North Carolina Law Review

Volume 94 | Number 1 Article 6

12-1-2015

Crowdfunding, Everyone's Doing It: Why & How North Carolina Should Too

Kelly Mathews

Crowdfunding, Everyone's Doing It: Why and How North Carolina Should Too*

94 N.C. L. REV. 276 (2015)

INTRODUCTION[**]

[**] Just days before this Comment went to print and after nearly three years of delays, the SEC approved final rules to implement crowdfunding. Crowdfunding, 80 Fed. Reg. 71,388 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, and 274). These final rules will become effective 180 days after publication in the Federal Register. *SEC Adopts Rules To Permit Crowdfunding*, SEC (Oct. 30, 2015), http://www.sec.gov/news/pressrelease/2015-249.html [http://perma.cc/UB2A-CLZ7].

This Comment proceeds from the premise that North Carolina should use the intrastate exemption to the Jumpstart Our Business Start-Ups Act to take advantage of the economic benefits of crowdfunding, even in the absence of rules enabling crowdfunding on a national scale. Jumpstart Our Business Start-Ups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012). Despite the recent passage of these rules, intrastate crowdfunding exemptions remain highly attractive financing alternatives for North Carolina's entrepreneurs seeking to raise capital under a less burdensome regulatory regime. *See* J.D. Alois, *Vote No: Commissioner Piwowar Dissents on Crowdfunding & Rule 147 Rules*, CROWDFUND INSIDER (Oct. 30, 2015, 1:43 PM), http://www.crowdfundinsider.com /2015/10/76576-vote-no-commissioner-piwowar-dissents-on-crowdfunding-rule-147-rules/ [http://perma.cc/2BC5-NC9M] (arguing that the SEC's final rules "engender a complex web of provisions and need for additional compliance that will prove costly for smaller issuers").

For instance, state exemptions can attract issuers by providing for relaxed, streamlined rules, which impose fewer costs on issuers. For example, where the federal regulation requires audited financial statements for issuers seeking $500,000 or more, Crowdfunding, 80 Fed. Reg. at 71,412–13, the proposed state rule would not require audited financial statements unless an issuer sought to raise more than $1,000,000. *See infra* Section IV.A.1. States can also provide for less burdensome disclosure requirements. *Compare* Crowdfunding, 80 Fed. Reg. at 71,398–418 (requiring disclosure of the names of directors, officers, and substantial shareholders; the issuer's business plan; the issuer's financial condition; the purpose and use of the proceeds; the target offering amount; the offering price of shares or a valuation calculation; and a description of the issuer's ownership and capital structure), *with infra* Section VI.D (describing a proposal to standardize disclosure and limit complex information to better fit the needs of investors and issuers). Further, North Carolina, like other states, may allow issuers to raise more money than that permitted under the federal rules. Compare Crowdfunding, 80 Fed. Reg. at 71,391–95, *with infra* Section VI.A. Moreover, by passing a state exemption and allowing its entrepreneurs an alternate avenue to crowdfund capital, North Carolina can keep pace with the fourteen other states that offer their residents a more attractive crowdfunding regime than available under the federal rules. *Compare infra* Sections IV.B and V.A (describing North Carolina's failure to pass a crowdfunding bill despite broad, bipartisan support and discussing the benefits that equity crowdfunding can bring to the state), *with infra* notes 98–111 and accompanying text (noting other state statutes authorizing intrastate crowdfunding).

Finally, the intrastate exemption remains attractive from a public policy standpoint, as the states are better positioned both to regulate smaller, local projects and to serve as valuable experimental laboratories for the federal government. *See infra* Section V.C. With regards to the mechanics of crowdfunding, the states should be able to react more quickly than the SEC to implement necessary changes and streamline their crowdfunding regimes. Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL'Y 639, 666 (2010) (explaining that the "SEC appears to be at the outer-range of federal agencies both in terms of the extent to which it is dominated by lawyers and the extent to which its operation is paralyzed by bureaucracy."); *see also* Mark Hatch, *Opinion: SEC Bureaucracy is Threatening to Quash an Innovation Renaissance*, WASH. POST (Sept. 7, 2012), https://www.washingtonpost.com

In 1994, when Internet usage was growing astronomically,[1] thirty-year-old Jeff Bezos quit his Wall Street job to start an online retail company out of his garage.[2] Bezos' parents provided him with a large portion of their life savings—"a few hundred thousand dollars"—to launch his startup, despite what he described as a seventy percent chance of losing the entire investment.[3] Within two months, Bezos's sales were as high as $20,000 per week, which allowed him to acquire venture capital just one year later.[4] Bezos's startup has since become the world's largest online retailer—Amazon.com—with annual revenues totaling $61 billion.[5] Although inspirational "garage-to-

/business/on-small-business/opinion-sec-bureaucracy-is-threatening-to-quash-an-innovation-renaissance/2012/09/07/1ce2cc88-f6ae-11e1-8253-3f495ae70650_story.html [https://perma.cc/UP9Q-5CZZ].

Additionally, the SEC has proposed amendments to SEC Rule 147 to make intrastate crowdfunding more attractive to issuers. Currently, SEC Rule 147 creates a safe harbor for qualifying intrastate offerings under section 3(a)(11) of the Securities Act of 1933. 17 C.F.R. § 230.147(a) (2015). In addition to issuing final crowdfunding rules, the SEC also proposed an amendment to relax Rule 147 and to provide that the rule would no longer operate as a safe harbor for conducting a valid intrastate exemption under section 3(a)(11) of the Securities Act. *See* Exemptions To Facilitate Intrastate and Regional Securities Offerings, 80 Fed. Reg. 69,786, 69,799 (Nov. 10, 2015) (to be codified at 17 C.F.R. pt. 230).

Instead, the amended Rule 147 would operate as a separate exemption for intrastate crowdfunding offerings. *Id.* at 69,788. The rules would allow an issuer to make offers accessible to out-of-state residents and to be incorporated out of state, so long as sales are made only to in-state residents, the issuer's principal place of business is in state, and the issuer satisfies at least one additional requirement that further demonstrates the in-state nature of the issuer's business. *Id.* at 69,788–89. The proposed amendment would retain the eighty percent threshold for "doing business in-state." *Id.* at 69,790–91. Additionally, the proposed amendment to Rule 147 would also allow state laws to permit issuers to raise up to $5 million in a twelve-month period. *Id.* at 69,791. Moreover, the proposed rule would relax the requirement that "offers and sales of securities . . . [are] made only to persons resident within the state or territory" in lieu of a less restrictive standard such that the issuer could satisfy the requirement "by establishing that the issuer had a reasonable belief that the purchaser of the securities in the offering was a resident of such state or territory[.]" *Id.* at 69,792–93. Finally, the proposed rule would amend the resale restriction to provide that "for a period of nine months from the date of the sale by the issuer of a security sold pursuant to this rule, any resale of such security by a purchaser shall be made only to persons within such state or territory . . . ." *Id.* at 69,794. This would open up the door for an intrastate secondary market, as described in Section VI.G of this Comment, and further, provide for the potential ability of secondary sales to out-of-state purchasers. *See id.* Thus, the proposed amendments to Rule 147 along with the SEC's new crowdfunding regulations mean that intrastate crowdfunding in North Carolina not only remains a viable option but should be even more attractive than before.

1. *Amazon Startup Story*, FUNDABLE, https://www.fundable.com/learn/startup-stories /amazon [http://perma.cc/23GL-3SBE]. In 1994, web-usage was growing at 2,300% per year. *Id.*

2. *Id.*

3. *Id.*

4. *Id.*

5. *Id.*

riches" startup stories like Amazon's tend to dominate the media,[6] they are rare exceptions. In fact, small businesses and startups are defined largely by struggles and failures, which mostly go unmentioned. Even in the land of opportunity, small businesses and startups often fail because capital is scarce and investors are risk averse. Like Bezos, entrepreneurs need startup capital—often large sums of it—to launch their businesses. But convincing investors to commit large sums of money to investments that pose a high risk of failure is extremely challenging.

Equity crowdfunding allows entrepreneurs to solicit many small, individual investments in exchange for equity securities without having to register with the Securities and Exchange Commission ("SEC").[7] Before Congress passed the "Jumpstart Our Business Startups" ("JOBS") Act in 2012,[8] equity crowdfunding was only an idea in the United States. While the SEC drags its feet, failing to promulgate rules to implement the equity crowdfunding exemption, several pioneering states have passed their own intrastate crowdfunding exemptions.[9] North Carolina nearly became one such pioneer, but its equity crowdfunding exemption failed despite overwhelming bipartisan support.[10] Many North Carolina legislators consider unacceptable the abandonment of efforts to bring equity crowdfunding to North Carolina.[11] Indeed, North Carolina State Rep.

6. For example, many have heard the story of how in 1923, Missouri-born cartoonist Walt Disney moved to Los Angeles, California, where he spent months working out of his uncle's garage to produce animated short films. *See* Jennie Cohen, *Great American Garage Entrepreneurs*, HISTORY (Oct. 6, 2011), http://www.history.com/news/great-american-garage-entrepreneurs [http://perma.cc/5CSF-HNCZ]. Disney's small startup has since become the world's largest media conglomerate—The Walt Disney Company. *Id.* Other "garage-to-riches" companies include Apple, Inc., Hewlett Packard, Google, Mattel, and the Yankee Candle Company. *Id.*

7. *See, e.g.*, Crowdfunding, 78 Fed. Reg. 66,428, 66,428 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249) ("[T]he [crowdfunding] proposal would exempt securities sold pursuant to Section 4(a)(6) from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934.").

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

9. *See infra* notes 98–111 (identifying fourteen states that have passed their own intrastate crowdfunding exemptions).

10. The original crowdfunding bill passed the North Carolina House by a vote of 103 to 1. *See House Bill 680*, N.C. GEN. ASSEMBLY, http://www.ncga.state.nc.us/gascripts/BillLookUp/BillLookUp.pl?Session=2013&BillID=H680 [http://perma.cc/3UMT-L5GP]; *Intrastate Crowdfunding Is Officially Dead in North Carolina—for Now*, N.C. JOBS ACT BLOG (Aug. 19, 2014), http://www.jobsnc.blogspot.com/2014/08/intrastate-crowdfunding-is-officially.html [http://perma.cc/2B73-UKHP].

11. Rick Smith, *Crowdfunding Killed in N.C.; Bill Backer Criticizes Senate Strategy*, CROWDFUNDBEAT (Aug. 20, 2014), http://crowdfundbeat.com/2014/08/18/crowdfunding-

W.A. Wilkins intimated that such efforts were just beginning: "We can do better. Let's kill this thing and do better."[12] By failing to pass an equity crowdfunding exemption, North Carolina forgoes tremendous potential benefits—including economic growth, job growth, and renewed innovation—at minimal cost to taxpayers.[13] Thus, a North Carolina crowdfunding exemption deserves another attempt.

This Comment argues that a successful crowdfunding exemption must strike a reasonable regulatory balance that both minimizes costs and burdens on small businesses and startups and protects investors from undue loss, fraud, and abuse. This balance would be appropriately achieved under a crowdfunding exemption that preserves many of the key provisions in the failed North Carolina bill, including: (1) prescribing reasonable target-offering limits and limits on the aggregate contributions of individual investors to curb potential investor losses, while still providing issuers with significant capital bases to support their startups; (2) requiring disclosures triggered by target-offering limits that reasonably enable investors to make fully informed investments, while minimizing burdens and costs for smaller issuers; and (3) retaining the failed North Carolina JOBS Act's "all-or-nothing" provision,[14] which prevents investor losses in undercapitalized companies while incentivizing issuers to be more responsive to investor concerns and to engage in more diligent planning.

A prudent crowdfunding exemption could also improve upon the failed bill. First, this Comment proposes eliminating unnecessary or overly burdensome disclosures in lieu of simpler, standardized disclosures. Second, mandating investor education requirements will help investors to understand those disclosures. Third, promoting competition among intermediaries will not only incentivize them to offer issuers better services but will also encourage them to compete to feature the best companies on their websites and to adequately screen issuers to prevent fraud and reduce investor losses. Fourth, to further incentivize the screening of potential issuers, a crowdfunding exemption should require intermediaries to absorb some loss in the

killed-in-nc-bill-backer-criticizes-senate-strategy/ [http://perma.cc/Q99G-ZH8B] (quoting Representative Wilkins).

12. *Id.*

13. *See Intrastate Crowdfunding Is Officially Dead in North Carolina—for Now*, *supra* note 10.

14. An Act To Enact the Jump-Start Our Business Start-Ups Act and To Enact the New Markets Job Act of 2014, H.B. 680, sec. 2, § 78(a), 2013 Gen. Assemb., Reg. Sess. (N.C. 2013) [hereinafter H.B. 680]; *see infra* Section VI.C.

event of fraud. Fifth, requiring intermediaries to maintain social networking features on their funding portals will facilitate communication between issuers and investors. Finally, loosening the resale restriction by vesting intermediaries with discretion to establish interportal, intrastate secondary markets for crowdfunded securities will provide for more accurate securities valuation and also provide investors with more adequate securities fraud remedies.

This Comment proceeds in six parts. Part I discusses the inadequacy of current capital-raising mechanisms available to entrepreneurs. Part II introduces the various forms of crowdfunding available to issuers. Part III highlights several key provisions of the recently passed federal JOBS Act. Part IV discusses North Carolina's attempt to implement its own intrastate equity crowdfunding exemption, House Bill 680, and the consequences of the bill's failure. Part V argues that the benefits of an equity crowdfunding exemption outweigh the drawbacks, which can be addressed by appropriate regulation. Finally, Part VI proposes provisions for a new North Carolina JOBS Act with a focus on minimizing unnecessary costs and burdens on small businesses and startups while protecting investors from loss, fraud, and abuse.

I. RAISING BUSINESS CAPITAL WITHOUT CROWDFUNDING

Because small businesses are the largest contributors to U.S. job growth, stimulating small businesses and promoting entrepreneurship is a logical formula for growing the American economy.[15] Unfortunately, small businesses tend to fail quickly,[16] often due to capital shortages.[17] Indeed, lack of access to capital is a major obstacle to starting a business.[18]

15. *See* Karen Gordon Mills & Brady McCarthy, *The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game* 3–4 (Harvard Bus. Sch., Working Paper No. 15-004, 2014), http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf [http://perma.cc/ES9U-MWWP] (explaining that small businesses employ "half of the private sector workforce" and create "two out of every three net new jobs" in the United States).

16. *Small Business Advisory: Crowdfunding*, NASAA (2013), http://www.nasaa.org/13676/small-business-advisory-crowdfunding/ [http://perma.cc/D96X-64KW] ("[R]oughly 50 percent of all small businesses fail within the first five years . . . .").

17. Sara Hanks & Andrew Stephenson, *Online Securities Offerings*, 33 BANKING & FIN. SERVS. POL'Y REP., Feb. 2014, at 1, 1.

18. Howard E. Van Auken, *Obstacles to Business Launch*, 4 J. DEV. ENTREPRENEURSHIP 175, 180–81 (1999); *see also* Remarks on Signing the Jumpstart Our Business Startups Act, 2012 DAILY COMP. PRES. DOC. 249 (Apr. 5, 2012), http://www.gpo.gov/fdsys/pkg/DCPD-201200249/pdf/DCPD-201200249.pdf [http://perma.cc/B5Y7-7HDJ]

Startups and small businesses have few viable financing options. First, entrepreneurs can finance a business through credit card debt.[19] Small businesses that use credit cards to meet their financing needs probably hope that either their cash flows will sufficiently grow to service their credit-card balances, or that they will eventually be able to refinance the debt at a lower interest rate.[20] Neither expectation takes into account the low success rate of small businesses,[21] which means that the entrepreneur has a good chance of being personally liable for the debt. Moreover, credit cards are not a sustainable source of business capital because of relatively low credit limits[22] that restrict a business's potential growth.[23]

As an alternative to credit cards, some fortunate entrepreneurs, like Bezos,[24] can solicit friends and family for startup cash.[25] This option is unrealistic for most entrepreneurs because it requires that the entrepreneur have family members who have the means and are willing to risk their investment on the entrepreneur's ideas.

("[N]o matter how good [entrepreneurs'] ideas are, if [they] can't get a loan from a bank or backing from investors, it's almost impossible to get their businesses off the ground.").

19. In a recent survey, credit cards were the preferred financing choice for small businesses, as thirty-seven percent of respondents indicated that they used credit cards to meet their financing needs, second only to revolving lines of credit from banks. NAT'L SMALL BUS. ASS'N, SMALL BUSINESS ACCESS TO CAPITAL SURVEY 4 (2012), http://www.nsba.biz/wp-content/uploads/2012/07/Access-to-Capital-Survey.pdf [http://perma.cc/L58C-9QGB].

20. *See, e.g.*, Karen E. Klein, *Advice for a Business Haunted by Decade-Old Credit Card Debt*, BLOOMBERG BUS. (Mar. 3, 2014), http://www.bloomberg.com/bw/articles/2014-03-03/advice-for-a-business-haunted-by-decade-old-credit-card-debt [http://perma.cc/F7NX-9LFF]. For some, the risk has proven worth the gamble. Consider Kevin Plank, who started successful athletic apparel manufacturer Under Armour with a whopping $40,000 in credit card debt and $20,000 of his own savings. *See* Mark Riddix, *6 Entrepreneurs Who Built Their Fortunes from Nothing*, INVESTOPEDIA (Mar. 25, 2011), http://www.investopedia.com/financial-edge/0411/6-entrepreneurs-who-built-their-fortunes-from-nothing.aspx [http://perma.cc/ZP37-3A7Y]. Since then, Plank has amassed a net worth of $500 million. *Id.*

21. *See Small Business Advisory: Crowdfunding*, *supra* note 16.

22. *See, e.g.*, *Credit Limits*, CITIGROUP, https://www.citicards.com/cards/wv/html/cm/know-the-rules/how-credit-cards-work/credit-limits.html [http://perma.cc/ZG83-UXZC] (explaining that creditors limit the credit available).

23. Credit card rates can be "as low as 11 percent or as high as 26 percent. The national average is currently 14.96 percent. For example, Wells Fargo's Cash Back card offers a zero percent introductory rate to new customers. After 12 months, the variable Annual Percentage Rate, or APR, kicks in and your rate could climb to anywhere between 12.15 and 25.99 percent." Zelkadis Evli, *Why Are Credit Card Interest Rates So High?*, YAHOO! FIN. (Oct. 11, 2013, 1:45 PM), http://finance.yahoo.com/blogs/just-explain-it/why-credit-card-interest-rates-high-132648813.html [http://perma.cc/CM9J-SH9K].

24. *See supra* notes 1–5 and accompanying text.

25. For example, Sam Walton opened his first Wal-Mart store with $25,000, of which $20,000 was contributed by his father-in-law. *See* Riddix, *supra* note 20.

Moreover, borrowing from friends and family may invite unwanted meddling in the business, or worse, harm relationships with friends or family.[26]

Most commonly, though, small businesses can apply for a bank loan or line of credit.[27] Historically, small community banks have been the most frequent lenders to small businesses.[28] But small business lending has declined steadily since 1998.[29] The financial crisis of 2008, which caused widespread bank failures and consolidation,[30] aggravated the decline.[31] Further, reactive legislation has subjected banks to more rigorous regulatory scrutiny, heightened capital requirements, and higher lending standards.[32] The resulting regulatory environment and economic uncertainty have caused many banks to tighten their lending requirements.[33]

Despite recent loosening of post-recession lending standards, access to credit for small businesses remains below pre-recession

26. *Borrowing from Friends and Family*, ENTREPRENEUR (Aug. 16, 2006), http://www.entrepreneur.com/article/24334 [http://perma.cc/DK54-FNMB] (citing START YOUR OWN BUSINESS: THE ONLY START-UP BOOK YOU'LL EVER NEED 183–88 (Riva Lesonsky ed., 2d ed. 2001)).

27. NAT'L SMALL BUS. ASS'N, *supra* note 19, at 4 (showing revolving lines of credit and bank loans as the first and fourth most common forms of financing, respectively).

28. TANYA D. MARSH & JOSEPH W. NORMAN, AM. ENTER. INST., THE IMPACT OF DODD-FRANK ON COMMUNITY BANKS 12 (2013), http://www.aei.org/wp-content/uploads/2013/05/-the-impact-of-doddfrank-on-community-banks_164334553537.pdf [http://perma.cc/9L43-7TAX] ("[One dollar] out of every $2 lent to small businesses comes from community banks.").

29. A recent study indicated that nonfarm, nonresidential loans of less than $1 million—"a common proxy for small business lending"—dropped from 51% to 29% since 1998. Ann Marie Wiersch & Scott Shane, *Why Small Business Lending Isn't What It Used To Be*, FED. RES. BANK CLEVELAND (Aug. 14, 2013), https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/2013-economic-commentaries/ec-201310-why-small-business-lending-isnt-what-it-used-to-be.aspx [https://perma.cc/T9EW-KBFH]. Reasons for this are numerous and include lower creditworthiness among small businesses, lower demand for small-business loans, and heightened lending standards resulting from stricter lending regulation. *Id.*

30. *See* Mills & McCarthy, *supra* note 15, at 36.

31. *See generally id.* (describing both secular and cyclical trends causing reduced small-business lending). According to the Small Business Administration ("SBA"), from 2008 to 2011, small business lending declined almost 18%; small commercial and industrial lending declined by 20%. REBEL A. COLE, U.S. SMALL BUS. ADMIN., HOW DID THE FINANCIAL CRISIS AFFECT SMALL BUSINESS LENDING IN THE UNITED STATES? 2 (2012), https://www.sba.gov/sites/default/files/files/rs399tot.pdf [http://perma.cc/3J43-Y9TK].

32. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 616, 124 Stat. 1376, 1615 (2010) (codified at 12 U.S.C. § 1844(b) (2013)) (requiring capital requirements to be countercyclical); 12 U.S.C. § 5365(i) (2013) (mandating annual and semi-annual stress tests by the Federal Reserve and the banks, respectively).

