrictions normally applicable to Rule 504 offerings are that the issuer "may not use general solicitation or advertising to market the securities, and purchasers generally receive 'restricted securities,'" which may not be

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[211] 17 C.F.R. § 230.504 (2014). Maine's rule does not prescribe use of a particular crowdfunding method, and specifically does not require use of a single portal similar to that required under the proposed SEC rules. *See* ME. REV. STAT. tit. 32, §16304(6-A) (2015); 02-032-523 ME. CODE R. §§ 1-8 (LexisNexis 2015).

[212] 17 C.F.R. § 230.504(b)(2). The exemption is not available to companies that have no specific business plan or to companies required to report under SEC rules, 17 C.F.R. § 230.504(a), and sales under Rule 504 must be aggregated with any Rule 505 sales in the same twelve-month period. 17 C.F.R. § 230.504(b)(2).

[213] While no specific form of disclosure is required under Rule 504, issuers must still comply with the general antifraud provisions of the securities laws, which require disclosure of material information. For an example of such an antifraud provision, see 17 CFR §240.10b-5, which provides:

> Employment of manipulative and deceptive devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b)To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

resold except based on either SEC registration or another exemption.[214] However, Rule 504(b)(1) in addition provides as follows:

> To qualify for exemption under this § 230.504, offers and sales must satisfy the terms and conditions of §§ 230.501 and 230.502 (a), (c) and (d), except that the provisions of § 230.502 (c) and (d) will not apply to offers and sales of securities under this § 230.504 that are made:
>
> (i) Exclusively 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 are made in accordance with those state provisions;
>
> (ii) In one or more states that have no provision for the registration of the securities or the public filing or delivery of a disclosure document before sale, if the securities have been registered in at least one state that provides for such registration, public filing and delivery before sale, offers and sales are made in that state in accordance with such provisions, and the disclosure document is delivered before sale to all purchasers (including those in the states that have no such procedure) . . . .[215]

Thus, the prohibition on general solicitation and advertising does not apply, and investors receive non-restricted securities if the offering is sold in accordance with a state law that requires the public filing and delivery to investors of a substantive disclosure document.[216]

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[214] *Small Business and the SEC: A Guide for Small Businesses on Raising Capital and Complying with the Federal Securities Laws*, *supra* note 44.

[215] 17 C.F.R. §§ 230.504(b)(1)(i)-(ii). In order to comply with this provision both the offers and sales must be made exclusively in one or more states that provide for such registration, so this approach could not accomplish addressing a nationwide market unless every state adopted essentially the same provision. Moreover, in the event an issuer wishes to use internet crowdfunding, it would presumably be required to limit the offerees to residents of the applicable state or states. *See Securities Act Rules: Questions and Answers of General Applicability*, *supra* note 173 and accompanying text.

[216] 17 C.F.R. §§ 230.504(b)(1)(i)-(ii). It should be noted that Rule 504 specifically requires a "substantive" disclosure document to qualify for the state exemption under Rule 504(b)(1)(i). 17 C.F.R. §§ 230.504(b)(1)(i). Whether

Moreover, if the issuer sells in accordance with a state law that requires registration and disclosure document delivery it may also sell in a state without those requirements, provided that it delivers to all purchasers the disclosure documents mandated by a state in which it registered.[217]

Maine therefore crafted its rules to provide a vastly simplified form of registration and disclosure statement, which it believes satisfies Rule 504.[218] Maine provides by statute for a short form registration statement that is intended to comply with the Rule 504(b)(1) requirements,[219] and the administrator has prescribed a form that is intended to be able to be completed with minimal administrative burden to the issuer.[220]

Whether the Maine statute overcomes the obstacles that apply to state crowdfunding statutes that rely on the intrastate exemption, of course, remains to be seen. The Maine procedure has not been tested either in the courts or before the SEC, having become effective only on January 1, 2015.[221] However, there are at least three aspects of Rule 504 that may cause concern even to the Maine-type approach.[222] The

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Maine's simplified disclosure meets this requirement has not been tested. *See infra* notes 218-20 and accompanying text.

[217] 17 C.F.R. §§ 230.504(b)(1)(ii); *see also Small Business and the SEC: A Guide for Small Businesses on Raising Capital and Complying with the Federal Securities Laws*, *supra* note 44.

