

Washington Law Review

Volume 91 | Number 2

6-1-2016

State Equity Crowdfunding and Investor Protection

Christopher H. Pierce-Wright

Follow this and additional works at: <https://digitalcommons.law.uw.edu/wlr>

 Part of the [Securities Law Commons](#)

Recommended Citation

Christopher H. Pierce-Wright, Comment, *State Equity Crowdfunding and Investor Protection*, 91 Wash. L. Rev. 847 (2016).

Available at: <https://digitalcommons.law.uw.edu/wlr/vol91/iss2/21>

This Comment is brought to you for free and open access by the Law Reviews and Journals at UW Law Digital Commons. It has been accepted for inclusion in Washington Law Review by an authorized editor of UW Law Digital Commons. For more information, please contact cnyberg@uw.edu.

STATE EQUITY CROWDFUNDING AND INVESTOR PROTECTION

Christopher H. Pierce-Wright

Abstract: Since Kansas enacted the first blue sky law in 1911, securities regulation has sought to protect investors from fraud and speculation. Historically, this meant precluding substantial numbers of small businesses from raising capital in the form of equity investments. In order to facilitate small-business capital formation, in 2012 the federal government passed the Jumpstart Our Business Startups Act (JOBS Act). Although Title III of the JOBS Act required the Securities and Exchange Commission to undergo rulemaking to allow for small-dollar equity investments, the agency dragged its feet. In the interim, states anxious to jumpstart their own economies took the initiative. Legislation has now been enacted in over half the states. Although a laudable attempt to make raising capital easier, this legislation potentially provides an avenue for fraudulent offerings and significant investor losses. This Comment reviews the historical context in which state crowdfunding exemptions have been passed and compares enacted state laws to the JOBS Act's requirements. It argues that in order to effectively prevent fraud while enabling small-business capital formation, states should adopt specific protection measures in their crowdfunding laws. These prophylactic measures, including requirements on both issuers and intermediaries, as well as protections for investors, promise to better help business while also protecting investors.

INTRODUCTION

On March 5, 2015, the nation's capital completed its first equity crowdfunding campaign.¹ The offering, set up through the online crowdfunding platform EquityEats,² sought to raise \$200,000 in thirty days for a new restaurant in the District's Penn Quarter neighborhood.³ In return for investing between \$100 and \$10,000, the 339 D.C. residents who participated were promised a ten percent interest in the company, a portion of the restaurant's cash flow, and other perks like priority reservations and an opportunity to discuss the business with

1. Steven Overly, *The City's First Equity Crowdfunding Campaign Reaches Its Goal*, WASH. POST (Mar. 5, 2015), http://www.washingtonpost.com/business/capitalbusiness/the-citys-first-equity-crowdfunding-campaign-reaches-its-goal/2015/03/05/2116ebbe-c374-11e4-ad5c-3b8ce89f1b89_story.html [https://perma.cc/MF8K-D7CZ].

2. EQUITYEATS, <https://www.equityeats.com/> [https://perma.cc/79KE-M9DW] (last visited Mar. 1, 2015).

3. Overly, *supra* note 1.

management.⁴

Small-dollar equity investments, or equity crowdfunding, provide a new means through which small business owners can raise the capital needed to start and expand their businesses.⁵ Although a small subset of the most promising companies can access any number of different sources of financing, from venture capital firms⁶ to angel investors,⁷ most have to rely on other sources like traditional bank loans or an owner's personal savings.⁸ Slowly, those traditional constraints have loosened as different means of financing become available. Equity crowdfunding is one of these means, made available to small businesses by states and, more recently, the federal government to facilitate investment in small businesses.

Until recently, small businesses had been all but prohibited from raising money through small-dollar equity investments. The goals of the Securities and Exchange Commission (SEC or the Commission)—to protect investors, maintain efficient markets, and facilitate capital formation⁹—are inherently at odds. That conflict has disproportionately

4. J.D. Alois, *Prequel, the First DC Equity Crowdfunding Offer, Closes Fully Funded*, CROWDFUND INSIDER (Mar. 5, 2015, 5:07 PM), <http://www.crowdfundinsider.com/2015/03/63878-prequel-the-first-dc-equity-crowdfunding-offer-closes-fully-funded/> [https://perma.cc/8A34-GL8Y].