33. *See* Mills & McCarthy, *supra* note 15, at 34–35 fig.24 (showing a decreasing average loan-to-deposit ratio since the recession).

levels.[34] The decline in small business lending by commercial banks has forced entrepreneurs to look for alternative sources of capital, including venture capital ("VC") funding,[35] angel investors,[36] and even public offerings of securities via initial public offerings ("IPO").[37] However, these sources of funding are peppered with inadequacies. They are available only to an extremely low percentage of small businesses and often require the entrepreneur to surrender some degree of control.[38] For example, VC firms[39] are highly selective,[40] often focus their efforts on a small geographic area,[41] and generally carry a higher cost of capital as compared to other avenues for financing.[42] While a venture capitalist's financial or business

34. *See id.* at 24–25 figs.13–14 (showing decreased small-business loan balances and a lower percentage of small business loans as a share of total loans since the recession).

35. Venture capital firms invest equity capital in "young, high-growth companies." *Venture Capital*, U.S. SMALL BUS. ADMIN, http://www.sba.gov/content/venture-capital [http://perma.cc/UEY9-GZF9]. VC firms "take higher risks in exchange for potential higher returns" on their investments, and they also participate in managing the businesses they invest in. *Id.*

36. Angel investors are generally "high net worth individuals who seek high returns through private investment in startup companies." *Id.* They also seek involvement in the businesses that they invest in, which can be particularly helpful because angel investors tend to invest in industries that the angel investors are particularly familiar with. *Id.*

37. An IPO, perhaps the most implausible means of financing a startup, allows a company to access the capital markets to raise equity capital. *See* Michael S. Colo, *IPO: Is It Appropriate?*, POYNER SPRUILL, http://www.poynerspruill.com/publications/Pages/IPOIsitAppropriate.aspx [http://perma.cc/V78F-M6M2].

38. Attractive business startups that do manage to obtain VC funding are likely to give up some control because venture capitalists actively participate in the businesses they invest in. *See Venture Capital*, *supra* note 35. Likewise, angel investors are often former executives of large corporations, capable of providing superior advice to entrepreneurs. *See, e.g.*, Tanya Prive, *Angel Investors: How the Rich Invest*, FORBES (Mar. 12, 2013, 9:27 AM), http://www.forbes.com/sites/tanyaprive/2013/03/12/angels-investors-how-the-rich-invest/ [http://perma.cc/HFP5-NWE6].

39. The majority of venture capital "comes from a group of wealthy investors, investment banks and other financial institutions that pool such investments or partnerships." *Venture Capital Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/v/venturecapital.asp [http://perma.cc/JU7Y-SG9L].

40. *See* Dileep Rao, *Why 99.5% of Entrepreneurs Should Stop Wasting Time Seeking Venture Capital*, FORBES (July 22, 2013, 10:00 AM), http://www.forbes.com/sites/dileeprao/2013/07/22/why-99-95-of-entrepreneurs-should-stop-wasting-time-seeking-venture-capital/ [http://perma.cc/MLT3-HD7U] (noting that, according to the Small Business Administration, only about 300 of the 600,000 businesses started each year receive venture capital funds).

41. *See* Linda Brewster Stearns & Mark S. Mizruchi, *Banking and Financial Markets*, *in* THE HANDBOOK OF ECONOMIC SOCIOLOGY 284, 291 (Neil J. Smelser & Richard Swedberg eds., 2005) ("VC firms have traditionally invested in start-ups located within the same geographic region . . . .").

42. VC expected rates of return were a whopping 50% to 70% during a firm's startup stage, 40% to 60% during the "first stage," 35% to 50% during the "second stage," and 25% to 35% during the bridge to an IPO. *See* Aswath Damodaran, *Valuing Young,*

expertise may be useful, many entrepreneurs are reluctant to surrender control or compromise on their original ideas, as VC firms often require.[43] Additionally, wealthy individual investors, known as "angel investors," may offer funding on terms not unlike those of VC firms.[44] Finally, notwithstanding its excessive costs,[45] an IPO is available exclusively to companies with consistently high growth.[46]

Such potential sources of capital are often unsuitable or unavailable to most small businesses and startups. The persistent scarcity of adequate alternative capital-raising mechanisms continues to handicap American small businesses and startups, undercutting potential innovation, job creation, and the increased productivity associated with small businesses.[47]

Startup, and Growth Companies: Estimation Issues and Valuation Challenges 15 tbl.2 (May 2009), http://people.stern.nyu.edu/adamodar/pdfiles/papers/younggrowth.pdf [http://perma.cc/69RC-VGFP]. Between July 1, 2011, and June 30, 2012, on the other hand, the average interest rates for variable and fixed-rate SBA loans were 5.3% and 5.8%, respectively. FITSMALLBUSINESS, GUIDE TO SBA LOAN INTEREST RATES 21 (Feb. 21, 2014), http://www.slideshare.net/FitSmallBusiness/guide-to-sba-loan-interest-rates [http://perma.cc/DN3C-NSTT].

43. *See, e.g.*, *4 Common Venture Capital Myths*, ENTREPRENEUR (Dec. 1, 2009), http://www.entrepreneur.com/article/204198 [http://perma.cc/PE8H-7GB8] (explaining that VC firms assume substantial control, including veto rights on investments, acquisitions, and mergers).

44. *See, e.g.*, *Getting Started with Angel Investing*, ENTREPRENEUR, http://www.entrepreneur.com/article/52742 [http://perma.cc/2RZ7-7TP7]. Notably, angel-funded firms have a much greater chance of survival compared to other firms. *See* William R. Kerr, Josh Learner & Antoinette Schoar, *The Consequences of Entrepreneurial Finance: A Regression Discontinuity Analysis* 5 (Harvard Bus. Sch., Working Paper No. 10-086, 2010), http://www.hbs.edu/faculty/Publication%20Files/10-086.pdf [https://perma.cc/RQ3H-QDZX]. Because angel investors typically enjoy unique approval among other investors, angel-funded firms are more likely to raise capital above and beyond that provided by the original angel investor. *See id.*

45. The substantial costs of an IPO, including paying lawyers, accountants, investment banking firms, and registering and reporting to the SEC, may exceed a firm's entire offering target. *See* PRICEWATERHOUSECOOPERS, CONSIDERING GOING PUBLIC? THE COSTS OF GOING AND BEING PUBLIC MAY SURPRISE YOU 1 (2012), http://www.pwc.com/en_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf [http://perma.cc/A9KQ-LEKW].

46. Generally, IPO candidates are those that have had growing sales and net income for at least three to five years prior to the IPO. *See* Colo, *supra* note 37. Of course, most startups and young small businesses lack the requisite stability or operating history required for a successful IPO. *See id.*

47. *See* Yasser Killawi, *Preserving an Entrepreneurial America: How Restrictive Immigration Policies Stifle the Creation and Growth of Startups and Small Businesses*, 8 OHIO ST. ENTREPRENEURIAL BUS. L.J. 129, 131 (2013).

II. WHAT ABOUT CROWDFUNDING?

Crowdfunding, a fusion of crowdsourcing and microlending,[48] provides startups and small companies with access to a much larger pool of investors than traditional forms of financing.[49] Crowdfunding connects entrepreneurs with financiers of all levels of wealth and sophistication. In the crowdfunding model, many investors individually contribute a small amount of money to the business, limiting each investor's risk and collectively allowing the business to meet its funding goal.[50]

Sites like Kickstarter,[51] Indiegogo,[52] and GoFundMe[53] have paved the way for crowdfunding to blossom into a viable financing tool in the United States. However, crowdfunding's origins long predate the Internet. In 1885, publishing mogul Joseph Pulitzer used "the crowd" to pay for the Statue of Liberty's pedestal.[54] France offered America the Statue of Liberty so long as America provided the pedestal upon which the statue would rest.[55] Through a newspaper, Pulitzer urged the American people to raise the money.[56] In just five months, 160,000 investors contributed $101,091 of the

48. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 27 (2012) ("Crowdfunding is a merger of two distinct antecedents: crowdsourcing and microfinance."). In 2005, Kiva, a microlending portal, opened for business. *See History*, KIVA, http://www.kiva.org/about/history#2005 [http://perma.cc/3NGT-2923]. Kiva allows users to lend to entrepreneurs in poor, global communities who do not have access to traditional credit. *See About Us*, KIVA, http://www.kiva.org/about [http://perma.cc/6G4H-PFR9]. Individuals can contribute as little as twenty-five dollars to an entrepreneur of their choice and receive interest payments in return. *Id.* For example, in 2014, Kiva funded a $100,000 loan to a manufacturer of eco-friendly beauty products, creating three hundred new jobs in Haiti. *Kreyol Essence*, KIVA, http://www.kiva.org/lend/722883 [http://perma.cc/4KZZ-7SU2]. As of October 2015, Kiva has loaned $762,769,675, funding 1,762,672 borrowers via 1,342,537 lenders. *Statistics*, KIVA, http://www.kiva.org/about/stats [http://perma.cc/98H2-5MQW (dark archive)].

49. *See supra* Part I.

50. *See* Bradford, *supra* note 48, at 27–29 ("Crowdfunding is just a combination of [crowdsourcing and micro-lending]—small contributions from a large number of people to fund small entrepreneurial ventures.").

51. *What Is Kickstarter?*, KICKSTARTER, https://www.kickstarter.com/hello?ref=footer [http://perma.cc/AR4M-A6G7] (providing a platform where "backers" can provide funds for startups in exchange for "rewards").

52. *How It Works*, INDIEGOGO, https://www.indiegogo.com/learn-how-to-raise-money-for-a-campaign [http://perma.cc/9H6Z-6KX7].

53. *Common Questions*, GOFUNDME, https://www.gofundme.com/questions/ [https://perma.cc/R52R-W39L].

54. *The Statue of Liberty: A Pioneering Example of Crowdfunding*, COTEC (Mar. 3, 2014), https://www.actbycotec.com/en/media.104/articles.168/the_statue_of_liberty_a_pioneering_example_of_crowdfunding.a528.html [http://perma.cc/ZSG2-3EF3].

55. *Id.*

56. *Id.*

$250,000 cost for Lady Liberty's pedestal (approximately $6.3 million today).[57] Seventy-five percent of the donations were under one dollar.[58]

An early example of Internet crowdfunding occurred in 1997, when the British rock band Marillion raised $60,000 from its U.S. fan base to help finance its North American tour.[59] Since then, four types of online crowdfunding have emerged: debt-based crowdfunding, donation-based crowdfunding, rewards-based crowdfunding, and equity crowdfunding.[60] Debt-based, or "peer-to-peer" ("P2P") crowdfunding emerged in the United States in 2006.[61] P2P lending sites allow individuals to apply for unsecured loans, financed by individual investors who earn interest on each loan.[62] In 2010, GoFundMe began offering donation-based crowdfunding, where users solicit donations for charitable causes or personal goals or needs.[63] Rewards-based crowdfunding—perhaps the most popular of the varieties of crowdfunding—was first offered in 2008 by Indiegogo[64] and then in 2009 by Kickstarter.[65] Rewards-based

57. *Id.*

58. *Id.*

59. *See* Tim Masters, *Marillion "Understood Where the Internet Was Going Early On"*, BBC (Aug. 31, 2013), http://www.bbc.com/news/entertainment-arts-23881382 [http://perma.cc/QU8M-Z8G5] ("Inspired by [the fans who crowdfunded Marillion's 1997 North American tour], the band turned the tables in 2001 and asked fans to pre-order an album 12 months before release. Some 12,000 signed up to finance the recording, resulting in the album Anoraknophobia.").

60. *Types of Crowdfunding*, FUNDABLE, https://www.fundable.com/crowdfunding101/types-of-crowdfunding [http://perma.cc/ZC5P-SNB2].

61. Judd Hollas, *Is Crowdfunding Now a Threat to Traditional Finance?*, CORP. FIN. REV., July–Aug. 2013, at 27, 30.

62. In October 2014, average interest rates as posted on Lending Club, the largest P2P lender in the world, ranged from 7.64% for prime loans, to 22.53% for riskier loans. *Lending Club Statistics*, LENDING CLUB, https://www.lendingclub.com/info/demand-and-credit-profile.action [http://perma.cc/Z4MQ-QXRL (dark archive)].

63. *Common Questions*, *supra* note 53. For example, when Farrah Soudani was critically injured in the Aurora, Colorado, movie theater massacre in 2012, donations through the site reached $171,000 in just fifteen months to pay for her medical expenses. *Help Farrah and Family—CO Theater Tragedy*, GOFUNDME, http://www.gofundme.com/Help-Farrah [http://perma.cc/5FKE-37H5].

64. *See About Us*, INDIEGOGO, https://www.indiegogo.com/about/our-story [http://perma.cc/GL62-DVN5].

65. *See Pressroom*, KICKSTARTER, https://www.kickstarter.com/press [http://perma.cc/P35W-6BUG]. One wildly successful campaign advertised the "Pebble Smartwatch," which runs downloadable sports and fitness apps and connects to a smartphone. *Pebble: E-Paper Watch for iPhone and Android*, KICKSTARTER, https://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android [http://perma.cc/UY2B-HTBT]. The watch retailed at $150 but the campaign allowed backers to pre-order the watch for just $99. *Id.* The company sought $100,000, acquired 68,929 backers, and raised $10,266,845. *Id.*

crowdfunding allows entrepreneurs to solicit contributions in exchange for future goods, experiences, or even a simple thank you.[66]

Last, the newest form of crowdfunding, known as "equity crowdfunding," allows individuals to invest in nonpublicly traded companies in exchange for equity securities.[67] The SEC currently permits limited equity crowdfunding but only for accredited investors[68] and a small number of unaccredited but sophisticated investors to participate in crowdfunded offerings.[69] Prior to the passage of the federal JOBS Act,[70] equity financing was not practically available to small businesses due to burdensome registration and compliance costs[71] and restrictive securities laws.[72] But following passage of the federal JOBS Act, equity crowdfunding has the potential to be a game changer for startups and small businesses.

III. THE FEDERAL JOBS ACT INTRODUCES EQUITY CROWDFUNDING IN THE UNITED STATES

President Obama signed the federal JOBS Act on April 5, 2012,[73] to encourage entrepreneurship, increase small businesses' access to capital, "ease the overwhelming regulations" that hinder small

66. *See* Chance Barnett, *Crowdfunding Sites in 2014*, FORBES (Aug. 29, 2014, 6:11 PM), http://www.forbes.com/sites/chancebarnett/2014/08/29/crowdfunding-sites-in-2014/ [http://perma.cc/PB6G-C9R6 (staff-uploaded archive)].

67. *What Is Equity Crowdfunding?*, SYNDICATE ROOM, https://www.syndicateroom.com/investors/what-is-equity-crowdfunding.aspx [http://perma.cc/S9QY-AVNY].

68. JOBS Act, Pub. L. No. 112-106, § 201(a)(1), 126 Stat. 306, 313 (2012) (directing the SEC to revise its rules in section 230.506 of title 17 of the Code of Federal Regulations to permit solicitation of securities offerings so long as all purchasers are accredited investors). Accredited investors are generally persons or entities with high levels of financial sophistication or net worth, *see* 17 C.F.R. § 230.501(a) (2015), including any individual or married couple who has net worth of $1 million or greater (excluding the investor's primary residence), or an individual that made $200,000 alone, or $300,000 with a spouse, in each of the previous two years. *Id.* § 230.501(a)(5)–(6).

69. *See* 17 C.F.R. § 230.508(b)(2) (permitting only thirty-five unaccredited investors but requiring that they or a representative be sufficiently sophisticated to evaluate the "merits and risks of the prospective investment").

70. JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (codified in scattered sections of 15 U.S.C.).

71. *See, e.g.*, William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private"*, 55 EMORY L.J. 141, 151 (2006) ("Compliance costs required by the securities laws and by SOX have a large element of fixed costs that do not vary proportionately with firm size.").

72. *See* Ross S. Weinstein, Note, *Crowdfunding in the U.S. and Abroad: What To Expect When You're Expecting*, 46 CORNELL INT'L L.J. 427, 428 (2013).

73. JOBS Act, Pub. L. No. 112-106, 126 Stat. 306.

businesses,[74] and promote economic growth.[75] The JOBS Act accomplishes these goals by amending the Securities Exchange Act of 1934 in several ways.[76] Most importantly for this Comment, Title III of the JOBS Act, or the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012," ("CROWDFUND Act") permits unaccredited investors to participate in online securities offerings.[77] The following section highlights several key provisions of Title III, which still require SEC rulemaking for full implementation.

A. *Overview of the Federal JOBS Act's Crowdfunding Exemption*

The SEC has yet to implement rules regarding several key provisions of Title III. Specifically, these provisions include: (1) aggregate offering limits and the accompanying disclosures triggered by certain offering limits; (2) aggregate annual limits on individual investor contributions; (3) pre- and post-offering disclosure requirements; (4) the "all-or-nothing" provision on equity crowdfunding issuers' target offering amounts and the Act's one-year prohibition of crowdfunded securities; and (5) rules governing intermediaries that feature issuers of crowdfunded securities. Each is discussed in more detail below.

1. Aggregate Fundraising Limits and Accompanying Disclosures

Title III of the JOBS Act amends the Securities Act of 1933 to allow businesses, or securities "issuers," to raise up to $1,000,000 in any twelve-month period.[78] Issuers seeking $100,000 or less must

74. 157 CONG. REC. H9801 (2011) (daily ed. Dec. 16, 2011) (statement of Rep. Dold).

75. Congress acknowledged that "the future success of our economy rests in the hands of small, private business[.]" 158 CONG. REC. H1222 (daily ed. Mar. 7, 2012) (statement of Rep. Sessions). Providing such small businesses with access to the capital they need will create "an economic environment that promotes growth and generates more revenue for the Federal government." *Id.*

76. These amendments include (1) reducing the financial reporting obligations of smaller companies, *see* JOBS Act § 102, 126 Stat. at 308–10 (codified in various sections of 15 U.S.C. §§ 77a–aa, 78a–pp); (2) permitting general solicitation and advertising for certain securities offerings, *see* § 201, 126 Stat. at 313–15 (to be codified as amended at 15 U.S.C. § 77d); (3) providing for a potential exemption for private offerings under $50 million, *see* § 401, 126 Stat. at 323–25 (to be codified at 15 U.S.C. §§ 77c(b), 77d, 77r(b)(4)); and (4) relaxing the number of equity holders permitted before SEC registration is required. *See* §§ 501, 502, 602, 126 Stat. at 325–27 (to be codified at 15 U.S.C. §§ 78l(g), 78o(d)).

77. *See* § 302(a)(6)(B), 126 Stat. at 315 (to be codified as amended at 15 U.S.C. § 77d) (permitting sale to any investor, though with limits on the amount to be invested by any individual investor).

78. § 302(a)(6)(A), 126 Stat. at 315.

provide filed tax returns for the previous calendar year in addition to financial statements certified by the "principal executive officer."[79] Issuers seeking between $100,001 and $500,000 must provide financial statements reviewed by an independent public accountant.[80] If seeking to raise more than $500,000, an issuer must provide audited financial statements.[81]

2. Aggregate Annual Limits on Individual Investor Contributions

The FEDERAL JOBS Act limits the aggregate contributions of unaccredited investors. "Accredited investors" include financial institutions, high-net-worth individuals, sophisticated investors, and the directors of an issuer.[82] The term "unaccredited investors," therefore, includes everyone else, such as nonwealthy, unsophisticated, and individual retail investors.[83] An individual investor with annual income or net worth less than $100,000 can contribute up to $2,000 or 5% of his or her annual income or net worth, whichever is greater.[84] If the investor's annual income or net worth is $100,000 or more, the investor's aggregate investment is limited to 10% of the investor's annual income or net worth, up to a maximum contribution of $100,000.[85] The Federal JOBS Act does not place a cap on the contributions of accredited investors.[86]

3. Pre-Offering and Post-Offering Disclosure Requirements

Issuers must file with the SEC and provide investors with extensive pre-offering disclosures that include: (1) background information regarding the issuer, its officers, directors, and each person holding more than twenty percent of the issuer's shares; (2) information regarding the issuer's ownership and capital structure; (3) information regarding the issuer's business plan; (4) the issuer's target offering amount, a deadline to reach the target, and the intended use of the proceeds; (5) the price of the securities or a method for calculating the price; (6) a description of the issuer's financial condition and other recent offerings; (7) regular updates regarding the target offering amount and requisite deadline; and (8) requisite

79. 15 U.S.C. § 77d-1(b)(1)(D)(i) (2013).
80. § 77d-1(b)(1)(D)(ii).
81. § 77d-1(b)(1)(D)(iii).
82. *See* 17 C.F.R. § 230.215 (2012).
83. *See id.*
84. 15 U.S.C. § 77d(a)(6)(B)(i) (2012).
85. § 77d(a)(6)(B)(ii).
86. *See id.*

information under future SEC rules, once they are issued.[87] The issuer must also provide post-offering annual operational and financial reports subject to future SEC rule.[88]

4. Target Offering Limits and Resale Restrictions

Offering proceeds will be released to the issuer once its target offering amount is reached, subject to additional SEC rulemaking.[89] Specifically, the SEC must make rules determining to what extent investors may cancel their commitments to invest.[90] Investors cannot transfer or resell their crowdfunded securities for one year after the offering, subject to limited exceptions.[91]

5. Rules Governing Intermediaries

Offerings will be made through intermediaries who will register with the SEC either as funding portals or broker-dealers.[92] Intermediaries must conduct background checks on issuers.[93] The SEC will prescribe rules regarding additional disclosures, investor education materials and questions to be provided by intermediaries, as well as other matters the SEC may decide to require.[94]

Although Congress provided a guiding framework by enacting these provisions, the SEC must also promulgate rules that fill in the gaps left open by Congress, as noted above. The next section explains the SEC's delay in doing so, and discusses how states have acted to fill that void.