[218] In the words of the Maine Office of Securities,

> The purpose of this rule is to facilitate public investment in small businesses. The rule accomplishes this purpose by (a) permitting the use of a simplified registration statement form for smaller offerings and (b) promoting uniformity with other jurisdictions that require the registration of securities.

02-032-523 ME. CODE R. §§ 1-8 (LexisNexis 2015).

[219] ME. REV. STAT. tit. 32, §16304(6-A) (2015).

[220] 02-032-523 ME. CODE R. § 5 (LexisNexis 2015); *Fund-ME Short-Form Seed Capital Registration Filing Checklist*, ME. OFFICE OF SEC., http://www.maine.gov/pfr/securities/Crowdfunding/Seed_Capital_Cover_Sheet_Fillable.pdf (last visited Mar. 20, 2015), *archived at* http://perma.cc/83Z2-W5PW.

[221] *Office of Securities*, ME. OFFICE OF SEC., http://www.maine.gov/pfr/securities/index.shtml (last visited Mar. 20, 2015), *archived at* http://perma.cc/WZ4D-ZWYC.

[222] Note that in addition to these three aspects, there is also a $1 million cap on Rule 504 offerings in any twelve-month period. 17 C.F.R. § 230.504(b)(2) (2014). Whether this amount is sufficient operating cash for any particular startup depends of course on the nature of the startup. However, this limitation is not lower than the similar limitations in other crowdfunding statutes,

first is the requirement in Rule 504(b)(1)(i) that the offers and sales be "*[e]xclusively* in one or more states . . . ."[223] The second is the requirement in that same subsection of Rule 504 that the state procedure "require the public filing and delivery to investors of a *substantive disclosure document* before sale . . . ."[224] The third aspect arises if an intermediary is used and is analogous to the concerns discussed above in the context of the intrastate exemption.[225]

Unfortunately, there is little guidance on either of the first two of these issues. With respect to the first (the geographic requirement), Rule 504(b) is in one respect difficult to parse. It is at least arguable that Rule 504(b), as a threshold condition of applicability, requires that there be offers and sales confined in at least the first instance to "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 are made in accordance with those state provisions."[226] Or to put the question more simply: does Rule 504 require that there actually be *bona fide* offers and sales *exclusively* in the initial registering state or states (e.g., Maine) before offers and sales can be made pursuant to Rule 504(b)(1)(ii)[227] in states that do not have such a registration process? And if the offer is made through internet-based crowdfunding, what steps are needed to avoid the very first offer being deemed to constitute an offer outside the original state?[228] Or, can you register in one state without offers and sales in that state and then sell in other states? It must be admitted that this question is to some extent theoretical since there are, to the authors' knowledge, only two jurisdictions that do not require registration and thus fit the description in Rule 504(b)(1)(ii).[229]

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including the JOBS Act. *See supra* note 108 and accompanying text. And mitigating this limitation is that Rule 506 offerings are not aggregated with Rule 504 offerings and thus an entity taking advantage of the Maine rule will not be precluded from additional financing based on the Rule 506 exemption. *See* 17 C.F.R. § 230.504(b)(2).

[223] 17 C.F.R. § 230.504(b)(1)(i) (2014) (emphasis added).

[224] *Id.* (emphasis added).

[225] *See supra* text accompanying notes 202-08.

[226] 17 C.F.R. § 230.504(b)(1)(i); *see also* 17 C.F.R. § 230.504(b)(1)(ii) (2014).

[227] 17 C.F.R. § 230.504(b)(1)(ii).

[228] *See supra* note 209, notes 169-77 and accompanying text.

[229] The two jurisdictions are New York and the District of Columbia. *See* Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7644, 64 Fed. Reg. 11,090, 11,090 n.12 (Mar. 8, 1999).

Having said that, however, Rule 504 is clear and unambiguous that offers and sales in states with a registration process must be in accordance with such processes or they will not be exempt under Rule 504(b)(1)(i).[230] In other words, a registration in one state will not be the basis of an exemption under Rule 504 for offers or sales in another state if that other state has a registration process.[231] Thus, for an issuance of securities to be to be exempt under Rule 504 (b)(1)(i) and (ii)[232] no offer or sale can be made in any state where there is a registration process unless there is compliance with that process.