87. § 77d-1(b).
88. § 77d-1(b)(4).
89. § 77d-1(a)(7).
90. *Id.*
91. § 77d-1(e) (permitting transfer of such securities only back to the issuer, to an accredited investor, to a family member, or as part of a registered offering).
92. § 77d-1(a)(1).
93. § 77d-1(a)(5).
94. *See* § 77d-1(a)(3), (a)(4)(C)(iii). Under its proposed rules, the SEC would require intermediaries to "positively affirm" that investors review financial education materials that meet SEC standards, once established. Crowdfunding, 78 Fed. Reg. 66,428, 66,471 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249). At the same time, the SEC expressed the view that intermediaries should be empowered to design their own compliance programs, considering the intermediary's business model, types of offerings, and "other relevant considerations." *Id.* Thus, the SEC's proposal empowers intermediaries to decide what education materials to provide, reasoning that "an intermediary's familiarity with its business and likely investor base would make it best able to determine that format in which to present the [educational materials]." *Id.*

B. Lack of SEC Rules For JOBS Act Implementation

While Congress has created the general framework for equity crowdfunding, several provisions in the JOBS Act still require SEC rulemaking for full implementation.[95] Although Congress directed the SEC to issue rules to implement Title III of the JOBS Act within 270 days of enactment,[96] the January 5, 2013, deadline has long since passed. In the vacuum left by SEC inaction, states have taken the initiative by passing their own crowdfunding exemptions under section 3(a)(11) of the Securities Act of 1933, which exempts completely intrastate crowdfunding transactions from SEC regulation.[97] As of this writing, fourteen states have passed intrastate crowdfunding exemptions, including Kansas,[98] Georgia,[99] Wisconsin,[100] Michigan,[101] Alabama,[102] Maine,[103] Indiana,[104] Idaho,[105] Colorado,[106] Maryland,[107] Tennessee,[108] Washington,[109] Texas,[110] and Oregon.[111] Unfortunately, while North Carolina was one of the first

95. *See supra* Section III.A.

96. JOBS Act, Pub. L. No. 112-106, §§ 302(b), 304(a)(2), 126 Stat. 306, 315–22 (codified as amended at 15 U.S.C. §§ 77a, 77c).

97. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (2012) (exempting intrastate offerings from SEC registration so long as the issuer is a business organized in the state where its securities are issued and all investors reside in that state).

98. KAN. ADMIN. REGS. § 81-5-21 (2015).

99. GA. COMP. R. & REGS. 590-4-2.08 (West, Westlaw through July 31, 2015).

100. WIS. STAT. §§ 551.202(26), 551.205 (2015).

101. MICH. COMP. LAWS ANN. § 451.2202a (West, Westlaw through 2015 Mich. Pub. Acts 130).

102. ALA. CODE § 8-6-11 (West, Westlaw through Act 2015-520).

103. ME. REV. STAT. ANN. tit. 32, § 16304(6-A)(D) (West, Westlaw through Ch. 377 of the 2015 1st Reg. Sess.).

104. IND. CODE ANN. § 23-19-2-2(27) (West, Westlaw through 2015 1st Reg. Sess.).

105. Idaho takes an approach unique from the traditional crowdfunding exemptions seen in other states. IDAHO CODE § 30-14-203 (LEXIS through 2015 Reg. and 1st Extra. Sess.). The Director of the Department of Finance of Idaho reviews, approves, and issues orders on a case-by-case basis. *Id.* For an example of one of these orders, see Treasure Valley Angel Fund, LLC, No. 2012-7-02 (Idaho Dep't of Finance Jan. 20, 2012), http://www.finance.idaho.gov/securities/Actions/Administrative/2012/2012-7-02.pdf [http://perma.cc/3YNV-4BZJ].

106. COLO. REV. STAT. § 11-51-308 (LEXIS through 1st Reg. Sess. of the 70th Gen. Assemb.).

107. Maryland's law only permits debt crowdfunding. MD. CODE. ANN., CORPS. & ASS'NS § 11-601 (LEXIS through ch. 475 of the 2015 Legis. Sess.)

108. TENN. CODE ANN. § 48-1-103(b)(9)(C) (2012).

109. WASH. REV. CODE ANN. §§ 21.20.310, .320, .325 (West, Westlaw through 2015 Reg. Sess. & 1st, 2d & 3d Spec. Sess.).

110. 7 TEX. ADMIN. CODE § 139.25 (West, Westlaw through 40 Tex. Reg. No. 5104, dated Sept. 18, 2015).

111. OR. REV. STAT. ANN. § 59.035(15) (West, Westlaw through Ch. 848 of the 2015 Reg. Sess.).

states to draft an intrastate equity crowdfunding exemption, the bill's failure in the state legislature has kept North Carolina off that list.[112]

IV. THE NORTH CAROLINA JOBS ACT

The North Carolina Jumpstart Our Business Startups Act, or House Bill 680 ("H.B. 680"), was intended to a less restrictive version of the Federal JOBS Act. Compared with the federal exemption, H.B. 680 included higher offering limits, fixed (instead of variable) annual individual unaccredited investment limits, and less rigorous disclosure requirements.

Section IV.A of this Comment addresses H.B. 680's approach to each of the Federal JOBS Act provisions noted above. Section IV.B explains the reasons for and immediate effects of the bill's failure.

A. *North Carolina House Bill 680's Approach to Intrastate Crowdfunding*

House Bill 680's approach to crowdfunding included (1) aggregate offering limits and accompanying disclosures triggered by offering limits; (2) aggregate annual limits on individual investor contributions; (3) issuer pre- and post-offering disclosure requirements; (4) target offering limits and the "all-or-nothing" provision; (5) the nine-month resale restriction on crowdfunded securities; and (6) limited rules governing intermediaries. Each of these provisions is discussed below.

1. Aggregate Fundraising Limits and Accompanying Disclosures

The North Carolina JOBS Act would have permitted issuers to raise up to $1,000,000 within any twelve-month period without producing audited financial statements.[113] In contrast, the federal exemption requires audited financials from issuers that seek to raise $500,000 or more[114] and financial statements reviewed by an independent public accountant for those seeking financing greater than $100,000.[115] Moreover, H.B. 680 provided issuers with an additional option not seen in the federal exemption—to raise up to $2,000,000 with audited financial statements.[116]

112. *See supra* note 10.
113. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(3)(a).
114. 15 U.S.C. § 77d-1(b)(1)(D)(iii) (2013).
115. § 77d-1(b)(1)(D)(ii).
116. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(3)(b).

2. Aggregate Annual Limits on Individual Investor Contributions

Under H.B. 680, unaccredited investors'[117] aggregate contributions would have been limited to $2,000 per issuer, per year.[118] Accredited investors would not have been subject to any aggregate investment cap.[119] By contrast, the federal exemption provides for a variable cap based on unaccredited investors' annual income or net worth,[120] rather than the fixed investment cap in H.B. 680 that would have applied to all unaccredited investors, regardless of their income or net worth.[121]

3. Pre-Offering and Post-Offering Disclosure Requirements

Although pre- and post-offering disclosure requirements under the federal exemption remain subject to SEC rulemaking,[122] H.B. 680 closely mirrored the requirements prescribed in the federal crowdfunding exemption. Under H.B. 680, issuers would have been required to produce a set of disclosures at least ten days prior to their securities offerings.[123] Required disclosures included: (1) background information about the underwriter, the company, its executive officers, and any shareholders with at least ten percent ownership in the company's securities; (2) the company's business plan; (3) the issuer's target offering amount, a deadline to reach that target, and a statement describing the intended use of the offering proceeds; (4) information regarding the issuer's capital structure; (5) information regarding the terms and potential modifications to securities, the differences among classes of securities, and the total percentage ownership of the company that the offered securities represent; (6) a discussion of significant factors that make a particular offering risky; (7) a description of any litigation or legal proceedings involving the company or its management; and (8) the websites that would be used in connection with the offering.[124]

House Bill 680 would have required issuers to display on the cover page of their disclosure documents a legend that alerted investors awareness to the risks associated with crowdfunded

117. H.B. 680 borrows the SEC's definition of "accredited investor." *Compare id.* sec. 2, § 78A-17.1(a)(4), *with* 17 C.F.R. § 230.501(a) (2012) (defining "accredited investor").
118. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(4).
119. *Id.*
120. 15 U.S.C. § 77d(a)(6)(B)(i)–(ii) (2012).
121. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(4).
122. *See supra* Section III.A.3.
123. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(5).
124. *Id.* sec. 2, § 78A-17.1(a)(5)(b).

securities.[125] Additionally, the bill would have required investors to certify in writing that they understood the financial risks of investing in crowdfunded securities.[126] Subsequent to the offering, H.B. 680 would have required issuers to provide to investors quarterly financial and operational reports.[127]

4. Target Offering Limits and Resale Restrictions

Under H.B. 680, offering proceeds would have been collected and deposited in escrow in a North Carolina bank.[128] The proceeds would have been released to the issuer only once the aggregate capital raised from all investors met the issuer's offering target.[129] Under the "all-or-nothing" rule, similar to that provided in the federal exemption,[130] if the issuer failed to reach its offering target by the deadline stated in the pre-offering disclosures, investors would have been free to cancel their commitments.[131] Post-offering, H.B. 680 would have temporarily prohibited investors from reselling or transferring securities, subject to limited exceptions.[132]

5. Rules Governing Intermediaries

Additionally, under H.B. 680, intermediaries would have been required to obtain evidence from an issuer that the issuer was incorporated and "authorized to do business" in North Carolina.[133] Intermediaries would also have been prohibited from certain activities that may create conflicts of interest.[134] Specifically, intermediaries would have been prohibited from offering investment advice or recommendations, advertising particular securities, compensating or furnishing commissions based on sales of certain securities on the intermediary's website, and holding, investing, or handling investors' funds or securities.[135] The federal exemption

125. *Id.* sec. 2, § 78A-17.1(a)(7) (including warnings about liquidity risk, the potential inaccuracy of disclosure documents, and the investor's burden to examine the issuer and terms of the offering).
126. *Id.* sec. 2, § 78A-17.1(a)(8).
127. *Id.* sec. 2, § 78A-17.1(c).
128. *Id.* sec. 2, § 78A-17.1(a)(5)(c).
129. *Id.*
130. *See supra* Section III.A.4.
131. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(5)(c).
132. *Id.* sec. 2, § 78A-17.1(a)(7).
133. *Id.* sec. 2, § 78A-17.1(a)(9)(a).
134. *Id.* sec. 2, § 78A-17.1(a)(11)-(12).
135. *Id.*

provides similar requirements, though the SEC may impose additional requirements via rulemaking.[136]

B. *"We Can Do Better. Let's Kill This Thing and Do Better."*[137]

House Bill 680 passed the North Carolina House of Representatives with near unanimous support.[138] The bill was then approved by the senate commerce committee,[139] before it stalled as part of a complicated legislative power play between the state house, senate, and Governor McCrory.[140] Rather than passing the crowdfunding exception on its own, the senate attached the language of H.B. 680 to a bill that would have enacted several controversial economic development incentives and budget initiatives that were deeply unpopular in the house, but supported by the governor.[141] In a "legislative insurrection" against the senate, governor, and house leadership, H.B. 1224 was narrowly defeated, taking the popular crowdfunding exemption with it.[142] Thus, if the votes on H.B. 680 were at all predictive, the crowdfunding exemption was politically popular and would have easily passed had it not been embroiled in the showdown between the house, senate, and governor.[143] However, there may still be room for improvement. In the wake of the crowdfunding exemption's defeat, one state legislator simply said: "We can do better. Let's kill this thing and do better."[144]

The state suffered tangible consequences as a result of the bill's failure, as North Carolina's small businesses and startups were denied

136. 15 U.S.C. § 78c (2013).

137. Smith, *supra* note 11.

138. *See supra* note 10.

139. *See, e.g.*, Samantha Hurst, *North Carolina's Senate Commerce Committee Approves Equity Crowdfunding Bill*, CROWDFUND INSIDER (July 18, 2014, 7:23 AM), http://www.crowdfundinsider.com/2014/07/44473-north-carolinas-senate-approves-equity-crowdfunding-bill/ [http://perma.cc/V3XH-U25T]; David Rani, *Crowdfunding Bill Endorsed by Senate Committee*, NEWS & OBSERVER (July 16, 2014), http://www.newsobserver.com/news/business/article10026410.html [http://perma.cc/8KYX-ZZHB].

140. Laura Leslie, *House Defeats Senate Gambit on TAs, Incentives*, WRAL (Aug. 20, 2014), http://www.wral.com/house-defeats-senate-gambit-on-tas-incentives/13906612/ [http://perma.cc/398U-72L8].

141. H.B. 1224, 2013 Gen. Assemb., Reg. Sess. (N.C. 2013); Mark Binker, *Senate Wants To Tie Teaching Assistant Money to Economic Development Bill*, WRAL (Aug. 14, 2014), http://www.wral.com/senate-wants-to-tie-teaching-assistant-money-to-economic-development-bill/13894547/ [http://perma.cc/JA4R-ZJTK].

142. Leslie, *supra* note 140.

143. *Intrastate Crowdfunding Is Officially Dead in North Carolina—For Now*, *supra* note 10.

144. Smith, *supra* note 11.

the tremendous potential benefits of equity crowdfunding.[145] Some small businesses that were counting on crowdfunding immediately relocated to new states where crowdfunding exemptions had already passed.[146] Likewise, states that already have crowdfunding exemptions have produced several notable business successes.[147]

V. THE CASE FOR EQUITY CROWDFUNDING IN NORTH CAROLINA

The General Assembly should bring equity crowdfunding to North Carolina under a new and improved crowdfunding exemption. North Carolina forgoes tremendous benefits associated with equity crowdfunding while also suffering from a competitive disadvantage compared to other states where exemptions have been passed. Allowing North Carolinian entrepreneurs to draw on equity crowdfunding can help grow the state's economy by encouraging entrepreneurship—thus improving on already innovative ideas; entrepreneurs' access to the capital they desperately need; and increasing investor opportunities, returns, and diversification.

At the same time, there are also concerns associated with equity crowdfunding that have challenged its development. Those concerns include the high risks associated with startups, the high rate of small business failure, and potential abuse by fraudsters. On balance, the benefits of equity crowdfunding outweigh the concerns, which

145. *See, e.g.*, Lauren K. Ohnesorge, *Groundfloor Leaves Raleigh for Atlanta, Cites "Progressive Stance"*, TRIANGLE BUS. J. (Aug. 19, 2014, 11:21 AM), http://www.bizjournals.com/triangle/news/2014/08/19/groundfloor-leaves-raleigh-for-atlanta-cites.html [http://perma.cc/TVZ2-QHA6 (staff-uploaded archive)]; *see also* Ruth Simon & Angus Loten, *'CrowdFunding' Gets a State-Level Test Run*, WALL ST. J. (Dec. 4, 2013, 7:46 PM), http://www.wsj.com/articles/SB10001424052702303722104579237862928397316 [http://perma.cc/92P8-ZTGH (staff-uploaded archive)] (reporting on the first small companies to take advantage of Georgia's crowdfunding exemption).

146. For example, Groundfloor, a Raleigh-based real estate investment startup, moved to Atlanta, Georgia, where equity crowdfunding was already legal. Ohnesorge, *supra* note 145. Notably, Groundfloor explained that the primary reason for the move was that Georgia was "arguably the most forward-thinking state on issues related to crowdfunding[.]" *Id.*

147. Bohemian Guitars, which sells oilcan guitars starting at $250, used the Georgia exemption to raise $126,000, enough to manufacture 1,000 guitars. *See* Simon & Loten, *supra* note 145. More recently, Tecumseh Brewing used Michigan's intrastate exemption to raise $175,000. Stateside Staff, *Tecumseh Brewing Is MILE's First Crowdfunding Success*, MICH. RADIO (May 15, 2014), http://michiganradio.org/post/tecumseh-brewing-company-miles-first-crowdfunding-success [http://perma.cc/68HJ-5779]. Construction and rehabilitation financing have "had some success raising funds for real-estate projects, especially . . . in deals where a bank loan would be difficult or not well-suited to the deal." Nicole Fallon, *Crowdfunding Goes Mainstream: Trends and Tips for 2015*, BUS. NEWS DAILY (Nov. 25, 2014, 10:06 AM), http://www.businessnewsdaily.com/7506-crowdfunding-trends-tips.html [http://perma.cc/P4BL-SDZX].

appropriate legislation can mitigate. Ultimately, states are best positioned to regulate crowdfunding by legislating to capture its benefits and to mitigate its risks.

A. Benefits of Equity Crowdfunding

Currently, there are at least two barriers to entrepreneurs' access to business capital. First, entrepreneurs cannot access investor funds if they cannot connect with investors.[148] This barrier is often the cause of the geographic concentration of business capital in certain areas, like Silicon Valley.[149] Notably, the majority of startup capital is raised within fifty miles of the startup firm's location.[150] The Internet can help ameliorate this disconnect. Online equity crowdfunding portals allow investors to remotely search, identify, and evaluate investment opportunities.[151] The Internet's ability to connect financiers and entrepreneurs is already evinced by other varieties of crowdfunding.[152]

Second, private small business investment is generally limited to wealthy, "sophisticated" individuals, or firms that specialize in startup firm investments.[153] However, crowdfunding expands the investor base by providing entrepreneurs a fresh, untapped, and abundant source of capital.[154] Equity crowdfunding will allow "unaccredited" investors[155]—everyday people—to begin to invest in small businesses and startup companies.[156] Thus, unlike companies funded by angel investors or venture capital, projects funded by equity crowdfunding reach their target offering goals by soliciting small contributions from a large number of investors.[157] Furthermore, crowdfunding empowers people to wed their passions and interests to a financial return, which already takes place with existing forms of crowdfunding.[158] Investors

---

148. *See supra* notes 34–47 and accompanying text.
149. Bradford, *supra* note 48, at 101; *see also* Stearns & Mizruchi, *supra* note 41, at 291.
150. *See* Thomas E. Vass, *North Carolina's New Nexus of Innovation: Where Local Capital in N.C. Cities Funds Local Investment Opportunities in Technology Commercialization*, BESTTHINKING, http://www.bestthinking.com/articles/economics/political_economy/north-carolina-s-new-nexus-of-innovation-where-local-capital-in-n-c-cities-funds-local-investment-opportunities-in-technology-commercialization [http://perma.cc/VP8D-5UWK].
151. *See supra* notes 67–72 and accompanying text.
152. *See supra* notes 60–72 and accompanying text.
153. *See supra* notes 35–47 and accompanying text.
154. *See supra* notes 73–77 and accompanying text.
155. *See* 17 C.F.R. § 230.215 (2012) (defining "accredited investor").
156. *See supra* Section III.A.1.
157. *See supra* notes 67–72 and accompanying text.
158. *See supra* notes 60–66 and accompanying text.

uninterested in traditional purposes for investing may find such an option particularly attractive.[159]

While equity crowdfunding expands the investor base, it also expands the *entrepreneurial* base. Lack of access to capital poses a substantial obstacle to small business startups.[160] After investing the time and effort necessary to bring its ideas to fruition, a would-be startup faces the bona fide risk that a capital shortfall could stonewall its project.[161] Facing that risk leaves many would-be entrepreneurs with cold feet.[162] Equity crowdfunding may encourage entrepreneurship and increase innovation by reducing capital risks.[163]

Furthermore, crowdfunding portals will facilitate open communication among investors, potential customers, and entrepreneurs, allowing these three groups to align their interests.[164] Investors can air their concerns by providing specific recommendations to issuers. Issuers will benefit from customer and investor feedback before spending substantial sums on production, allowing issuers to perfect their products and proactively respond to

159. *See, e.g.*, *Why Invest*, SEC, http://investor.gov/introduction-markets/why-invest #.VJbmmsAAA [http://perma.cc/PHJ9-WDKR] (explaining that people generally invest to attain financial security or grow their wealth).

160. *See supra* Part I.

161. *See, e.g.*, *Quitting My Corporate Job for My Dream Startup Ruined My Life*, BANKS.COM (Oct. 21, 2014), http://www.banks.com/articles/quitting-my-corporate-job-my-dream-startup-ruined-my-life [http://perma.cc/LGN2-XRXK] ("I was running out of funds for the entire project at a much quicker rate than I had predicted. There were so many unexpected costs in the startup process that I hadn't accounted for being new to the realm of starting my own business."); Taylor Sloper, *Too Scared To Leave Your 9-to-5? Code Fellows' Brent Turner Debunks Silly Startup Myths*, GEEKWIRE (Oct. 22, 2013, 4:37 PM), http://www.geekwire.com/2013/codefellows-ceo-brent-turner/ [http://perma.cc/WBW8-8WH2] ("There's no question that joining or founding a startup involves more risk financially than taking a secure corporate job.").

162. *See* ALAN S. GUTTERMAN, BUSINESS TRANSACTIONS SOLUTIONS § 313:4 n.4, Westlaw (database updated Sept. 2015) (noting that the "climate of entrepreneurship" includes "perceptions of prospective entrepreneurs regarding the availability of opportunities . . . their ability to start businesses and . . . the availability of support from others"); Mark Williams, *Fear of Failure Blamed for Central Ohio's Lack of Business Startups*, COLUMBUS DISPATCH (Sept. 18, 2013, 1:37 AM), http://www.dispatch.com /content/stories/business/2014/09/18/fear-is-one-reason-area-hasnt-grown-businesses.html [http://perma.cc/T3AF-R48M] (attributing fear of failure and fundraising struggles to startup hesitancy).

163. *See, e.g.*, NADINE SCHOLZ, THE RELEVANCE OF CROWDFUNDING: THE IMPACT ON THE INNOVATION PROCESS OF SMALL ENTREPRENEURIAL FIRMS 61 (2015) ("Crowdfunding reduces this risk because it 'is helpful in validating the market demand and idea concept; a normal new venture does not have this possibility to show this demand.' " (internal ellipses omitted)).

164. Intermediaries are required by the SEC's proposal to provide communication channels on their funding portals. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,557 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249).

customer needs before they enter the market.[165] Accordingly, crowdfunding allows "[n]ew ideas [to] be free market tested earlier in their development cycle and discarded or funded at a faster rate."[166]

Thanks to the unique risks associated with small startup companies, crowdfunded securities should provide higher risk premiums, potentially resulting in higher returns to investors.[167] Before crowdfunding was possible, investments in small or startup companies were generally available only to wealthy individuals and institutional investors.[168] New opportunities provided by crowdfunding will allow unsophisticated investors to better diversify their investment portfolios.[169]

B. Concerns Associated with Equity Crowdfunding

There are also several concerns associated with permitting small businesses and startups to solicit equity capital from nontraditional and "unsophisticated" investors.[170] The preceding discussion illustrates one of the primary drawbacks to crowdfunded securities—the risk of loss, which is "inherent in small business startups."[171] However, the only way to completely eliminate the risk would be to "bar small business financing altogether."[172] Alternatively, the aggregate individual investment limits found in the federal and state

165. *See* Howard Greenstein, *Tool To Predict Tech Startup Success*, INC. (Aug. 29, 2011), http://www.inc.com/howard-greenstein/tool-to-predict-tech-startup-success.html [http://perma.cc/DDT7-NH5L (dark archive)] (discussing a recent study that found many startups failed because they focused more on their product than their potential customers and would benefit from incorporating customer feedback in the design of product prototypes).

166. Howard Leonhardt, *The Enormous Implications of Crowdfunding*, CROWDFUNDBEAT, http://crowdfundbeat.com/2014/10/13/the-enormous-implications-of-crowdfunding/ [http://perma.cc/9MUP-YGHD].

167. A security's risk premium "is a form of compensation for investors who tolerate the extra risk—compared to that of a risk-free asset—in a given investment." *Risk Premium Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/r/riskpremium.asp [http://perma.cc/TW77-AXRX].

168. *See supra* notes 34–46, 68 and accompanying text.

169. Ryan Caldbeck, *How Crowdfunding Can Boost Your Investment Diversity*, FORBES (Dec. 19, 2013, 12:05 PM), http://www.forbes.com/sites/ryancaldbeck/2013/12/19/how-crowdfunding-can-boost-your-investment-diversit/ [http://perma.cc/37CE-MFXG].

170. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,517, 66,519 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249) (referring to the risks faced by "unsophisticated investors"); Alan R. Palmiter, *Pricing Disclosure: Crowdfunding's Curious Conundrum*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 373, 374 (2012) (noting the SEC's "view that there is no way unsophisticated investors can apply a DCF/CAPM analysis . . . ."); Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 461 (2003) (suggesting disclosures may be tailored to "unsophisticated" investors).

171. Bradford, *supra* note 48, at 99; *see supra* notes 16–18 and accompanying text.

172. Bradford, *supra* note 48, at 99.

JOBS acts strike a balance by making losses to any single investor "relatively small and bearable."[173] Moreover, the risks inherent in equity crowdfunding are comparable to other types of crowdfunding, to which "the public is already contributing billions of dollars."[174] And those types of crowdfunding do not necessarily offer returns to investors to compensate for risk.[175]

Equity crowdfunding may not offer issuers the support and business expertise provided by VC funds and angel investors.[176] However, the "crowd," which includes investors, and perhaps even potential customers and experts, will supply additional, qualitative insight to issuers through communication portals on intermediaries' websites.[177] Crowdfunding portals may also choose to employ their own experts to assist issuers, similar to crowdfunding offerings seen elsewhere.[178]

Like any arrangement where people provide funds to an unfamiliar person, crowdfunding opens the door to fraud. Fraudulent issuers may raise money to pay themselves, family, or friends out of investors' pockets under the guise of a legitimate business.[179] Issuers may attempt to dupe "unsophisticated" investors by promising "unrealistic returns on investment."[180] The reduced transparency inherent in crowdfunding increases the likelihood of fraud, where investors "are likely to be strangers to the company, and, as such, would have no information about the company except that provided by the company or website where the securities are offered for sale."[181] These concerns can be mitigated by, among other things, providing for more useful, comprehensible, standardized disclosures supplemented with investor education requirements, and by incentivizing intermediaries to vigorously screen issuers. These proposals will be discussed in greater detail in Part VI.

173. *Id.*

174. *Id.*; *see also supra* Part II.

175. *See supra* notes 60–66 and accompanying text.

176. *See supra* notes 38–44 and accompanying text.

177. *See, e.g.*, *infra* text accompanying notes 427–30.

178. *See, e.g.*, *infra* text accompanying notes 192–97.

179. Lyndon M. Tretter, *Crowdfunding: Small-Business Incubator or Securities Fraud Accelerator?*, 18 WESTLAW J. SEC. LITIG. & REG., Aug. 21, 2012, at *1, *1, 18 No. 8 WJSLR; *see also* Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1767 (2012) (explaining that "fraudsters have for nearly a century found ways to adapt their schemes to new technologies" using methods such as boiler-room tactics, pump-and-dump operations, and Ponzi schemes).

180. Tretter, *supra* note 179, at *2; *see also* Hazen, *supra* note 179, at 1766–67 & n.192.

181. Hazen, *supra* note 179, at 1766.

Given that online equity crowdfunding is brand new, its practical implications are unclear. Variations of equity crowdfunding platforms exist outside the United States, but most face the same uncertainty that seems to plague the industry in general.[182] The United Kingdom,[183] Germany,[184] Italy,[185] and France,[186] among other countries, have already established their own variations of crowdfunding, but often with informal or unclear guidance and shoddy enforcement.[187] Several questions remain unanswered. Will equity crowdfunding effectively improve access to business capital? Which regulatory schemes are effective? Is fraud pervasive, and if so, what regulatory measures are available to effectively combat fraud?

For over ten years, companies have been able to offer liquid equity securities under established securities laws in Australia.[188] The Australian Small Scale Offering Board ("ASSOB") is the best, and

182. *See generally* Weinstein, *supra* note 72, at 437–49 (2013) (describing variations on crowdfunding outside the United States and the challenges faced by investors, issuers, intermediaries, and regulators).

183. The United Kingdom simply applies current securities regulations to the equity crowdfunding industry, without prescribing additional rules exclusive to equity crowdfunding. *See* Financial Services and Markets Act 2000, c. 8, §§ 85(1), 86(1)(b) (U.K.) (exempting from registration those securities offered to fewer than 150 persons). The U.K. crowdfunding space currently consists of two funding portals. Weinstein, *supra* note 72, at 437. To participate, investors are required to undergo a rigorous certification process. *Id.* at 439.

184. Crowdfunding in Germany essentially operates similarly as it does throughout Europe—without any real regulatory "approval or disapproval." Weinstein, *supra* note 72, at 447. For example, crowdfunding in Germany operated on an assumption that offerings were limited to €100,000 until the crowdfunding platform Seedmatch challenged this limit in 2012. *Id.* German regulators acquiesced, and now crowdfunding campaigns may exceed the limit. *Id.* Subsequently, German authorities published guidance, but it only noted existing regulations that "might restrict or prohibit crowdfunding activity." *Id.* (citing Jörg Begner, *Crowdfunding and Supervisory Laws*, BAFIN, at 9 (3d Q. 2012) http://www.bafin.de/SharedDocs/Downloads/EN/Mitteilungsblatt/Quarterly/bq1203.pdf?blob=publicationFile [http://perma.cc/453V-5J6J].

185. Crowdfunding was legalized in Italy, but with minimal guidance. *See* Weinstein, *supra* note 72, at 443–44. Equity crowdfunding is limited to small businesses. *See id*. Companies that have existed for longer than forty-eight months or with revenues over €5 million by the second year are ineligible for crowdfunding. *See id.* at 444.

186. France has a unique system called "CIGALES," which operates a federation of democratically governed clubs that pool their money to invest in "ethically operated small businesses or businesses with particular social or cultural goals." *Id*. at 444–45. The clubs operate altruistically and do not require a return on their investments. *Id.*

187. For example, one U.K. funding portal has been presenting equity opportunities to investors without regulatory approval and is yet to be stopped. *See id.* at 441. Likewise, while German law provides for low investment caps, Seedmatch raised over €100,000 in violation of an unofficial and previously assumed limitation *See id.* at 447.

188. *See Corporations Act 2001* (Cth) ch 6D s 708 (Austl.).

perhaps only established equity crowdfunding platform to date.[189] ASSOB functions like a traditional stock market, and it is primarily self-regulated by the funding portals that operate within it.[190] Individual stock offerings are limited to "[twenty] unaccredited investors per year," but offerings are unlimited as to "accredited and overseas investors."[191]

ASSOB illustrates that equity crowdfunding can be successful and not as risky as some commentators suggest.[192] One study noted that as of April 21, 2014, more than eighty percent of firms financed through ASSOB were still functioning.[193] There have been no reported incidents of fraud.[194] Moreover, ASSOB is uniquely supportive of its issuers. ASSOB provides templates and appoints trained sponsors to assist issuers in the crowdfunding process.[195] ASSOB intermediaries often employ sophisticated finance and investment professionals that meticulously screen and select higher-capability firms before listing firms on their portals.[196] Additionally, the ASSOB lobby engages regulators "to build an environment that allows for capital-raising in a controlled yet not onerous environment."[197]

However, in ASSOB, the average contribution per investor is $30,000.[198]Although this number could be misleading—because high-end contributions tend to greatly exceed the mean—it is far greater

189. *See* AUSTL. SMALL SCALE OFFERING BOARD, http://assob.com.au/ [http://perma.cc/SS8T-W6XY] ("ASSOB matches entrepreneurs, job creators and business pioneers seeking growth capital with investors desirous of investing in high growth opportunities.").

190. *Crowd Funding—Lessons Learned in 8 Years of Equity Crowd Funding*, IPLEDGE (Jan. 28, 2014), https://www.ipledg.com/crowd-funding-lessons-learned-in-8-years-of-equity-crowd-funding/ [http://perma.cc/VR6N-7D6L].

191. *See id.*

192. *See, e.g.*, Hazen, *supra* note 179, at 1767 (suggesting fraud is a serious concern associated with crowdfunding); Palmiter, *supra* note 170, at 415 (identifying barriers to pricing disclosure under a crowdfunding exemption); Benjamin P. Siegel, *Title III of the Jobs Act: Using Unsophisticated Wealth To Crowdfund Small Business Capital or Fraudsters' Bank Accounts?*, 41 HOFSTRA L. REV. 777, 796–99 (2013) (suggesting that lack of transparency, fraud, and potential investor losses under a crowdfunding exemption pose risks).

193. Richard Swart, *The Truth About Crowd Selection and Crowdfunding Success*, CROWDFUND INSIDER (Apr. 21, 2014, 8:00 AM), http://www.crowdfundinsider.com/2014/04/36354-truth-crowd-selection-crowdfunding-success/ [http://perma.cc/9UDT-DWG2].

194. *Id.*

195. *Crowd Funding—Lessons Learned in 8 Years of Equity Crowd Funding*, *supra* note 190.

196. *See* Swart, *supra* note 193.

197. *Crowd Funding—Lessons Learned in 8 Years of Equity Crowd Funding*, *supra* note 190.

198. *Id.*

than the ideal investment sizes envisioned by advocates for crowdfunding in the United States.[199] Furthermore, because only twenty unaccredited investors may participate in any individual offering,[200] ASSOB does not necessarily lend itself to the entire "crowd." Thus, although ASSOB does not provide an ideal prototype for a vision of equity crowdfunding in the United States, it does suggest a that a similar model could work. In any case, equity crowdfunding must first be tested and experimented with to remove any uncertainty—a task for which states are uniquely suited.

C. *The Advantages of State Regulation of Crowdfunding*

State legislators may be wary of passing a state crowdfunding exemption because a federal exemption is near, especially once the SEC passes the rules necessary to implement crowdfunding in the United States. Even if the federal exemption is imminent, crowdfunding may nonetheless be more appropriate for intrastate, rather than national, offerings. Consequently, regulators have opined that the SEC's resources are better spent elsewhere.[201] Regulating crowdfunding at the local level makes sense because most projects will be smaller, local projects.[202] Local economic conditions tend to have stronger effects on small business, independent of the national economy.[203] Moreover, given the small size of crowdfunded offerings, issuers, and individual investment amounts, states "have a more direct interest in these offerings."[204] Likewise, states are "in a better position to communicate with both the issuer and the investor to ensure that this exemption is an effective means of small business capital formation."[205] Finally, amid the major void of data available on the implications of crowdfunding, states should be empowered to fulfill

199. *See supra* notes 78–86 and accompanying text.

200. *Crowd Funding—Lessons Learned in 8 Years of Equity Crowd Funding*, *supra* note 190.

201. *The JOBS Act at a Year and a Half: Assessing Progress and Unmet Opportunities: Hearing S. 113-178 Before the S. Subcomm. on Sec., Ins. & Inv. of the S. Comm. on Banking, Hous. & Urban Affairs*, 113th Cong. 60 (2013) (statement of Rick Fleming, Deputy General Counsel, North American Securities Administrators Association).

202. *See id.*

203. *See, e.g.*, *id.*; Wendell Cox, *How Texas Avoided the Great Recession*, NEWGEOGRAPHY (July 20, 2010), http://www.newgeography.com/content/001680-how-texas-avoided-great-recession [http://perma.cc/AL5P-DG95] ("Texas . . . fully escaped the "housing bubble" that did so much damage in California, Florida, Arizona, Nevada and other states.").

204. *See The JOBS Act at a Year and a Half: Assessing Progress and Unmet Opportunities: Hearing S. 113-178 Before the S. Subcomm. on Sec., Ins. & Inv. of the S. Comm. on Banking, Hous. & Urban Affairs*, *supra* note 201.

205. *Id.*

their traditional roles as experimental laboratories in exploring equity crowdfunding.[206] In any case, providing access to crowdfunded capital to entrepreneurs remains a prerogative and perhaps even a responsibility exclusive to the states.

VI. "WE CAN DO BETTER": A NEW AND IMPROVED NORTH CAROLINA CROWDFUNDING EXEMPTION PROPOSAL

North Carolina's crowdfunding framework must focus on a reasonable regulatory balance that minimizes unnecessary costs and burdens on small businesses and startups, while protecting investors from undue loss, fraud, and abuse. H.B. 680 was a prudent bill that could have achieved that balance. This proposal retains many of H.B. 680's provisions, while proposing certain improvements.

First, a new North Carolina crowdfunding exemption (the "proposal") should retain several of H.B. 680's provisions, including H.B. 680's offering limits, offering-amount triggered disclosures, aggregate individual unaccredited investor limits, the "all-or-nothing" rule, and post-offering disclosure requirements, with some exceptions.

This proposal can improve inherent shortcomings in H.B. 680's disclosure requirements, including excessive costs, lack of utility, and risk of fraud by: (1) providing for standardized disclosures; (2) removing the requirement that issuers provide a "statement of significant risks," in lieu of more general statements of risk; (3) providing for mandated investor education requirements; (4) promoting competition among intermediaries; (5) providing for mandated social networking features on intermediaries' funding portals; (6) requiring intermediaries to retain at least fifteen to twenty-five percent of investor losses in the event of fraud; and (7) loosening H.B. 680's resale restriction in lieu of vesting intermediaries with discretion to establish interportal, intrastate, secondary markets for crowdfunded securities.

A. *Proposed Offering Limits and Disclosures Triggered by Certain Offering Amounts*

The proposal should retain the offering limits and related disclosures proposed under H.B. 680. By not overburdening small

206. *See, e.g.*, Santosky v. Kramer, 455 U.S. 745, 773 (1982) (Rehnquist, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country." (quoting New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting))).

companies with the costs of stringent reporting and compliance requirements, the relevant provisions of the original bill were sufficient to prevent prospective North Carolina startups from moving opportunistically to other states with less burdensome crowdfunding regulations. Additionally, reports produced by companies with little if any operating history would be useless to investors.[207] Moreover, H.B. 680's original limits—up to $1 million uninhibited by additional disclosures or expensive reporting requirements and up to $2 million with audited financial statements[208]—attracted overwhelming bipartisan support.[209]

While there is no "magic number,"[210] $1 million establishes a significant capital base for a company in its initial startup stages. Requiring audited financial statements for companies seeking over $1 million to $2 million seems reasonable given the higher amount of the offering, especially since those companies are more likely to have the requisite operating history and growth targets to justify requiring audited financial statements.[211]

Raising these limits would likely provide no substantial benefits. While higher limits may make North Carolina more attractive to issuers seeking to use the exemption, neither any state exemption nor the federal exemption currently offer limits higher than $2 million.[212] These limits strike the right balance of minimizing burdens to smaller businesses at their most vulnerable stages and requiring further disclosures when businesses seek larger offerings after they have had

207. *See, e.g.*, *Spurring Job Growth Through Capital Formation While Protecting Investors*: *Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 112th Cong. 64 (2011) (statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School) (noting that any company raising only $1 million is likely to be an early-stage startup with little operating history "or, possibly, even [without] financial statements"); Damodaran, *supra* note 42, at 5 ("The limited history that is available for young companies is rendered even less useful by the fact that there is little operating detail in them. Revenues are small or non-existent . . . and the expenses often are associated with getting the business established, rather than generating revenues. In combination, they result in significant operating losses."); Georgia Quinn, *SBA Office of Advocacy Requests Redo by SEC on Crowdfunding Regulations*, CROWDFUND INSIDER (Jan. 17, 2014, 10:06 AM), http://www.crowdfundinsider.com/2014/01/30154-sba-office-advocacy-asks-redo-sec-crowdfunding-regulations/ [http://perma.cc/B32T-C8X9].

208. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(3)(b).

209. *See supra* note 10 and accompanying text.

210. Bradford, *supra* note 48, at 118.

211. *See, e.g.*, *Spurring Job Growth Through Capital Formation While Protecting Investors*: *Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, *supra* note 207, at 66–67 ("Because the maximum aggregate amount that may be raised in any 12-month period is $1 million, this exemption is likely to be used primarily by early stage issuers that do not yet have an operating history or, possibly, even financial statements.").

212. *See, e.g.*, 15 U.S.C. § 77d(a)(6)(B)(i) (2012); *infra* note 214.

some success.[213] Likewise, lowering these limits increases the risk that prospective North Carolina startups will move to other states with more favorable limits, most of which currently mirror H.B. 680's limits.[214] The North Carolina JOBS Act would have only required issuers seeking to raise greater than $1 million to provide audited financial statements.[215] The federal exemption, by contrast, requires audited financials from issuers seeking to raise only $500,000.[216]

Further, provisions requiring audited financial statements for small offerings[217] undermine the purpose of the crowdfunding exemption.[218] Audits are overly burdensome to small business startups because they are so costly.[219] The SEC's proposed rules estimated costs of $4,000 for the preparation and filing of the annual report for offerings of $100,000 or less; $14,350 for an annual review for offerings between $100,000 and $500,000; and $28,700 for the

213. *See* Damodaran, *supra* note 42, at 4–5 (describing the typical small business's early struggles for revenue and later profitability).

214. *See, e.g.*, ALA. CODE § 8-6-11(a)(14)(c) (West, Westlaw through Act 2015-520) (providing that issuers may raise up to $1 million without audited financials); IND. CODE ANN. § 23-19-2-2(27)(C) (West, Westlaw through 2015 1st Reg. Sess.) (providing that issuers may raise up to $1 million without, and $2 million with audited financials); MICH. COMP. LAWS ANN. § 451.2202a(1)(c) (West, Westlaw through 2015 Mich. Pub. Acts 130) (providing that issuers may raise up to $1 million without, and $2 million with audited financials); WIS. STAT. § 551.202(26)(c)(1)(a) (2013) (providing that issuers may raise up to $1 million without, and $2 million with audited financials); GA. COMP. R. & REGS. 590-4-2.08(1)(c) (West, Westlaw through July 31, 2015) (providing that issuers may raise up to $1 million without audited financials); KAN. ADMIN. REGS. § 81-5-21(a)(3) (2013) (providing that issuers may raise up to $1 million without audited financials). *But see* ME. REV. STAT. ANN. tit. 32, § 16304(6-A)(B) (West, Westlaw through Ch. 377 of the 2015 1st Reg. Sess.) (providing that issuers may raise up to $1 million but issuers raising over $500,000 must provide audited financials).

215. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(3)(b).

216. 15 U.S.C. § 77d-1(b)(1)(D)(iii) (2013).

217. *See, e.g.*, § 77d(a)(6)(A) (2012); ME. REV. STAT. ANN. tit. 32, § 16304(6-A)(E)(5)(c) (West, Westlaw through ch. 377 of the 2015 1st Reg. Sess.) (requiring audited financials for offerings greater than $500,000).

218. Companies using the crowdfunding exemption to offer up to $1 million in securities annually would be required to provide the same level of financial disclosure required of an emerging growth company, which may have revenue up to $1 billion, when conducting an IPO of unlimited size. *See* Comment Letter from Ernst & Young, LLP to Elizabeth M. Murphy, Sec'y, SEC 2 (Feb. 3, 2014), http://www.ey.com/Publication/vwLUAssets/CommentLetter_CC0389_Crowdfunding_3February2014/$FILE/CommentLetter_CC0389_Crowdfunding_3February2014.pdf [http://perma.cc/LC8F-GBTQ] [hereinafter EY Comment Letter]. Furthermore, it would be challenging for the principal executive officer to provide U.S. GAAP-basis financial statements without engaging a financial expert. *Id.* at 3.

219. An audit costs around "$15,000 to $20,000 for the *smallest* businesses and $50,000 to $75,000 for middle-market businesses." Gwen Moran, *Looking to Borrow? An Audited Financial Statement Can Help*, ENTREPRENEUR (Mar. 19, 2012), http://www.entrepreneur.com/article/222806 [http://perma.cc/M3PU-7CQU].

requisite annual audit for companies raising $500,000 or more.[220] Though inconsequential for established businesses, these costs can be extremely detrimental to a small business.[221] Moreover, in addition to requiring issuers to pay for such audits,[222] the costs to issuers of compliance and reporting would devour a significant chunk of capital, discouraging the use of the crowdfunding exemption.[223] The SBA Office of Advocacy[224] ("SBA Advocacy") addressed this very concern when it submitted to the SEC its second comment letter in five years.[225] Advocacy explained that forcing small businesses, which often have little or no revenue, to produce audited financial statements would be extremely detrimental relative to their cash flows and the levels of capital they seek to raise.[226]

Worse, issuers would be required to incur these expenses up front, prior to qualifying for a crowdfunded offering.[227] There is a substantial risk that after incurring these costs, the market may not support the issuer's products, thus deterring issuers from using the exemption at all.[228] Issuers may be incentivized to minimize these

220. Crowdfunding, 78 Fed. Reg. 66,428, 66,521 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249).

221. In fact, this has been a source of concern expressed in various SEC comment letters. *See, e.g.*, Comment Letter from Kiran Lingam, Gen. Counsel, SeedInvest, LLC, to Elizabeth M. Murphy, Sec'y, SEC 1 (Jan. 22, 2014), https://www.sec.gov/comments/s7-09-13/s70913-139.pdf [https://perma.cc/UR9D-DWDP] ("The majority of startups will have a tough time financing this level of upfront costs ahead of conducting a crowdfunding raise."); *see infra* notes 227–35 and accompanying text.