But, as we have previously discussed with respect to the intrastate exemption, crowdfunded offerings on the internet raise issues as to where the offers and/or sales are deemed to have been made.[233] If and to the extent the intrastate exemption requirements pertaining to the location of offers and sales are incorporated into Rule 504, the efficacy of the Maine approach may be similarly encumbered.

With respect to the second requirement (the substantive disclosure document), a bit of the history of Rule 504 may be instructive. The Rule 504 exemption for state registered securities resulted from perceived abuse of Rule 504 by promoters of microcap investments, particularly with the growth of the internet.[234] Prior to 1992 Rule 504 exempted public and private offerings under $1 million if registered with a state.[235] Offerings under $500,000 were exempt from the restriction on general solicitation and advertising.[236] In 1992 the SEC liberalized the rules to eliminate all restriction on advertising or resale of Rule 504 offerings.[237] When a secondary market developed in what had been expected to be largely private offerings, including abuses described as "pump and dump" schemes, the SEC revised the rules in 1999 to reinstate the restricted status of shares and prohibit general solicitation and advertising except in cases where there was a publicly available state registration and review.[238] In doing so, the SEC observed "[i]n adopting this reform, we [the SEC] note that the state

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[230] 17 C.F.R. § 230.504(b)(1)(i).
[231] *See id*.
[232] 17 C.F.R. §§ 230.504(b)(1)(i)-(ii).
[233] *See supra* note 209, notes 169-77 and accompanying text.
[234] Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, 64 Fed. Reg. at 11,090-91.
[235] *Id.* at 11,092.
[236] *Id.*
[237] *Id.*
[238] *Id.* at 11,092-93.

registration and review system is generally comprehensive."[239] It also noted in that release that the disclosure document "must provide substantive disclosure to investors, including the business and financial condition of the issuer (including financial statements), the risks of the offering, a description of the securities, and the plan of distribution."[240] The release indicated that, as an example, a form U-7 (Small Company Offering Registration) would satisfy this requirement.[241] It remains to be seen if the Maine disclosure form[242] will meet this test and be acceptable to the SEC.

Finally, as noted above, use of an intermediary or other portal will run into the same issues in Maine as would be the case in states with crowdfunding based on the intrastate exemption.[243] Intermediaries will, in most if not all cases, have to comply with SEC rules for broker-dealers.[244]

V. Conclusion

It can be argued that, notwithstanding the very significant limitations on an intrastate offering, a startup at the initial stage of formation could consider crowdfunding using state law. This certainly is the position of the states enacting such laws, even if only by implication.

To do so, however, in states that base their exemption on the intrastate offering exemption, such a startup will have to have neither substantial revenues, nor significant assets, nor employees out-of-state, and must elect to incorporate within the state in which it is operating (with the notion of possibly reincorporating in another state if necessary at the time of institutional financing).[245] Given the uncertainties in the integration rules under Rule 147,[246] it would also have to be highly confident that it would not need to seek any out-of-state funding for a considerable time.

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[239] *Id.* at 11,093.
[240] *Id.* at 11,093 n.36.
[241] *Id.* at 11,093 nn.36-37.
[242] *Fund-ME Short-Form Seed Capital Registration Filing Checklist*, *supra* note 220.
[243] *See supra* text accompanying note 233.
[244] *See supra* note 209.
[245] *See supra* text accompanying notes 183-91.
[246] *See supra* text accompanying notes 193-95.

Perhaps all of these circumstances may be possible at a startup's nascent stage; but, even if so, other limitations—namely those on offerees and purchasers and the offering process itself[247]—make expectations of the usefulness of state crowdfunding laws at a startup's early stage, or indeed at any stage, largely illusory.

The Maine approach, based on the entirely different basis of Rule 504, may offer promise of being more useful for crowdfunding, but its application is not free from doubt. Even assuming a given offering can be done so that all the offers and sales are restricted geographically as required by Rule 504—and such an assumption is not free from doubt for all the reasons discussed[248]—there will remain uncertainty regarding the sufficiency of the state's disclosure format unless and until the SEC addresses the issue. The prospect of the SEC doing so in the near term does not seem likely.

Accordingly, although the development of state crowdfunding laws seems to be proceeding apace, it is certainly open to question whether any of them will provide significant benefit to early stage companies seeking funding. Startups will continue to need to access funding sources that will simply not be available under state crowdfunding offering.

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[247] *See supra* text accompanying notes 169-82.

[248] *See supra* note 209, notes 169-77 and accompanying text.