222. The SEC estimates that offerings of $100,000 or less will cost issuers between $2,500 and $7,500; offerings between $100,001 and $500,000 will cost issuers between $15,000 and $45,000; and offerings greater than $500,000 will cost issuers between $37,500 and $112,500. *See* Crowdfunding, 78 Fed. Reg. at 66,521.

223. *See* EY Comment Letter, *supra* note 218, at 1.

224. The Small Business Administration's Office of Advocacy was established in 1980, in part to protect small businesses from "unnecessary and disproportionately burdensome" regulatory requirements. *See* Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164 (1980).

225. Quinn, *supra* note 207.

226. *See* Comment Letter from Winslow Sargeant, Ph.D, Chief Counsel for Advocacy, to Elizabeth M. Murphy, Sec'y, SEC 1–2 (Jan. 16, 2014), https://www.sba.gov/content/1162014-crowdfunding-file-number-s7-09-13 [http://perma.cc/F7Y8-KE6X] [hereinafter Sargeant Letter].

227. *See* H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(3)(b) (requiring issuers raising over $1 million to produce pre-offering audited financials).

228. *See* R. Kevin Saunders II, Note, *Power to the People: How the SEC Can Empower the Crowd*, 16 VAND. J. ENT. & TECH. L. 945, 961 (2014).

preliminary costs[229] by choosing a lower target-offering amount, "leaving the company undercapitalized and more prone to failure."[230]

Even if these expenses were tolerable, the financial audits and burdensome reporting requirements noted above miss the point. Their purpose is not to inform investors about the economic prospects of an investment, but rather to enable investors to make a *fully informed* investment.[231] Audited financials produced by companies with minimal, if any, operational history or revenue are useless to investors.[232] Indeed, venture capitalists rarely request audited financials,[233] likely realizing the opportunity cost to their invested dollars, which may be better spent elsewhere. Certainly, concerns related to the riskiness of crowdfunded companies and fraud in online securities offerings are not without merit.[234] But these concerns can be effectively mitigated in ways less burdensome to small issuers.[235]

Nonetheless, offering limits and their accompanying disclosures are irrelevant unless issuers can solicit enough investors to buy into the issuers' ideas. The next section discusses the intricacies of these challenges and the balance between limiting investor losses and easing issuers' capital-raising efforts.

B. Proposed Aggregate Annual Limits on Individual Investor Contributions

The proposed exemption should retain H.B. 680's $2,000 fixed aggregate annual limit on individual unaccredited investor contributions.[236] The costs and complexity of verifying investor financials weigh against imposing a variable cap. Instead, the fixed

229. *See supra* notes 215–20 and accompanying text.

230. Saunders, *supra* note 228, at 962; *see also* J. Tol Broome Jr., *Avoiding the Traps That Cause New Businesses To Fail*, ANVIL MAG., Jan. 2001, http://www.anvilmag.com/comment/101f2.htm [http://perma.cc/BC9P-565J] (noting that undercapitalization is the "number one small-business killer").

231. Louis Brandeis, *What Publicity Can Do*, HARPER'S WKLY., Dec. 20, 1913, at 12, http://www.law.louisville.edu/library/collections/brandeis/node/196 [http://perma.cc/DBX4-9YML] ("Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.").

232. *See, e.g.*, Damodaran, *supra* note 42, at 5 ("The limited history that is available for young companies is rendered even less useful by the fact that there is little operating detail in them. Revenues are small or non-existent . . . and the expenses often are associated with getting the business established, rather than generating revenues. In combination, they result in significant operating losses."); Quinn, *supra* note 207.

233. *See* Quinn, *supra* note 207.

234. *See supra* Section V.B.

235. *See infra* Section VI.D.

236. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(4) (2013).

amount should be reasonable to protect investors from risk of loss and fraud. "Reasonable" means not too high, thus protecting investors from risk of loss and fraud, but not too low, threatening the feasibility of crowdfunding as a capital-raising alternative.

A variable approach ensures that investors' crowdfunding investments are limited to a specific proportion of their income or net worth, effectively limiting the investor's potential investment to a sum the investor can afford.[237] By contrast, a fixed limit applies equally to all investors, not all of whom can reasonably afford the same investments. The lower the investor's income or net worth, the less affordable a fixed limit becomes.[238]

Nonetheless, fixed limits are more easily administered. Oddly, the SEC's proposed rules do not require intermediaries to verify that each investor's income is in compliance with aggregate investment limits for individual investors under a variable approach.[239] Rather, investors would self-certify,[240] leaving intermediaries to simply rely on investor representations.[241] Even if intermediaries were required to verify investor income, the risks and costs to both parties might be prohibitive.[242]

Regardless, it is unclear whether a variable limit could actually be enforced under a self-certification regime. Investors could falsely certify or overstate their income or net worth, defeating the purpose of the individual investment limit.[243] Even honest investors may

237. *See* Bradford, *supra* note 48, at 129–30.

238. For example, consider a bus driver whose income is $15,000 per year. If she invested $2,000 into a venture that fails, that sum represents almost 14% of her income. But if her investment is capped at 3% of her income, she can only invest $450, a much more manageable loss.

239. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,470 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249).

240. *See id.*

241. *See id.* For example, investors who exceed their contribution limits could continue to circumvent the rule because there would be no enforcement authority.

242. Investors may be forced to divulge additional information necessary for intermediaries to calculate income or net worth to comply with investment limits—information not limited to income taxes, paystubs, or other documents that include one's social security number and other personal identifying information. This could expose investors (especially where fraud is concerned), and it may even deter investors from participating, contrary to the JOBS Act's objective—making funds more available. *See* JOBS Act, Pub. L. No. 112-106, pmbl., 126 Stat. 306, 306 (to be codified in various section of 15 U.S.C. §§ 77a-aa, 78a-pp). Moreover, verifying this information would impose additional compliance costs on intermediaries. Those costs, including hiring and training additional employees and creating compliance programs associated with individual investment limits, would likely be passed on to issuers and investors.

243. *SEC's Crowdfunding Proposal: Will it Work for Small Businesses?: Hearing Before H. Subcomm. on Investigations, Oversight, & Regulations of the Comm. on Small*

mistakenly overstate their income or net worth when self-certifying, increasing the likelihood of financial distress in the event of loss.[244] For example, an investor may mistakenly believe that the value of her home may be counted towards her net worth, resulting in a risky crowdfunding investment that represents a large part of her savings.[245] A fixed investment cap provides a simpler and less expensive[246] approach than the federal JOBS Act's variable approach.[247] Therefore, the wisest way to limit individual investments is to provide for a fixed dollar limit.

Without quantifiable data on the "best" fixed individual investment limit,[248] increasing or decreasing H.B. 680's original $2,000 investment limit[249] would be largely arbitrary.[250] The $2,000 cap is reasonable, neither too high nor too low.[251] There are at least three reasons to maintain the $2,000 individual aggregate investment limit. First, "a uniform limit, unless it is very small, does not necessarily limit all investors to an amount they can afford to lose."[252] Moreover, adopting the higher, $5,000–$10,000 limits seen in other states[253] may frustrate bipartisan support by reducing investor protection. If passed,

---

Bus., 113th Cong. 8 (2014) (statement of Mercer Bullard, President, Fund Democracy, Inc.), http://www.gpo.gov/fdsys/pkg/CHRG-113hhrg86267/html/CHRG-113hhrg86267.htm [http://perma.cc/G7VF-Q6ZQ].

244. *Id.*

245. *Id.*

246. *See* Bradford, *supra* note 48, at 127–28.

247. *See* Section III.A.2.

248. *See* Bradford, *supra* note 48, at 129.

249. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(4).

250. *Cf.* Hazen, *supra* note 179, at 1765 ("It is naïve to assume that limiting offerings to small amounts per investor will deter scammers from taking advantage of investors via crowdfunding. Even limiting the exemption to relatively small amounts such as $250 or $500 does not mean that there is an insufficient investor-protection stake such that scrutiny is not warranted.").

251. For example, the $10,000 limit seen in some states, like Wisconsin, WIS. STAT. § 551.202(26)(d) (2013), could subject unwary investors to catastrophic losses. Other states have already attributed lower limits, like the former $1,000 limit in Kansas, to failures. *See* Simon & Loten, *supra* note 145.

252. *See* Bradford, *supra* note 48, at 127 (advocating for a $500 individual investment limit).

253. *See, e.g.*, ALA. CODE § 8-6-11(a)(14)-d (West, Westlaw through Act 2015-520) (providing for $5,000 limit); IND. CODE ANN. § 23-19-2-2(27)(E) (West, Westlaw through 2015 1st Reg. Sess.) (providing for $5,000 limit); ME. REV. STAT. ANN. tit. 32, § 16304(6-A) (West, Westlaw through ch. 377 of the 2015 1st Reg. Sess.) (providing for $5,000 limit); MICH. COMP. LAWS ANN. § 451.2202a(1)(d) (West, Westlaw through 2015 Mich. Pub. Acts 130) (providing for $10,000 limit); WIS. STAT. § 551.202(26)(c)(1)(a) (2013) (providing for $10,000 limit); GA. COMP. R. & REGS. 590-4-2.08(1)(d) (West, Westlaw through July 31, 2015) (providing for $10,000 limit). *But see* KAN. ADMIN. REGS. § 81-5-21(a)(4) (2013) (providing for $1,000 limit).

higher limits may subject "foolhardy investors" to unbearable losses.[254] Indeed, it may be wise to adopt a cautious approach given the uncertainty and potentially unforeseen risks associated with equity crowdfunding.[255]

Second, a reasonable limit on individual investment is consistent with the purpose of equity crowdfunding, which is premised on soliciting a large, aggregate amount of funds from many small, individual contributions.[256] Thus, a lower limit would not compromise the utility of an equity crowdfunding exemption. However, similar to low target-offering limits, an individual investment limit that is too low may frustrate offering success.[257] Dismal offering prospects may cause prospective issuers to move to other states that provide for higher individual investment contributions.[258] Moreover, lower investment caps are irrelevant if the investors they seek to protect are not participating in crowdfunding. That is, if low-income investors are investing responsibly or not participating in crowdfunding at all, then the costs of limiting the investment base outweigh any protective benefit to a miniscule minority of investors. Indeed, low-income Americans, unlike wealthier investors, tend to favor the safest investments, despite their lower performance.[259] Even lower-income

254. *See* Bradford, *supra* note 48, at 140; Hazen, *supra* note 179, at 1766 ("[Crowdfunding] also is likely to attract investors with limited funds who cannot tolerate high investment risk, even for small amounts of money.").

255. *See supra* Section V.B.

256. *See supra* notes 67–72 and accompanying text.

257. In fact, after Kansas issuers complained of difficulties in reaching their target offering amounts, Kansas increased its $1,000 individual investment limit, attributing failures to the low limit. *See* Simon & Loten, *supra* note 145 (explaining that Kansas increased its individual unaccredited investor cap from $1,000 to $5,000). Note also that Kansas has a smaller population relative to many other states, thus a smaller investment base to draw from. For example, as of July 2013, Kansas's population was 2.984 million. *Public Data*, GOOGLE, https://www.google.com/publicdata/explore?ds=kf7tgg1uo9ude_&met_y=population&idim=state:20000:29000:31000&hl=en&dl=en#!ctype=l&strail=false&bcs=d&nselm=h&met_y=population&scale_y=lin&ind_y=false&rdim=country&idim=state:20000:37000&ifdim=country&hl=en_US&dl=en&ind=false [http://perma.cc/SJ7B-VKA4] (comparing the population growth of North Carolina to Kansas over the previous century). Compare that to North Carolina's population, which was 9.481 million as of July 2013. *Id.* Thus, a higher $5,000 cap is probably not necessary in North Carolina.

258. *See, e.g.*, *supra* note 257.

259. For example, low-income Americans favor gold over the stocks, bonds, and real estate favored by wealthier investors, despite the fact that gold has had the lowest returns over the last 200 years of any of those investment classes. John Aziz, *Why the Poor's Investment of Choice Is So Alarming*, THE WEEK (Apr. 23, 2014), http://theweek.com/article/index/260333/why-the-poors-investment-of-choice-is-so-alarming [http://perma.cc/VXW6-ZK5L]. Likewise, given that these investors even prefer "plain-vanilla savings accounts and CDs over stocks," it is unlikely that crowdfunded securities would appear attractive to them. *See* Jeff Cox, *Lower-Income Investors Still Cling to Gold Hopes*, CNBC

Americans that do prefer "safer" investments represent a small subset of low-earners, however, because most low-income Americans abstain from investing at all.[260]

Third, the potential alternatives to a lower individual investment limit are unwise. Supporters of the individual investment cap have characterized it as "the fundamental investor protection in crowdfunding."[261] As noted above, the administrative challenges to implementing a variable approach are burdensome, and permitting self-certification under such a regime could subject investors to unbearable losses. Alternatively, a "free-market" approach, where investors could invest any amount of money risks subjecting investors to losses limited only by the investor's liquidity.[262] Likewise, if intermediaries, competing for investors, are charged with determining individual investor contribution limits, intermediaries could establish either unlimited or very high individual investment limits to attract more investors. Either of the preceding alternatives, which fail to protect investors, would likewise fail to attract bipartisan support.

The reasonable $2,000 aggregate investment limit for individuals in H.B. 680 addresses these concerns—it is neither too high, nor too low.[263] It targets a broad swathe of investors without blindly seeking

(Apr. 22, 2014), http://www.cnbc.com/id/101603207 [http://perma.cc/83Z5-XYWE]. Differences in financial literacy, attitudes about future prospects of the economy, and familiarity, among other reasons, account for the difference. *See id.* Lower-income investors, in contrast to wealthy investors, prefer gold, which is a safer, pessimistic investment that will have value even when society breaks down. *See id.* "Rich people are by definition those who are doing well within the current economic system, while poor people are by definition not doing so well within it. So it's totally unsurprising that the rich are expressing higher levels of confidence in a system they are doing well within, and the poor are expressing lower levels of confidence." *See* Aziz, *supra*.

260. For example, in a 2012 Financial Capability study, 18% of respondents with incomes below $25,000 tried to plan for retirement, and only 11% of that group had nonretirement investments. FIN. INDUS. REGULATORY AUTH., INV. EDUC. FOUND., FINANCIAL CAPABILITY IN THE UNITED STATES 14, 16 (2012), http://www.usfinancialcapability.org/downloads/NFCS_2012_Report_Natl_Findings.pdf [http://perma.cc/9ZF5-ESE6].

261. Saunders, *supra* note 228, at 972; *see also* Andrew A. Schwartz, *Keeping It Light, Chairman White: SEC Rulemaking Under the Crowdfunding Act*, 66 VAND. L. REV. EN BANC 43, 60 (2013) ("The annual cap is so important to the entire statutory scheme that the SEC should properly place a relatively heavy burden on intermediaries to enforce it.").

262. *See, e.g.*, *Madoff Victims Recount the Long Road Back*, WALL ST. J. (Dec. 9, 2013, 6:21 PM), http://www.wsj.com/articles/SB10001424052702303560204579248221657387860 [http://perma.cc/5DXA-M284 (staff-uploaded archive)] (discussing several victims who lost their entire savings to fraudster Bernie Madoff's Ponzi scheme).

263. However, the paternalism inherent in limiting individual investment in crowdfunding strikes the author as ironic, considering that Americans are free to do many risky things with their money. For instance, Americans "are perfectly within their rights

to protect a small group of merely *potential* investors or compromising equity crowdfunding's feasibility as an alternative capital-raising mechanism. This provision is protective enough to generate the bipartisan support that the bill will need in order to pass, particularly when accompanied by other provisions specifically designed to protect vulnerable investors.[264]

C. The "All-or-Nothing" Provision

North Carolina's equity crowdfunding exemption should also retain H.B. 680's "all-or-nothing" provision. This provision requires that offering proceeds be held in escrow and released if and when the issuer's campaign reaches the target-offering amount, as stated in the issuer's pre-offering disclosures.[265] Until the target is reached, investors should be able to withdraw their investments.[266] Combining the "all-or-nothing" provision with the option to withdraw creates several protective benefits. First, it protects investors from losses resulting from making risky investments in undercapitalized companies. Second, it maintains checks on issuers by promoting responsiveness in funding-portal communication, weeding out potentially unsuccessful companies. Third, the "all-or-nothing" and optional withdrawal provisions encourage diligent planning.

The "all-or-nothing" provision helps prevent investor losses in unattractive ventures by shifting to issuers the risk of loss due to undercapitalization. Moreover, since the "crowd" is comprised of a diverse array of investors, sophisticated and unsophisticated,[267] the "all-or-nothing" provision makes it more difficult for unscrupulous issuers to poach unsophisticated or "foolhardy" investors.[268] An "all-or-nothing" provision works in tandem with interactive portals because investors can continue to share information while the offering is open, resulting in a more informed "crowd."[269] If an

under current law to go to Las Vegas or Atlantic City and bet their entire lifesavings on one roll of the dice," but are unable to invest their chosen amount in a crowdfunding venture. *See* 158 CONG. REC. H1222-04 (daily ed. Mar. 7, 2012) (statement of Rep. Polis). If it is true that "[t]he line between gambling and investing is artificial and thin," it seems inconsistent to allow unlimited gambling, but not unlimited investment. MICHAEL LEWIS, THE BIG SHORT 256 (2010).

264. *See supra* Section VI.A; *infra* Sections VI.C–G.
265. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(5)(c).
266. *See id.*
267. *See infra* text accompanying notes 388–90.
268. *See* Bradford, *supra note* 48, at 140.
269. *See id.* at 139–40.

investor "conclude[s], based on information shared, that an offering is not a suitable investment[,]" she can withdraw her bid.[270]

Of course, the more liberal "all-or-something" provisions found in other state exemptions[271] are not without merit. An issuer may avoid undercapitalization when retaining some of its offering proceeds, which may occur when the issuer covers upfront costs pursuant to its crowdfunded offering.[272] The reduced risk will encourage more issuers to use the crowdfunding exemption, diversifying funding portal offerings and attracting more investors.

Nonetheless, undercapitalization is just as likely to occur when funding falls far short of the issuer's operating requirements, which is much more likely under an "all-or-something" regime. Then, in the event of failure, the loss is wholly owned by the investors, who were either unwilling or unable to withdraw their funds in the underfunded company. Furthermore, the threat that investors may withdraw their funds before the issuer reaches its target creates a greater incentive for issuers to be more responsive when communicating over funding portals. This communication mutually benefits both parties.[273] Issuers receive free, tailored recommendations to improve their businesses.[274] Investors and customers can voice their concerns. Likewise, the "all-or-nothing" provision provides an early indicator of success or failure.[275] The issuer must convince investors that its venture is worth the risk.[276] Thus, the market can reject the issuer's idea before crowdfunding participants risk their money in an issuer's unworthy venture.

Finally, an "all-or-nothing" provision prevents issuers from overreaching or setting arbitrary targets.[277] Since the offering will fail if it falls short of its target, issuers will budget more diligently.[278] The "all-or-nothing" provision, therefore, protects vulnerable investors and incentivizes issuers to be responsive and diligent without

270. *Id.*

271. *See, e.g.*, IND. CODE ANN. § 23-19-2-2(27)(F)(vi) (West, Westlaw through 2015 1st Reg. Sess.) (permitting investors to choose whether to cancel the investor's commitment to invest if the target goal is not reached before the deadline stated in the disclosure).

272. *See supra* notes 227–30 and accompanying text.

273. *See infra* Section VI.D.4.

274. *See* Bradford, *supra* note 48, at 135 (suggesting that recommendations may "help the entrepreneur refine her business plan").

275. *Cf. supra* notes 130–131 and accompanying text.

276. *See* Richard A. Epstein, *The Political Economy of Crowdsourcing: Markets for Labor, Rewards, and Security*, 82 U. CHI. L. REV. DIALOGUE 35, 44–45 (2015).

277. *See* Bradford, *supra* note 48, at 140.

278. *Id.*

significantly impeding issuers' ability to utilize crowdfunding to raise capital.

Like most other provisions, the effectiveness of the "all-or-nothing" provision substantially depends on the disclosure requirements because of the upfront costs that disclosure requirements impose on issuers, as discussed above.

D. Proposed Pre-Offering and Post-Offering Disclosures and Reporting Requirements

As discussed throughout this Comment, nearly all provisions inherent in an effective crowdfunding regulatory regime depend upon useful, effective, and affordable disclosures, including the "all-or-nothing" provision, investor contribution limits, investor education, intermediary regulation, and resale restrictions. North Carolina should improve on H.B. 680's disclosure requirements, which would have required extensive and sometimes ambiguous issuer-drafted disclosures.[279] Before explaining recommended disclosure requirements under the proposed exemption, it is helpful to understand the benefits and shortcomings inherent in certain disclosures.

1. Overburdening Small Issuers with Excessive Costs and Liability

Disclosures are undoubtedly necessary because they provide investors with the information required to make informed investment decisions.[280] Disclosures may also prove useful for appraisal purposes, especially since crowdfunded securities will be illiquid, and thus not easily valued if resale restrictions are retained.[281] More importantly, mandatory disclosures help to prevent investors from being duped by

279. For example, H.B. 680 required "a discussion of significant factors that make a particular offering risky," while also requiring issuers to display on the cover page of their disclosure documents a legend that warned investors of the risks of crowdfunded securities. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(13). The bill also required issuers to provide information regarding the differences among classes of securities. *Id.* sec. 2, § 78A-17.1(a)(5)(b)(4).

280. *See* Brandeis, *supra* note 231, at 12.

281. *See, e.g.*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: UNIQUE AND HARD-TO-VALUE ASSETS 18 (Aug. 2012) (explaining potential difficulty with determining "hard to value or illiquid assets"); *see also* Azam Ahmed, *For Sale: Illiquid Assets, Hard To Value*, N.Y. TIMES: DEALBOOK (Mar. 28, 2011, 3:09 PM), http://dealbook.nytimes.com/2011/03/28/for-sale-illiquid-assets-hard-to-value/?_r=0 [http://perma.cc/W7HV-JFA2] (explaining hedge fund managers' use of "side-pockets" for illiquid investments such as toxic loans that would be sold at fire-sale prices after the financial crisis).

fraudsters, who historically have been successful at developing innovative scams in response to new technologies.[282]

Disclosures, however, do not achieve these goals unless they are meaningful.[283] Moreover, excessive disclosure requirements frustrate the core purpose of any crowdfunding exemption—increasing accessibility of capital to startups and small businesses.[284] Many of the required disclosures under H.B. 680[285] and other state exemptions[286] implicate "complex areas of corporate law and finance."[287] Under H.B. 680, issuers would likely be required to enlist professional legal and financial expertise to draft disclosure forms containing details regarding the issuer's capital structure, rights and comparisons among its security classes, and quarterly reports.[288] Similar to audited financial statements, such disclosures may be prohibitively expensive for small issuers to produce.[289]

282. Hazen, *supra* note 179, at 1767–68 (describing how several types of fraud schemes, including boiler-room sales operations, "pump-and-dump" schemes, and Ponzi schemes, have adapted to take advantage of new technologies). For a colorful illustration of how such operations work, see generally JORDAN BELFORT, THE WOLF OF WALL STREET (2013) (describing the rise and fall of Jordan Belfort, who founded Stratton Oakmont, a brokerage house that engaged in pump and dump schemes and other forms of securities fraud); *see also What Is a Boiler Room Operation?*, INVESTOPEDIA, http://www.investopedia.com/ask/answers/04/080604.asp [http://perma.cc/8W5Y-8QFS]. Bernie Madoff operated a successful "Ponzi" scheme, in which he duped unsuspecting investors with promises of large returns and virtually no risk, only to pocket the investors' cash for himself. *See* Diana B. Henriques, *Madoff Scheme Kept Rippling Outward, Across Borders*, N.Y. TIMES (Dec. 19, 2008), http://www.nytimes.com/2008/12/20/business/20madoff.html?pagewanted=all&_r=1& [http://perma.cc/G3D4-QK9B (dark archive)]. When the investors wanted to cash out, Madoff paid from the pool of other investors' funds. *See id.* Madoff drew some skepticism as he consistently reported returns well above market rates, but it was not until the credit crunch in 2008 when Madoff's scheme collapsed as investors rapidly pulled out their money. *See id.*

283. *See, e.g.*, 12 C.F.R. § 208.84(c)(6) (mandating meaningful disclosures). S*ee generally* ERNST & YOUNG, DISCLOSURE EFFECTIVENESS (2014), http://www.ey.com/Publication/vwLUAssets/EY-disclosure-effectiveness-what-companies-can-do-now/$FILE/EY-disclosure-effectiveness-what-companies-can-do-now.pdf [http://perma.cc/K3UL-9KGA] (describing how to make corporate disclosures more meaningful).

284. *See supra* Section VI.A.

285. *See* H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(5)(b) (requiring disclosures such as a description of the company's capital structure, the terms and potential modifications to securities, the differences among classes of securities, and how other classes of securities may affect the rights of crowdfunded securities).

286. *See, e.g.*, ME. REV. STAT. ANN. tit. 32, § 16304(6-A)(E)(6) (West, Westlaw through ch. 377 of the 2015 1st Reg. Sess.) (requiring a detailed description of the issuer's capital structure).

287. John S. Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 600 (2013).

288. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(5), (c).

289. *See supra* note 219 and accompanying text.

At the same time, asking issuers to prepare a "discussion of significant factors that make the offering speculative or risky"[290] is not only redundant, but will likely require the employ of a securities attorney and possibly even an accountant, further increasing the upfront cost to the issuer.[291] Furthermore, certifying a statement that outlines significant risks associated with the issuer subjects the issuer to uncertain levels of potential liability notwithstanding good faith.[292] It would be impossible to forecast all significant risks, especially for startups with limited or no operating history and no point of reference to identify such "significant" risks.[293] Would a statement as general as "we could fail and lose your entire investment" be sufficient? Naturally, with a startup this is a significant risk, but these types of generic risks are better disclosed elsewhere in the form of a general disclaimer.[294] Of course, this type of information is less specific, but a relaxed disclosure requirement would prevent issuers from subjecting themselves to liability potentially equaling the purchase price of the offered securities,[295] thus reducing an issuer's litigation risk without unduly degrading investor information when sufficient alternative disclosures are provided.[296]

Thus, disclosures are necessary, but overburdening issuers with excessive costs and potential liability—only to provide disclosures that do not satisfy their purpose—is not helpful to issuers *or* investors. The next section discusses disclosures that overburden investors with too much information, or incomprehensible information, which is a significant part of the problem.

290. *See* H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(13).

291. *See* ANNE M. KHADEMIAN, THE SEC AND CAPITAL MARKET REGULATION: THE POLITICS OF EXPERTISE 91 (1992) (noting broad demand for securities lawyers and the law firms that employ them).

292. *See, e.g.*, Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 627 (1996) ("When risky investments go wrong, brokers and customers may blame each other for the misfortune. Courts and others resolving these disputes must then decide whether the broker withheld information about the risk, or whether the customer knew about the risk and simply made a bad decision.").

293. Even venture capitalists require *some* operating history to perform due diligence. *See Venture Capital*, *supra* note 35.

294. *See* H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(7) (requiring issuers intermediaries to provide a legend to apprise investors of the general risks of investing in crowdfunded securities).

295. *See infra* note 409 and accompanying text.

296. *See infra* Sections VI.D.3–4 (proposing a simplification of the disclosure process by limiting the amount of complex information and providing simple, standardized disclosure forms).

2. Limits on Disclosure Value for "Unsophisticated" Investors

Even if the information described above could be had at a low cost, of what value is it to "unsophisticated" and nontraditional retail investors? The theoretical effectiveness of such disclosures for investor-protection purposes is informed by two assumptions: that (1) "unsophisticated" investors read the disclosures; and (2) they are fully capable of understanding the disclosures.[297] Indeed, the Supreme Court's "reasonable investor" standard explicitly endorses these expectations.[298] Moreover, "courts expect reasonable investors to have an awareness of general economic conditions and to understand the principles of diversification, the time-value of money, the nature of margin accounts, and the securities industry's compensation structure."[299] Theoretically, investors use information contained in disclosures to value an issuer's securities or to make informed predictions on the economic prospects of the issuer.[300] However, studies consistently show that a significant proportion of retail investors lack even *basic* financial literacy—a necessity for understanding these disclosures—which undermines the entire rationale for disclosure requirements.[301]

Furthermore, the volume of information contained in the prescribed securities disclosures can create cognitively-crippling

297. Barbara Black, *Behavioral Economics and Investor Protection: Reasonable Investors, Efficient Markets*, 44 LOY. U. CHI. L.J. 1493, 1495–96 (2013) ("For example, a widow with a tenth grade education was expected to read and understand written disclosures about risk and illiquidity in a lengthy complex prospectus . . . .").

298. *See* Basic Inc. v. Levinson, 485 U.S. 224, 233–34 (1988) (rejecting the notion that "investors are nitwits" and explaining that investors should not be ascribed "child-like simplicity") (quoting Flamm v. Eberstadt, 814 F.2d 1169, 1175 (7th Cir. 1987)); *see also* Black, *supra* note 297, at 1493–95 (noting the high degree of rationality ascribed to investors by courts and questioning whether that standard "comport[s] with observed reality").

299. *See* Black, *supra* note 297, at 1494–95 (citing several cases where federal courts held the reasonable investor to meet relatively high standards of financial literacy).

300. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-698, MUNICIPAL SECURITIES: OPTIONS FOR IMPROVING CONTINUING DISCLOSURE 16 (2012), http://www.gao.gov/assets/600/592669.pdf [http://perma.cc/2ETJ-325K] (recognizing that investors use disclosures to make investment decisions despite the fact that there is limited information on to what extent investors use disclosures); *Beginners' Guide to Financial Statements*, SEC, http://www.sec.gov/investor/pubs/begfinstmtguide.htm [http://perma.cc/Y9VL-V8SD] (asserting that financial statements provide "powerful information for investors[,] . . . the investor's best tool when it comes to investing wisely").

301. *See, e.g.*, SEC, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS vii-viii (2012) [hereinafter FINANCIAL LITERACY], http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf [http://perma.cc/JSB2-Y875] ("[S]tudies have found that investors do not understand the most elementary financial concepts, such as compound interest and inflation.").

information overload, causing investors to limit their attention to disclosures or avoid them altogether.[302] In fact, an SEC study identified these concerns and suggested that disclosures be provided in summary form with "concise, plain language descriptions of important information."[303] At least one state's crowdfunding legislation has attempted to address such concerns by requiring that certain disclosures, such as those identifying potential risks associated with an issuer, be "concise and organized logically."[304]

Even if the SEC's efforts to reduce legalese and financial jargon in financial disclosures were successful,[305] few if any synonyms exist for terms like "illiquidity"[306] or "capital structure."[307] Moreover,

302. *See generally* Paredes, *supra* note 170, at 419 (arguing that more disclosure is ineffective, creating "information overload" and causing people to adopt "simplifying decision strategies that require less cognitive effort, but that are less accurate than more complex decision strategies").

303. *See* FINANCIAL LITERACY, *supra* note 301, at xi-xii.

304. *See, e.g.*, WIS. STAT. § 551.202(26)(f)(2)(h)(i) (2013) (requiring "a discussion of significant factors that make the offering speculative or risky" to be "concise and organized logically").

305. The SEC has written a handbook, which explains that "[b]ecause many investors are neither lawyers, accountants, nor investment bankers, we need to start writing disclosure documents in a language investors can understand: plain English." Arthur Levitt, *Introduction* to SEC, OFFICE OF INV'R EDUC. & ASSISTANCE, A PLAIN ENGLISH HANDBOOK: HOW TO CREATE CLEAR SEC DISCLOSURE DOCUMENTS 3, 3 (1998). Sixteen years after publication, it is unclear whether the handbook has effected any changes in the industry. *See* ERNST & YOUNG, *supra* note 283; FINANCIAL LITERACY, *supra* note 301, at xiii (noting, in 2012, that many commenters continue to advocate for the use of "plain language and common terminology").

306. A thesaurus search yielded "no thesaurus results," and instead, asked "[d]id you mean algidity[?]" *Illiquidity Synonyms*, THESAURUS.COM, http://www.thesaurus.com/browse/illiquidity?s=thttp://www.thesaurus.com/browse/illiquidity?s=t [http://perma.cc/D5ZQ-CBUX]. "Algidity" is a nominalization of the adjective "algid," which means "chill, cold[.]" *Algid*, WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY (1961). However, in its required portal disclaimer of risk, N.C. H.B. 680 described illiquidity in the following terms:

> THESE SECURITIES ARE SUBJECT TO RESTRICTIONS ON TRANSFERABILITY AND RESALE AND MAY NOT BE TRANSFERRED OR RESOLD EXCEPT AS PERMITTED BY SUBSECTION (E) OF SEC RULE 147, 17 C.F.R. § 230.147(E) AS PROMULGATED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, AND THE APPLICABLE STATE SECURITIES LAWS, PURSUANT TO REGISTRATION OR EXEMPTION THEREFROM. INVESTORS SHOULD BE AWARE THAT THEY WILL BE REQUIRED TO BEAR THE FINANCIAL RISKS OF THIS INVESTMENT FOR AN INDEFINITE PERIOD OF TIME.

H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(7). The certification that each purchaser must sign follows the disclaimer, requiring each buyer to acknowledge "[that] the securities I am acquiring in this offering are illiquid, that there is no ready market for the sale of such securities, that it may be difficult for me to sell or otherwise dispose of this investment." *Id.* sec. 2, § 78A-17.1(a)(8)(c).

financial and operational statements require at least an intermediate level of mathematical competency.[308] Disclosures that demand even intermediate levels of mathematical competency may be ineffective at informing "unsophisticated" investors, given that even lawyers are notorious for struggling with math.[309]

Of course, navigating the legal and financial complexities necessary to write disclosures regarding complex topics requires legal or even financial expertise.[310] Hence, disclosure language is still subject to interpretation by legal and financial experts and the accompanying expert biases that contribute to the incomprehensibility of disclosures. Two examples of such biases, among others, include "status quo [bias]," or the tendency to prefer things to stay relatively the same,[311] and "curse of knowledge" bias, an inability to appreciate other perspectives, whether one's own earlier perspective or that of another.[312] Status quo bias is embodied, for example, in standard-form corporate charters and contracts in certain

307. No synonyms were identified on either Thesaurus.com or Investopedia.com. *See Capital Structure*, THESAURUS.COM, http://ask.reference.com/web?s=t&q=capital%20structure&l=dir&qsrc=2891&o=10300 [http://perma.cc/NJ79-7GDJ]; *Capital Structure Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/c/capitalstructure.asp [http://perma.cc/A79Q-TRBX] (defining capital structure as "[a] mix of a company's long-term debt, specific short-term debt, common equity and preferred equity . . . how a firm finances its overall operations and growth by using different sources of funds"). Of course, one could create a much simpler definition of capital structure, such as "the combination of debt and equity used to finance a company," but even such a relatively simple definition may require explanation for the benefit of the retail investor. *See* Kenneth B. Firtel, *Plain English: A Reappraisal of the Intended Audience of Disclosure Under the Securities Act of 1933*, 72 S. CAL. L. REV. 851, 864–65 (1999). Even if one were to create an even simpler definition, such as "the amount of money that a firm borrows, combined with the money it uses from proceeds from shareholders, to finance its operations," investors still need to understand why a disclosure would be telling them this, and the consequences that flow from a given capital structure. *See id.*

308. *See, e.g.*, Stefan J. Padfield, *Who Should Do the Math? Materiality Issues in Disclosures That Require Investors To Calculate the Bottom Line*, 34 PEPP. L. REV. 927, 943–44 (2007) (explaining how courts apply the general rule that failure to perform mathematical calculations for investors is not a material omission).

309. *See, e.g.*, Debra Cassens Weiss, *Posner: Lawyers Bad at Math Are an Increasing Concern; Inmates Blood-Pressure Suit Shows Why*, A.B.A. J.: SCI. & TECH. L. (Oct. 29, 2013, 12:51 PM), http://www.abajournal.com/news/article/posner_math_block_lawyers_an_increasing_concern_inmates_blood-pressure_suit/ [http://perma.cc/2HTP-Y4QF] (explaining Judge Richard Posner's agitation with "lawyers who explain that they picked law over a technical field because they have a 'math-block' ").

310. *See* KHADEMIAN, *supra* note 291, at 91.

311. *See, e.g.*, William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7, 7 (1988) ("A series of decision-making experiments shows that individuals disproportionately stick with the status quo.").

312. *See, e.g.*, Susan A.J. Birch & Paul Bloom, *The Curse of Knowledge in Reasoning About False Beliefs*, 18 PSYCHOL. SCI. 382, 382 (2007).

industries, which perpetuate themselves for years without change the same clauses and contract language.[313] While the ease and comfort of using time-tested language simplifies the process of drafting,[314] it perpetuates disclosure incomprehensibility.[315] Likewise, curse of knowledge bias "make[s] it difficult for experts to bridge the gap between themselves and novices because they have difficulty imagining ever having been so ill-informed on the topic and accurately imagining the information that novices might not know."[316] Accordingly, even where lawyers and accountants attempt to simplify disclosures, curse of knowledge bias may stifle their awareness that certain terms, clauses, or even general financial concepts are unfamiliar to everyday people.

As such, some disclosure requirements under H.B. 680 would likely have been more costly than effective, subjecting smaller issuers to burdensome expenses and potentially unlimited liability, without truly helping guide investors' decisions. The revised exemption should provide for either standardized disclosures where issuers can "fill-in-the-blank" or fill out disclosure tables, which provide a cost-effective alternative—both of which increase disclosure comprehension among investors.[317] Among other requirements,[318] H.B. 680 required issuers to produce pre-offering disclosures that included the terms and potential modifications to securities, the differences among classes of securities, and the total percentage ownership of the company that the offered securities represent.[319] Further, like many other states' crowdfunding laws, H.B. 680 required a "discussion of significant factors that make [the crowdfunded] offering speculative or risky,"[320] in addition to several mandated warnings of risk.[321] Post-offering,

313. *See* Brian JM Quinn, *Shareholder Lawsuits, Status Quo Bias, and Adoption of the Exclusive Forum Provision*, 45 U.C. DAVIS L. REV. 137, 178 (2011).

314. *See id.* at 177.

315. Pamela J. Hinds & Jeffrey Pfeffer, *Why Organizations Don't "Know What They Know": Cognitive and Motivational Factors Affecting the Transfer of Expertise*, *in* SHARING EXPERTISE: BEYOND KNOWLEDGE MANAGEMENT 3, 7 (Mark S. Ackerman, Volkmar Pipek & Volker Wulf eds., 2003).

316. *Id.*

317. *See* Wroldsen, *supra* note 287, at 629–31 (providing an example of a simple, easy-to-understand disclosure table of venture capital deal terms).

318. *See supra* Section IV.A.3 (outlining disclosure requirements under H.B. 680).

319. *See, e.g.*, H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(5)(b).

320. *See id.* sec. 2, § 78A-17.1(a)(13); WIS. STAT. § 551.202(26)(f)(2)-i (2013).

321. *See* H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(7)–(8) (requiring a disclaimer legend and investor certification that the investor understands the risks of an offering); COLO. REV. STAT. § 11-51-304 (LEXIS through 1st Reg. Sess. of the 70th Gen. Assemb.); IND. CODE ANN. § 23-19-2-2(27)(H)–(I) (West, Westlaw through 2015 1st Reg. Sess.);

H.B. 680 required issuers to provide investors with quarterly financial and operational reports.[322]

A new North Carolina crowdfunding exemption should retain most of the "core" requirements of H.B. 680, such as disclosure of issuer information, target offering amount, and the deadline to meet the target.[323] Additionally, the exemption should require limited complex disclosure information, including details about capital structure and investors' terms and rights under crowdfunded securities. The exemption should delineate specifically what information should be disclosed under these requirements. Finally, the discussion of significant factors that make a particular offering risky, and information regarding the differences among classes of securities should be omitted from the exemption.

3. The Benefits of Standardized Disclosures

Many of the shortcomings inherent in disclosure requirements can be addressed by standardized disclosure forms. By providing for standardized disclosure templates that are concise and logically ordered, this proposal simplifies and improves on H.B. 680's more exhaustive disclosure requirements.[324] Similarly, the regulations can supplement and remedy disclosure shortcomings by mandating website features like chat portals, which provide more effective "organic" regulation, incentivize intermediaries to screen issuers, and meet investor education requirements.

First, standardized disclosure templates will assist issuers with the costs and complexity involved in producing disclosures, much like the templates used for Regulation A offerings[325] or the disclosure

MICH. COMP. LAWS ANN. § 451.2202a(1)(h) (West, Westlaw through 2015 Mich. Pub. Acts 130); WIS. STAT. § 551.202(26)(h)(i).

322. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(c).

323. *See supra* Section IV.A.3. Specifically, required disclosures should include background information about the issuer, its business plan, the target offering amount and deadline to reach the target, websites where the issuer's securities will be offered, and any pending litigation involving the issuer. *See* H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(5).

324. *See* H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(5), (a)(13), (c).

325. In the Advocacy comment letter to the SEC regarding the proposed rules, it requested that the SEC provide a simple "question and answer" format for nonfinancial disclosures, such as that used for Regulation A offerings, or boilerplate disclosures for more complicated nonfinancial disclosures. Sargeant Letter, *supra* note 226, at 4. *See generally* Regulation A Offering Statement, Form 1-A, 17 C.F.R. § 239.90 (2015) (providing a "question and answer" format for information about the offering and tables for declaring information regarding both outstanding securities and the identities of directors, executive officers, and significant employees).

tables suggested by one commentator.[326] Such disclosure tables would consist of a column that includes specific securities terms, followed by a column modified to match each relevant term.[327] Templates would provide a free checklist to help issuers navigate financial- and legal-disclosure requirements. Specifically, templates would lay out the relevant disclosure provisions for issuers, similar to a manual that would guide them in identifying what information to disclose. Moreover, standardized disclosure templates would remove the burden of drafting disclosures de novo, thus substantially reducing or even eliminating costs to attain legal and financial expertise.[328]

Standardized disclosures also benefit investors. By prescribing a concise and logically organized standard template, regulators can ensure that the disclosures are readable, preventing attorneys from masking unsavory terms in legalese or otherwise burying information in an unorganized and complex document.[329] Further, such standardized disclosures serve to mitigate status-quo and curse-of-knowledge biases by channeling and simplifying drafting efforts by attorneys.[330]

Standardized disclosures would become more transparent still when coupled with investor education materials.[331] These disclosures would allow investors to locate specific provisions necessary to compare investment opportunities. Investors need only learn once where to look for each relevant provision, rather than taking the time to learn the format of each company's proprietary disclosures.[332] More importantly, investor education would help ensure that investors understand the disclosures.[333] This is especially important when applied to more complex information, discussed in the next section.

326. *See* Wroldsen, *supra* note 287, at 629–31 (providing an example of a simple, easy-to-understand disclosure table of venture capital deal terms).

327. *See id.*

328. *Cf.* KHADEMIAN, *supra* note 291, at 91 (stating that federal securities laws and SEC policies force corporations, investment bankers, brokerage houses, etc. to rely on securities lawyers to ensure compliance).

329. *See* Firtel, *supra* note 307, at 875 (explaining SEC's efforts via plain English to address dense boilerplate and obfuscation that "discouraged investors from reading the disclosure documents" or even rendered it "virtually impossible for investors to extract the significant information" from disclosures).

330. *See supra* notes 305–16 and accompanying text.

331. *See infra* Section VI.E.

332. *See* Wroldsen, *supra* note 287, at 626.

333. *See infra* Section VI.E.

4. Required Disclosure of Limited Complex Information

A successful crowdfunding exemption must strike a balance, effecting sufficient investor protection without overburdening small businesses and risky startups with excessive regulation and disclosure requirements. Minimal pre-offering disclosure requirements provided in some states' crowdfunding exemptions offer simplicity and cost-reduction, but they neglect one piece of the crowdfunding puzzle: investor protection.[334] Thus, certain complex matters, including a description of the company's capital structure and the terms and potential modifications to securities, should be provided in pre-offering disclosures.[335] Providing this information is important to ensure that investors know what they are getting when purchasing crowdfunded securities; ensure that investors may properly compare investment opportunities; and avoid chilling investment in crowdfunded companies.

First, general statements of risk and communication features on funding portals that convey qualitative information should be substituted in place of a "discussion of significant factors that make the offering speculative or risky."[336] Second, contrary to H.B. 680's requirement,[337] quarterly reports should only be required once the issuer reaches a specified benchmark, not immediately after it completes its first offering.

Third, information regarding capital structure and terms of securities[338] should be limited to clear, basic information. Capital structure, or the mix of debt and equity a firm uses to finance its operations,[339] is material to assessing a firm's risk, and thus material to any investment decision. In particular, highly leveraged firms are generally riskier than well-capitalized firms.[340] Higher debt may also

334. *See* ALA. CODE § 8-6-11(a)(14)(c) (West, Westlaw through Act 2015-520) (permitting satisfaction of disclosure requirements when disclosure is made "simultaneously with the execution by the purchaser of a written agreement"); GA. COMP. R. & REGS. 590-4-2.08(1)(f) (West, Westlaw through July 31, 2015) (requiring the names and addresses of those involved in the issuance but not quarterly financial reports); KAN. ADMIN. REGS. § 81-5-21(a) (2013) (requiring only the names and addresses of the issuer, all persons involved in the offer, the bank or institution in which the funds will be deposited, and no quarterly financial reports).

335. *See* H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(5).

336. *Id.* sec. 2, § 78A-17.1(a)(13).

337. *Id.* sec. 2, § 78A-17.1(c).

338. *See* THE ACCOUNTANT'S HANDBOOK § 4.8(b)(v) (Lynford Graham ed., 2012), LexisNexis.

339. *See Capital Structure*, *supra* note 307.

340. *See* TOBIAS ADRIAN & NINA BOYARCHENKO, FED. RES. BANK OF N.Y., INTERMEDIARY LEVERAGE CYCLES AND FINANCIAL STABILITY 1–2 (2012), http://www

afford investors a higher risk premium, and hence a higher expected return.[341] Vice-versa, investors can identify safer assets by looking for firms with little or no debt.[342] Young, small businesses may not have revenue streams sufficient to justify hiring a finance executive, many of whom command six-figure salaries for managing a firm's capital structure and accounting practices and controls.[343] Whether a firm has a finance executive or not, someone in the business must be charged with managing the business's finances, especially its capital structure.[344]

Moreover, the allocation of total debt and equity set out in a balance sheet should reveal an issuer's capital structure.[345] Standardized disclosures or disclosure tables, where firms can simply check a box or fill in a blank, can make it even easier for firms to identify this information while ensuring that material information is available to investors.[346] Firms that cannot identify their own fundamental financial metrics, especially with manageable standardized disclosures, should raise a red flag for investors. Investors may well associate financial incompetence with likelihood of failure, filtering out potentially unsuccessful firms and further improving the crowdfunding market.[347]

.newyorkfed.org/research/staff_reports/sr567.pdf [http://perma.cc/S54V-NU4H]. The financial crisis provides perhaps the best illustration of the risks inherent in using too much leverage. For example, by March 2008, when Bear Stearns had "a leverage ratio of more than 35-to-1, even a small loss of only 3.2 percent of the assets would obliterate stockholder equity." Troy S. Brown, *Legal Political Moral Hazard: Does the Dodd-Frank Act End Too Big To Fail?*, 3 ALA. C.R. & C.L. L. REV., no. 1, 2012, at 1, 32.

341. *See, e.g.*, ADRIAN & BOYARCHENKO, *supra* note 340, at 26 (describing the relationship between the risk of financial distress and the price of risk).

342. *See, e.g.*, RAYMOND J. LUCIA & DALE FEATHERLING, READY . . . SET . . . RETIRE! FINANCIAL STRATEGIES FOR THE REST OF YOUR LIFE 111 (2007) (explaining that real estate investment trusts with little or no debt are safer but generally offer lower returns).

343. *See, e.g.*, Darren Dahl, *When Should a Small Business Hire a Finance Chief*, N.Y. TIMES (Oct. 26, 2011), http://www.nytimes.com/2011/10/27/business/smallbusiness/when-should-a-small-business-hire-a-chief-financial-officer.html?pagewanted=all&_r=0 [http://perma.cc/4CBJ-QCFD (dark archive)] (emphasizing that a small business should hire a financial executive as soon as it "can afford one").

344. *See id.* (explaining that when the necessity of obtaining business capital causes a firm's CEO to be "distracted from critical revenue-generating activities[,]" it is time to hire a CFO).

345. *See* Jeff Partnoy & Lynn Turner, *Bring Transparency to Off-Balance Sheet Accounting*, *in* MAKE MARKETS BE MARKETS 85, 85–86 (2009), http://www.makemarketsbemarkets.org/report/MakeMarketsBeMarkets.pdf [http://perma.cc/BF3G-CL32].

346. *See* Wroldsen, *supra* note 287, at 628–32.

347. *See* Jill Hamburg Coplan, *Raising Capital: Equity vs. Debt*, BLOOMBERG BUS. (Dec. 4, 2009), http://www.bloomberg.com/bw/magazine/content/09_72/s0912030511552.htm [http://perma.cc/3ZJT-GVS9] ("Running your business without knowing your

Fourth, investors need to know what they are getting into. Knowing the terms and rights available under investors' crowdfunded securities better informs valuation judgments and comparisons with other investments.[348] If issuers are not charged with identifying the terms and rights associated with their securities, issuers could make up this information as they go along, to investors' detriment. Without knowing the convertibility of a stock, for example, investors may enter into a securities transaction unaware that the stocks they had bargained for could be converted to debt with lower returns, no voting rights, and without a proper conversion discount.[349] Moreover, investors cannot enforce rights that they are unaware of or that do not exist.[350]

Fifth, reduced transparency can mislead investors. For example, abusive off-balance-sheet accounting[351] partially contributed to the financial crisis by triggering "a daisy chain of dysfunctional decision-making by removing transparency from investors, markets, and regulators."[352] Notably, institutional investors prefer to invest in firms that produce higher-quality disclosures.[353] Scant disclosure may chill investment in crowdfunded companies by scaring off investors unwilling to take blind risks.

However, excessive disclosure may upset the balance between investor protection and costs to small businesses where certain information adds little value and contributes to information

numbers is like driving a car without being able to see your direction or speed . . . . It's only a matter of time before you crash.").

348. *See* William W. Barker, *Outside Bucks*, BUS. L. TODAY, July/Aug. 2000, at 15–16 (explaining that documentation in private financings should include information about investors' rights).

349. *See Convertible Securities*, SEC, http://www.sec.gov/answers/convertibles.htm [http://perma.cc/FVA8-TUYU] (identifying characteristics of certain convertible securities).

350. *See* Ira M. Millstein, *Non-Traditional Modes of Enforcement*, *in* ENFORCEMENT AND CORPORATE GOVERNANCE: THREE VIEWS 1, 3 (2005), http://www.ifc.org/wps/wcm/connect/6ab71c8048a7e7b3accfef6060ad5911/Focus_ENFCorpGov3.pdf?MOD=AJPERES [http://perma.cc/M4JK-GE5D] ("Why would any sensible investor invest if investor rights either didn't exist, or could not be enforced?").

351. Off-balance-sheet items, including financial derivatives, are items for which a firm does not have legal claim or responsibility. *Off Balance Sheet—OBS*, INVESTOPEDIA, http://www.investopedia.com/terms/o/off-balance-sheet-obs.asp [http://perma.cc/K7H4-DBU7] ("Off balance sheet items are of particular interest to investors trying to determine the financial health of a company. These items are harder to track, and can become hidden liabilities. Collateralized debt obligations, for instance, may become a toxic asset before investors realize a company's exposure.").

352. Partnoy & Turner, *supra* note 345, at 85.

353. *See* Brian J. Bushee & Christopher F. Noe, *Corporate Disclosure Practices, Institutional Investors, and Stock Return Volatility*, 38 J. ACCT. RES. 171, 172 (2000).

overload.[354] Specifically, issuers undertaking an unnecessarily exhaustive analysis about differences among classes of securities and how other classes of securities may affect the rights of crowdfunded securities would surely require the expensive employment of financial and legal professionals.[355] Investors must be charged with some diligence in making investment decisions. It should be enough that investors can ascertain this information themselves by reviewing an issuer's financial statements—especially simplified disclosures—which is what such disclosures were intended for.[356]

Sixth, quarterly reports, as noted above, should only be required if: (1) the issuer reaches a certain financial benchmark, such as operating cash flow; (2) the issuer solicits a second crowdfunded offering; or (3) resale restrictions are maintained after the restriction period. A benchmark is wise because, if the issuer has not achieved a requisite level of cash flow or operating history, it likely has not experienced the level of growth necessary to make periodic disclosure meaningful.[357] A second offering may indicate an issuer's need for further capital to sustain such growth. Moreover, the burdensome costs of periodic disclosures echo those of audited financials and other complex disclosures that require financial or legal expertise. Accordingly, producing periodic disclosures shortly after an offering may consume an issuer's crowdfunding proceeds, which could be better applied elsewhere.[358]

Of course, some of the information contained in the proposed disclosure requirements will not be immediately comprehensible to all investors. Especially if standardized disclosures are implemented, investor education requirements could be used to guide investors in navigating disclosure statements, thus helping to enhance investor protection.

354. *See supra* Sections IV.D.2–3.

355. *See* KHADEMIAN, *supra* note 291, at 91.

356. In fact, there are easily accessible resources instructing prospective investors how to determine capital structure from financial statements. *See, e.g.*, Hans Wagner, *Analyzing a Bank's Financial Statements*, INVESTOPEDIA, http://www.investopedia.com/articles/stocks/07/bankfinancials.asp [http://perma.cc/XV8X-29LF] (providing a crash course in financial statement analysis); *see also Financial Statement Analysis*, ACCOUNTINGTOOLS, http://www.accountingtools.com/financial-statement-analysis [http://perma.cc/7J48-XNV6].

357. *See supra* notes 283–96 and accompanying text.

358. *See supra* notes 217–30 and accompanying text.

E. Investor Education

A new North Carolina crowdfunding exemption should follow the lead of other states and organizations[359] by including investor education requirements. Educational requirements provide an additional safeguard to limit investor losses, increase investor comprehension, and help issuers to "positively affirm" that investors understand the risks inherent in equity crowdfunding.[360] Investor education materials should be provided by the applicable state regulator,[361] limited to relatively basic financial concepts, written in "plain English,"[362] logically organized and concise, and constructed to supplement standardized disclosures. Investors should review a brief presentation, video, or reading materials. Then, investors should be required to pass a test or quiz before they may begin using a funding portal, to ensure that they have successfully used and understood the educational materials. All such educational materials and quizzes could easily be provided online.

The applicable state regulator, rather than the intermediaries, should provide investor education materials to ensure uniformity, limit intermediaries' ability to withhold adverse information, and reduce regulatory uncertainty surrounding potentially ambiguous or unclear curricula. Additional the provision of such materials would limit intermediary liability in the event of loss and ensure that all investors receive the same education, no matter which portal they

359. Other states and organizations have recognized the importance of investor education and have already begun introducing public and private educational materials to assist investors and issuers. *See, e.g.*, *Crowdfunding Professional Association Launches New Global Crowdfund Investing Education Network*, PR NEWSWIRE (Feb. 21, 2013), http://www.prnewswire.com/news-releases/crowdfunding-professional-association-launches-new-global-crowdfund-investing-education-network-192244731.html [http://perma.cc/E9TM-M43W]; *Georgia Crowdfunding Community*, MEETUP, http://www.meetup.com/Georgia-Crowdfunding/ [http://perma.cc/2DXZ-T24D] (providing a platform for crowdfunding participants in Georgia to meet, share experiences, and educate their community on different types of equity and debt-based crowdfunding); *Information for Prospective Investors*, TEX. ST. SEC. BOARD, http://www.ssb.state.tx.us/Important_Notice/Information_for_Investors.php (last modified Nov. 7, 2014) [http://perma.cc/WS63-674N] (informing prospective investors about crowdfunding and providing guidance on deciphering certain disclosures); *Informed Investor Advisory: Crowdfunding*, NASAA, http://www.nasaa.org/12842/informed-investor-advisory-crowdfunding/ [http://perma.cc/HJ7F-63MM].

360. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,470 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

361. In North Carolina, the securities regulator would likely be the Securities Division of the Department of the Secretary of State. *See North Carolina Securities Division Homepage*, N.C. DEP'T SECRETARY ST., http://www.secretary.state.nc.us/sec/ [http://perma.cc/S6XY-FHVZ].

362. *See, e.g.*, *supra* notes 305 and 329 and accompanying text.

use. Then, intermediaries should be free to expand educational requirements, considering their unique businesses and investor bases.[363]

These educational materials need not be exhaustive. Rather, they should apprise investors of the *general* risks and responsibilities of investing in crowdfunded securities, including, but not limited to instructing investors how to locate specific, basic information contained in pre-offering disclosures; helping investors understand certain disclosure terms; advising investors on the risks associated with startups and small businesses; and educating investors about crowdfunding regulations.

There are several practical considerations that weigh against attempting to educate retail investors about more complex concepts. First, given the prolific financial incompetence among retail investors,[364] educational materials serve only to bring investors up to speed on core concepts. Facing intimidating or complex concepts, unsophisticated investors may be discouraged from participating in crowdfunding. Moreover, test-passage rates may suffer, diminishing the crowdfunding exemption's utility as an alternative capital-raising mechanism.[365] In any case, most investors are unlikely to apply complex concepts when making their investment decisions.[366] Educational materials increase the user-friendliness of standardized disclosures, thus encouraging the examination of disclosures by investors. Educational materials could direct investors to information contained in standardized disclosures relevant to compare investment opportunities.[367]

363. *See, e.g.*, Crowdfunding, 78 Fed. Reg. at 66,470.

364. *See, e.g.*, FINANCIAL LITERACY, *supra* note 301, at vii-viii ("[S]tudies have found that investors do not understand the most elementary financial concepts, such as compound interest and inflation.").

365. *Cf. id.*; Walter Hamilton, *Millions of Americans Lack Basic Financial Literacy, Studies Show*, L.A. TIMES (Dec. 27, 2013), http://articles.latimes.com/2013/dec/27/business/la-fi-financial-literacy-20131228 [http://perma.cc/Z6WU-NHAL] (suggesting that prolific financial illiteracy should be met with simpler financial products, rather than, or in addition to, financial education).

366. *See* FINANCIAL LITERACY, *supra* note 301, at vii-viii. Likewise, a recent survey revealed that an overwhelming amount of potential investors chose not to invest, fearing "talk[ing] to anyone about their money, and that's partly because they seem[ed] to fear looking stupid or revealing how little they [knew] about investing." Kimberly Palmer, *Why Millennials Are Scared To Invest*, U.S. NEWS (Oct. 31, 2014, 8:50 AM), http://money.usnews.com/money/blogs/alpha-consumer/2014/10/31/why-millennials-are-scared-to-invest [http://perma.cc/7SN7-RF3R].

367. *See* Wroldsen, *supra* note 287, at 630 (providing an example of a simple, easy-to-understand disclosure table of venture capital deal terms).

Educational requirements also address some of the major shortcomings of required disclosures. First, disclosures do not ensure that investors read or understand them,[368] only that the information is put in front of the investors, similar to "clickwrap" agreements[369] that buyers rarely read.[370] Conditioning access to the portal on the passage of a test is a sound, functional way to ensure that educational materials are read and understood.

However, requiring the state to produce and promulgate investor education materials will result in additional costs to taxpayers—a significant political hurdle and a drawback when compared to H.B. 680's lack of any such requirement beyond investor self-certification that the investor understands the relevant risks of crowdfunded securities.[371] To mitigate these concerns, the applicable state regulator could assess fees from intermediaries at a reasonable rate to cover the costs of providing educational materials. Additionally, cost-savings from reduced and standardized disclosure requirements would help balance any minimal assessment imposed by the state.

Further, North Carolina could simply provide a curriculum and final quiz that investors must pass, rather than furnishing the investor educational materials. Intermediaries would then produce compliant educational materials at their own expense. Such a requirement would also empower the intermediary, who is most familiar with its business and investor base,[372] to tailor its educational materials to its target audience of investors. Moreover, it would prevent intermediaries from undermining investor-education requirements. If educational materials are inadequate, investors would fail the required quiz, reducing investment via the funding portal.

368. *See supra* Section VI.D.2.

369. "A 'clickwrap' agreement appears when a user first installs computer software obtained from an online source or attempts to conduct an Internet transaction involving the agreement, and purports to condition further access to the software or transaction on the user's consent to certain conditions there specified; the user 'consents' to these conditions by 'clicking' on a dialog box on the screen, which then proceeds with the remainder of the software installation or Internet transaction." Kevin W. Grierson, *Enforceability of "Clickwrap" or "Shrinkwrap" Agreements Common in Computer Software, Hardware, and Internet Transactions*, 106 A.L.R.5th 309, 317 n.1 (2003).

370. *See* Susan E. Gindin, *Nobody Reads Your Privacy Policy or Online Contract? Lessons Learned and Questions Raised by the FTC's Action Against Sears*, 8 NW. J. TECH. & INTELL. PROP. 1, 14 (2009).

371. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(8).

372. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,471 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

Alternatively, the state may consider borrowing educational materials that are already being produced by other entities.[373]

By following this proposal, intermediaries would essentially be regulated by market incentives as they compete to attract investors. The next section provides a comprehensive discussion of this intermediary regulation beyond educational requirements.

F. Intermediary Regulation

Wisely, H.B. 680 did not burden intermediaries with excessive regulation, but rather elected to stimulate market competition.[374] Intermediaries should largely be governed by competitive market incentives to: combat fraud, feature quality companies, offer value-added services to assist issuers, and provide funding portal features to assist both issuers and investors.

Promoting competition among intermediaries is essential to a successful crowdfunding exemption.[375] Competition can mitigate the shortcomings of both ineffective and reduced disclosure requirements. First, intermediaries' and issuers' interests are normally aligned[376]—attracting investors is fundamental to both parties' success. The more investors that an issuer attracts, the more likely the issuer's crowdfunded offering will be successful. Likewise, since intermediaries will profit from fees equal to a percentage of the funds raised by its issuers' crowdfunded offerings, intermediaries are incentivized to feature successful issuers that attract more investors.[377]

373. The North American Securities Administrators Association ("NASAA") already has helpful crowdfunding and related investor educational materials on its website. *Investor Education*, NASAA, http://www.nasaa.org/investor-education/ [http://perma.cc/9UM8-9LQH]; *see also supra* note 359 and accompanying text.

374. H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(9)–(11).

375. *See The Laws that Govern the Securities Industry*, SEC, http:// www.sec.gov/about/laws.shtml [http://perma.cc/9SWW-NRBK]; *see also* 15 U.S.C. § 77b(b) (2006) (requiring the SEC to consider "whether an action is . . . in the public interest, . . . [for] the protection of investors, [and] whether the action will promote efficiency, competition, and capital formation"); Exec. Order No. 13,563 § 1(a), 3 C.F.R. 215, 215 (2012), *reprinted in* 5 U.S.C. § 601 app. at 103–04 (2014) (directing executive agencies to reevaluate existing rules while maintaining a regulatory system that promotes "economic growth, innovation, competitiveness, and job creation").

376. Abnormal circumstances might include fraud.

377. For example, according to a 2013 study, Kickstarter had over 110,000 campaigns, raising an aggregate of $612 million, with forty projects that raised over $1 million and a total campaign success rate of 44%. By comparison, Indiegogo had only 44,000 campaigns, raising an aggregate total of $44 million, with only four projects that raised over $1 million and a total campaign success rate below 34%. Jonathan Lau, *Dollar for Dollar Raised, Kickstarter Dominates Indiegogo SIX Times Over*, MEDIUM.COM (Aug. 28, 2013), https://medium.com/@jonchiehlau/dollar-for-dollar-raised-kickstarter-dominates-indiegogo-six-times-over-2a48bc6ffd57 [http://perma.cc/U7TE-B5S4]. The study attributed

Moreover, intermediaries will earn reputational goodwill by featuring the best companies. If intermediaries feature low-performing companies or companies that tend to fail, investor goodwill and patronage will diminish. Issuers will avoid sites that fail to generate sufficient investor traffic, where funding prospects are gloomy. Hence, success begets success—issuers' natural attraction to successful intermediaries will improve the quality of companies that intermediaries feature on their websites.

As a result, intermediaries have strong market incentives to rigorously screen the companies they feature. Recognizing that fraud is bad for business,[378] this practice may account for some of ASSOB's success.[379] Specifically, revelation of fraud within a particular funding portal may stymie investment in that portal.[380] To avoid stigma associated with a defrauded funding portal, issuers may choose alternative portals to showcase their startups.

Moreover, intermediaries may compete by offering premium services to their issuers, increasing the likelihood of issuer success. Intermediaries can increase their marketability by providing professional services and templates to assist issuers in navigating the

---

Kickstarter's success to the quality of companies it offers. *Id.* Indeed, the two competitors have different funding models: "Indiegogo accepts anybody. Kickstarter does not. Indiegogo gives campaigns the option of keeping all of the money if they miss their goal. Kickstarter does not." David Holmes, *Infographic: Kickstarter vs Indiegogo*, PANDODAILY (Oct. 14, 2013), http://pando.com/2013/10/14/infographic-kickstarter-vs-indiegogo/ [http://perma.cc/SQY2-J4XY].

378. *See, e.g.*, Howard M. Rossen & Howard H. Fairweather, *Damages in Fraud Actions*, 13 CLEV. MARSHALL L. REV. 288, 289 (1964) (noting that tort law recognizes damages in actions for fraud for injury to a plaintiff's business reputation); Richard I. Werder, Jr. & John M. Newman, Jr., *Rico* [sic.] *as a Vehicle for Intracorporate Claims by Nontarget "Perpetrator" Corporations*, 46 BUS. LAW. 1391, 1392 (1991) (explaining that RICO actions against officers and directors are increasingly made by shareholders when the company itself defrauded a third-party, resulting in damage to its business reputation or a reduction in its stock value).

379. Many intermediaries operating in Australia use finance and investment professionals to complete screening and curation of prospective crowdfunding candidates. *See* Swart, *supra* note 193. Correlated or not, more than eighty percent of the firms financed through ASSOB are still functioning. *Id.* Compare this with the success rate of new American firms, half of which are still in existence after five years. *See Frequently Asked Questions*, U.S. SMALL BUS. ADMIN., http://www.sba.gov/sites/default/files/sbfaq.pdf [http://perma.cc/595V-YGU3].

380. *Cf.*, Qingbo Yuan & Yunyan Zhang, *The Real Effects of Corporate Fraud: Evidence from Class Action Lawsuits*, J. ACCT. & FIN. (forthcoming) (manuscript at 4) (Oct. 6, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2459279 [http://perma.cc/VP87-TBYE] (finding that "total external financing significantly decreases after corporate fraud revelation").

crowdfunding process,[381] and even lobby and communicate with regulators to improve the crowdfunding environment.[382]

A new crowdfunding exemption can take advantage of these market based incentives with at least two additional intermediary regulations that would enhance investor protection without compromising competition: (1) providing for mandated chat features on intermediary funding portals; and (2) requiring intermediaries to have "skin-in-the-game" by requiring them to absorb some loss in the event of fraud. At a minimum, to ensure a comprehensive regulatory regime, intermediaries should be required to provide a "community" or "crowd" chat feature on their portals.[383] Interactive portals provide a valuable tool by facilitating feedback, dialogue, and questions from the crowd, which produce richer qualitative information.[384] Crowdfunding portals will facilitate open communication between investors, potential customers, and entrepreneurs, allowing the three groups to align their interests. Issuers receive "free, crowdsourced-brainstorming,"[385] benefitting from customer feedback before spending substantial sums on production. Issuers can then apply the information provided by investors and customers to perfect their businesses, to field questions, and to proactively address customer needs before entering the market, ultimately improving the likelihood of issuer success.[386]

Interactive crowdfunding portals also align nicely with crowdfunding's accelerated development cycle, giving issuers incentive to respond to investor concerns as they promote, test, and if

381. The ASSOB requires issuers to choose a "sponsor" that provides these services. *See ASSOB: Australia's Largest Capital Raising Platform for Growing, Unlisted Companies*, CROWD CAFE, http://www.thecrowdcafe.com/platform/assob/ [http://perma.cc/C6YC-XJBP].

382. Indeed, intermediaries operating within ASSOB have "helped shape the equity raising landscaping in Australia by lobbying and engaging regulators to build an environment that allows for capital raising in a controlled yet not onerous environment." *See Crowd Funding—Lessons Learned in 8 Years of Equity Crowd Funding*, *supra* note 190.

383. In its proposed rules, the SEC required intermediaries to provide such a feature. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,430 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249).

384. *See, e.g.*, Joan MacLeod Heminway, *Investor and Market Protection in the Crowdfunding Era: Disclosing to and for the "Crowd"*, 38 VT. L. REV. 827, 846 (2014) (discussing the "richer, but more dynamic disclosure environment in which investors, as well as issuers and intermediaries" contribute to the mix of available information).

385. *The Benefits of Crowdfunding*, FUNDABLE, https://www.fundable.com/learn/resources/guides/crowdfunding-guide/the-benefits-of-crowdfunding [http://perma.cc/464H-EUUP].

386. *See, e.g.*, Greenstein, *supra* note 165 (discussing a recent study that found focusing too much on the product and not enough on customers was a main contributor to startup failure).

necessary, discard their ideas.[387] Thus, issuers are incentivized to respond to investor concerns. Investors can satisfy their concerns by providing tailored advice or asking questions that disclosures do not answer. Moreover, the crowd will be composed of investors of various levels of sophistication and expertise.[388] Investors will, as always, have different expectations and goals.[389] Nontraditional investors will benefit from access to knowledge conveyed by sophisticated investors.[390] Hence, communication portals enable the crowd to inform itself.

Furthermore, while intermediaries cannot entirely prevent business failures or economically driven investor losses, they can, with the help of smart regulations, prevent fraud and create a safer crowdfunding experience for investors.[391] First, a new North Carolina exemption should retain H.B. 680's requirement that intermediaries avoid conflicts of interest.[392] But this, alone, is not enough, and so intermediaries should be required to have some "skin in the game,"[393] absorbing at least 15% to 25% of investor losses in the event of fraud. This offers two benefits. First, it provides fraud insurance to help

387. *See* Leonhardt, *supra* note 166 ("New ideas will be free market tested earlier in their development cycle and discarded or funded at a faster rate. The old innovators mantra of try a lot of stuff and keep what works will be applied at hyper speed rates.").

388. *See* Heminway, *supra* note 384, at 831 n.15 ("Crowdfunding . . . . draws its maximum power when the collective diversity is the greatest." (quoting KEVIN LAWTON & DAN MAROM, THE CROWDFUNDING REVOLUTION: HOW TO RAISE VENTURE CAPITAL USING SOCIAL MEDIA 181 (2013))).

389. Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1238 (1990) (arguing that the Capital Asset Pricing Model does not take into account that investors have different expectations, and thus value securities differently).

390. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,531 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249) ("[I]t is likely that investors and interested participants would provide relevant adverse information about an issuer or an offering through postings on chat sites, message boards, and other communication channels, including, but not limited to, the communication channels to be provided by the intermediary.").

391. *See* Hazen, *supra* note 179, at 1754; *cf. supra* Section V.B.

392. *See* H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(11)-(12).

393. A similar provision is found in the Dodd-Frank Act. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 941(d), 124 Stat. 1376, 1893–94 (amending the Securities Exchange Act at 15 U.S.C. § 78c(a) et seq. (2010)). While that rule applies to originators and mortgage lenders, and thus carries its own unintended consequences, *see* Chris Arnold, *Forcing Banks To Put More 'Skin in the Game'*, NPR (June 18, 2009, 12:01 AM), http://www.npr.org/templates/story/story.php?storyId=105558991 [http://perma.cc/QJ5D-HNNE]. Such a provision is more beneficial here, insofar as it gives intermediaries an incentive to screen issuers and prevent fraud. *Cf. id.*; Floyd Norris, *Banks Again Avoid Having Any Skin in the Game*, N.Y. TIMES (Oct. 23, 2014), http://www.nytimes.com/2014/10/24/business/banks-again-avoid-having-any-skin-in-the-game.html [http://perma.cc/LD4W-3S2Q (dark archive)].

moderate investor losses. Second, it incentivizes intermediaries to diligently screen and monitor issuers both before and after featuring issuers on their websites. Of course, an intermediary may still recover by seeking subrogation[394] from a fraudulent issuer.

Intermediaries will play a tremendous role in any crowdfunding environment. In addition to intermediaries' roles of connecting investors to entrepreneurs, intermediaries may also play an integral role as the brokers of a secondary market if resale restrictions are lifted.

G. Resale Restrictions

A new North Carolina crowdfunding exemption should loosen H.B. 680's resale restriction, which would have prohibited investors from selling or transferring securities for a certain period after issuance.[395] A new exemption should permit issuers to establish a limited, intrastate, interportal secondary market for crowdfunded securities.

Despite the shortcomings inherent in resale restrictions, commentators have suggested two potential benefits associated with them. First, a resale restriction may serve to protect secondary market investors, who do not have direct access to the information on the crowdfunding portal, from fraud.[396] Second, it affords investors a period "to observe the performance of the business" and gather information about its economic prospects "before trading occurs."[397]

This proposal reflects the views of critics of resale restrictions[398] who assert that the consequences of the resale restriction outweigh its

394. For purposes of this Comment, subrogation refers to the right of the intermediary, after compensating investors for losses resulting from fraud, to pursue the third-party fraudster in an action to recover those losses. *See, e.g.*, *Subrogation*, INVESTOPEDIA, http://www.investopedia.com/terms/s/subrogation.asp [http://perma.cc/M46Y-6DL6].

395. *See* H.B. 680, *supra* note 14, sec. 2, § 78A-17.1(a)(7).

396. Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 954 (2011).

397. Crowdfunding, 78 Fed. Reg. 66,428, 66,526 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249).

398. *See* Bradford, *supra* note 48, at 144–45 (explaining that investors unaware of such restrictions may be exposed to liability and that issuers could lose their exemptions if resale restrictions are "given any teeth"); Sherief Morsy, Note, *The JOBS Act and Crowdfunding: How Narrowing the Secondary Market Handicaps Fraud Plaintiffs*, 79 BROOK. L. REV. 1373, 1393–99 (2014) (arguing that resale restrictions limit private securities fraud remedies). The SEC has explained that its proposed one-year resale restriction could "reduce trading liquidity, raise capital costs to issuers and limit investor participation, particularly for investors who cannot risk locking up their investments for this period." Crowdfunding, 78 Fed. Reg. at 66,526.

potential benefits.[399] Specifically, resale restrictions have four negative consequences, some of which have been identified by the SEC in its own proposed rules.[400] First, a resale restriction will render crowdfunded securities illiquid, which would effectively tie up investor capital in their crowdfunded securities, preventing investors from cashing out, even if they wanted to.[401] Valuation will be difficult without a market to determine prices. Second, investors will require higher returns resulting from the higher liquidity premiums attributed to illiquid crowdfunded securities, thus raising capital costs to issuers.[402] Third, the resale restriction will "limit investor participation, particularly for investors who cannot risk locking up their investments for this period."[403] Finally, the resale restriction will limit private securities fraud remedies available to investors.[404]

Securities fraud and civil liability provisions of Securities Act section 10(b) and SEC Rule 10b-5 apply to crowdfunding transactions.[405] Additionally, a new provision, section 4A(c) of the Securities Act,[406] furnishes to crowdfunding investors in offerings made under Title III of the JOBS Act the remedies available under section 12(a),[407] which provides for liability if the issuer in the offer or sale of the securities "makes an untrue statement [or omission] of a material fact."[408] An investor that brings a successful action pursuant

399. *See* Crowdfunding, 78 Fed. Reg. at 66,526. The SEC further explained that the "illiquidity cost would be mitigated, in part, by provisions that allow investors to transfer the securities" during the resale restriction period in limited circumstances. *Id.* Those included "reselling the securities to accredited investors, back to the issuer or in a registered offering or transferring them to certain family members or trusts of those family members. These provisions likely would improve the liquidity of these securities and, thus, could increase investor participation in securities-based crowdfunding offerings." *Id.*

400. *See id.*

401. *See id.* ("The restrictions on resales, however, may impede price discovery.").

402. *See generally*, Yakov Amihud & Haim Mendelson, *Liquidity, the Value of the Firm, and Corporate Finance*, 2 J. APPLIED CORP. FIN. 17, 32 (2008) (arguing that a company's "liquidity risk" is an important factor affecting the company's value).

403. *See* Crowdfunding, 78 Fed. Reg. at 66,526.

404. For a more thorough discussion on the limitations of private securities remedies under a crowdfunded securities resale restriction, see generally Morsy, *supra* note 398 (describing how a resale restriction would harm plaintiffs in a crowdfunded securities fraud case).

405. Section 10(b) and Rule 10b-5 of the 1934 Act prohibit fraud and misstatements in connection with the purchase or sale of securities. 15 U.S.C. § 78j(b) (2012); 17 C.F.R. § 240.10b-5 (2013); *see also* Hazen, *supra* note 179, at 1769 (noting that, in addition to civil liability provisions, "mandated disclosures" are another form of "investor protection").

406. 15 U.S.C. § 77d-1(c)(1)(B) (2013) ("An action brought under [§ 77d-1] shall be subject to the provisions of section 77l(b) of this title and section 77m of this title, as if the liability were created under section [12] of [the Securities Act].").

407. § 77d(a)(2).

408. *See* § 77d-1(c)(2)(A).

to section 4A(c) may recover the price paid for the security, or damages if the investor has already sold the security.[409] However, as under sections 12(b) and 13 and Rule 10b-5, the plaintiff must prove "loss causation."[410] That is, damages are limited to loss of the security's value that result from material misstatements or omissions.[411] But without a secondary market to provide price information[412] an investor will find it difficult to prove loss causation.[413] In any case, if a plaintiff cannot sell his shares in response to a misstatement or omission, the result under a resale restriction is no harm, no foul.[414]

Nonetheless, intrastate crowdfunding exemptions, as opposed to the federal exemption, are only available under section 3(a) of the Securities Act, which requires all investors to reside in the state where securities are issued.[415] Thus, a secondary market option faces an obstacle where investors in the issuer's state could circumvent the exemption by purchasing and then reselling crowdfunded securities to nonresidents of the issuer's state. The secondary–market maker[416] would have to certify that crowdfunded securities purchased on its exchange are purchased by state residents.

409. *See* § 77d-1(c)(1)(A).

410. *See, e.g.*, Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345–46 (2005) (holding that a plaintiff in a Rule 10b-5 action must establish a causal connection between the fraudulent transaction and the resulting damages).

411. 4 THOMAS L. HAZEN, LAW OF SECURITIES REGULATION § 12.11(3) (6th ed. 2009).

412. *See SEC Proposes Rules To Implement Crowdfunding Exemption: What Factors Will Affect Its Success?*, GIBSON DUNN (Nov. 11, 2013), http://www.gibsondunn.com/publications/pages/SEC-Proposes-Rules-to-Implement-Crowdfunding-Exemption-What-Factors-Will-Affect-Its-Success.aspx [http://perma.cc/QRP8-AG2Y].

413. *See* Erica P. John Fund v. Halliburton Co., 131 S. Ct. 2179, 2187 (2011) ("As we have explained, loss causation is a familiar and distinct concept in securities law; it is not price impact."); Morsy, *supra* note 398, at 1404.

414. Morsy, *supra* note 398, at 1398 ("[W]hen the [material misstatement] was made, if the plaintiff could not sell his shares, how could the statement have been said to damage the plaintiff at all?").

415. 15 U.S.C. § 77c(a)(11) (2012) (corresponds to the amendments to the Securities Act of 1933 that were contained in the Securities Exchange Act of 1934, ch. 404, § 201, 48 Stat. 881, 905 (exempting intrastate offerings from SEC registration so long as the issuer is a business organized in the state where its securities are issued and all investors reside in that state)).

416. "A 'market maker' is a firm that stands ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price. You'll most often hear about market makers in the context of the Nasdaq or other '[OTC] markets.' " *Market Maker*, SEC, http://www.sec.gov/answers/mktmaker.htm [http://perma.cc/B7SL-ET8Q].

Ideally, an established market similar to Over-the-Counter-Bulletin-Boards ("OTCBB"),[417] which rely on traders to supply pricing information,[418] or Second Market, where companies can transact private-placement offerings,[419] would be most desirable.[420] Once again, either alternative would be limited to intrastate trading unless one of two things occurs: either the SEC curbs the resale restriction in the federal exemption[421] before finalizing its proposed rules[422] so that securities could be traded on national exchanges; or Congress modifies the section 3(a) intrastate securities offerings exemption[423] to permit interstate trading in securities issued under intrastate exemptions.[424] Given the dismal prospects of either event occurring, an intrastate secondary market remains the lone alternative.

A secondary market for North Carolina crowdfunded securities would be made possible by vesting intermediaries with discretion to facilitate interportal, intrastate-crowdfunded securities trading. Under the section 3(a) intrastate securities offerings exemption, intermediaries are required to verify that investors are state residents.[425] Once verified, crowdfunded securities could be traded among investors either within or between portals. Investors would all have access to the same information posted on each online portal.

417. An OTCBB is "an electronic quotation system that displays real-time quotes, last-sale prices and volume information for many over-the-counter securities that are not listed on a national securities exchange." *OTC Bulletin Board (OTCBB)*, SEC, http://www.sec.gov/answers/otcbb.htm [http://perma.cc/45Q2-4ZPV].

418. *Investor Information*, FIN. INDUSTRY REG. AUTHORITY, http://www.finra.org/Industry/Compliance/MarketTransparency/OTCBB/ [http://perma.cc/2PKK-ATBX] ("Subscribing market makers can utilize the OTCBB to enter, update, and display their proprietary quotations in individual securities on a real-time basis.").

419. SECOND MARKET, https://www.secondmarket.com/ [http://perma.cc/3ATN-4C29] ("Our online portal allows private companies and funds to customize, control and seamlessly execute private securities transactions.").

420. *See* Morsy, *supra* note 398, at 1403 (explaining that allowing for a secondary market for crowdfunded securities, similar to "Second Market," is more desirable than a resale restriction).

421. 15 U.S.C. § 77d-1(e) (2013).

422. Crowdfunding, 78 Fed. Reg. 66,428 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249).

423. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (2012).

424. Specifically, both provisions were passed by Congress and are not just SEC regulations. Also, both the intrastate exemption and the federal crowdsourcing exemption would be effectively nullified if securities issued under the intrastate exemption were permitted to be resold on national exchanges—permitting states issuers to circumvent the federal crowdsourcing regulations by choosing to issue their securities in the state with the most favorable laws while also transforming such (initially) intrastate offerings into interstate offerings.

425. 15 U.S.C. § 77c(a)(11).

To stymie investor fraud concerns, funding portals offering a secondary market feature could impose more stringent requirements on issuers and investors. Such requirements might include identity verification, heightened education requirements, and heightened disclosure requirements on companies seeking to issue tradable securities.[426]

Additional technological features could also assist issuers and investors. For example, Second Market[427] permits investors to create profiles that include information about their investments and "network[s] of 'trusted' investors[,]" provides financial news updates and "updates on [participants'] investments[,]" and it even offers "analyst coverage of certain companies."[428] Likewise, provisions in this proposal noted above, including investor education requirements[429] and social media features that help investors stay informed,[430] will help promote a viable secondary market. A secondary market option certainly is not a perfect alternative to a resale restriction. However, by curbing the concerns noted above without burdening investors with additional risks, it is a superior alternative.

CONCLUSION

In sum, H.B. 680 was a laudable attempt at a North Carolina crowdfunding exemption. North Carolina's lawmakers should go back to the drawing board and draft a bill that minimizes risks to investors without overburdening issuers with excessive costs and hurdles. North Carolina can provide innovative small businesses and startups with access to the capital they desperately need "by exempting offerings where the cost of registration clearly exceeds any possible benefits."[431]

The provisions recommended in this proposal achieve that balance. First, they limit potential losses to investors while providing issuers with sufficient capital to support their startups.[432] Furthermore, standardized, useful, and comprehensible disclosures,[433]

426. *Cf.* Hazen, *supra* note 179, at 1754 (discussing the need for greater regulation in crowdfunding to prevent fraud and investor losses).
427. *See supra* notes 419–20.
428. Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 198–99 (2012).
429. *See supra* Section VI.E.
430. *See* LAWTON & MAROM, *supra* note 388, at 181.
431. Bradford, *supra* note 48, at 150.
432. *See supra* Sections VI.A–B.
433. *See supra* Section VI.D.

accompanied by the investor education requirements[434] provided for in this proposal, ensure that disclosures achieve their traditional purposes—enabling investors to make fully informed investments, while minimizing costs to issuers.[435] Moreover, an "all-or-nothing" provision maintains checks on issuers by incentivizing them to be more responsive to investor concerns and to engage in more diligent planning, thus preventing investor losses in undercapitalized companies.[436] This proposal also promotes competition among intermediaries, who are then incentivized to offer issuers premium services, to screen issuers, and to offer the best companies on their websites.[437] Requiring intermediaries to absorb some investor losses in the event of fraud will provide a form of fraud insurance to investors.[438] Finally, loosening H.B. 680's resale restriction by vesting intermediaries with discretion to establish interportal, intrastate secondary markets for crowdfunded securities will improve securities valuation and improve securities fraud remedies available to investors.[439]

Of course, a crowdfunding exemption is not meant to prevent investor losses in risky startups or ensure a favorable return on investment. Nor is there an available model that provides an impenetrable shield against fraud.[440] Nonetheless, where North Carolina is concerned, the uncertainty surrounding equity crowdfunding will persist until North Carolina begins its own experiment. The North Carolina legislature should "do better"[441] and prioritize passing its own intrastate equity crowdfunding exemption.

434. *See supra* Section VI.E.
435. *See supra* Part II.
436. *See supra* Section VI.C.
437. *See supra* Section VI.F.
438. *See supra* Section VI.F.
439. *See supra* Section VI.G.
440. *See supra* text accompanying notes 179–81.
441. Smith, *supra* note 11.

Providing equity crowdfunding to North Carolina entrepreneurs can help create economic growth, job creation, and increased innovation at minimal cost to taxpayers. Drafting a successful crowdfunding exemption will focus on providing effective investor protection without overburdening small businesses and risky startups with excessive regulation and disclosure requirements. This Comment proposes provisions to achieve that balance.

KELLY MATHEWS***

*** I am grateful to Kelsey Hendrickson for her tremendous guidance and support in preparing this Comment before it was ever selected for publication, and to Brian Liebman and the rest of the Law Review editors and staff for their overall commitment to excellence, exemplified by their tireless efforts and thoughtful comments throughout the editing process. I am forever grateful to my parents for their love, encouragement, and unwavering belief in me. Finally, special thanks go to my amazing fiancée, Lindsay, for her unconditional love and support—and especially for her enduring patience throughout law school. As with everything, God has truly blessed me by surrounding me with great people who made this piece possible.