5. Online crowdfunded investing, made most popular through online platforms like Kickstarter and Indiegogo, has been around since ArtistShare began in 2003. DAVID M. FREEDMAN & MATTHEW R. NUTTING, *EQUITY CROWDFUNDING FOR INVESTORS: A GUIDE TO RISKS, RETURNS, REGULATIONS, FUNDING PORTALS, DUE DILIGENCE, AND DEAL TERMS* (2015). The fundraising conducted on these earlier platforms differs from equity crowdfunding. Because a non-equity “offering” is not registered, it cannot provide investors with anything defined as a “security” by state or federal law. *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 30–32 (2012) (distinguishing “donation” and “reward” models of crowdfunding, which do not involve the sale of a security, from “equity” crowdfunding, which does). The earliest crowdfunding platforms allowed businesses to offer “perks,” like a product. *See, e.g., How It Works*, INDIEGOGO, <https://www.indiegogo.com/how-it-works>. Because none of these websites offer equity interests, they are not subject to securities regulation. *See infra* notes 167–69 and accompanying text.

6. *See* Dileep Rao, *Why 99.95% 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/> [https://perma.cc/YV3Q-32WN] (discussing the limited availability of venture capital financing for the substantial majority of small businesses).

7. *See* 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/> [https://perma.cc/CMP4-UZ2W] (“Angel investors invest their own money when participating in startup fundraising rounds, where the typical amount raised ranges from \$150,000 to \$2,000,000.”).

8. Catherine Clifford, *Top Sources of Small-Business Financing in 2012*, ENTREPRENEUR (Jan. 2, 2012), <http://www.entrepreneur.com/article/222540> [https://perma.cc/D36L-HCFV].

9. *What We Do*, U.S. SEC. EXCHANGE COMMISSION, http://www.sec.gov/about/whatwedo.shtml#VNEgd_54rN8 [https://perma.cc/4K6G-ZQMC] (last modified June 10, 2013).

burdened small businesses.¹⁰ Because securities regulators chose disclosure as the primary method of investor protection, the resulting fixed costs are substantial and cost prohibitive for many businesses interested in accessing the public securities markets.¹¹ During the summer of 2011, the regulation landscape began to change when Kansas passed the first equity crowdfunding law.¹² That law was intended to match local businesses with investors who “wanted to make a profit, but [who] also wanted to support the business in their town.”¹³ That single state exemption was followed shortly by the passage of the Jumpstart Our Business Startups Act (JOBS Act),¹⁴ which President Obama signed into law in April of 2012.¹⁵ Title III of the JOBS Act was intended to “open[] up exciting new opportunities for small businesses and startups . . . to raise capital from investors online”¹⁶ by allowing businesses to raise up to \$1 million from the general public¹⁷ through online fundraising portals.¹⁸ Unfortunately, the JOBS Act’s effectiveness was predicated on the SEC promulgating rules within 270 days.¹⁹ The SEC proposed rules in early 2014²⁰ and on October 30, 2015 finally

10. See generally Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC’s Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J. L. & BUS. 1 (2007) (arguing that, despite the SEC’s acknowledgement of hurdles small businesses face in raising capital, “with rare exception, the SEC has turned a deaf ear” to small businesses’ needs).

11. See Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 908–09 (2011) (discussing securities disclosure requirements and enforcement mechanisms and concluding that “a small business issuer will typically find that the costs of a registered public offering . . . outweigh the benefits”).

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

13. Jaime Brockway, *The State That Paved the Way for Equity-Based Crowdfunding*, BEACON READER (Sept. 11, 2014, 8:08 PM), <https://www.beaconreader.com/jaime-brockway/the-state-that-paved-the-way-for-equity-based-crowdfunding> [<https://perma.cc/G6BN-DN4L>].

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

15. Leigh Ann Caldwell, *Obama Signs “JOBS Act” into Law, Calls It a “Game-Changer,”* CBS NEWS (Apr. 5, 2012, 3:55 PM), <http://www.cbsnews.com/news/obama-signs-jobs-act-into-law-calls-it-a-game-changer/> [<https://perma.cc/TZ6A-HXGK>].

16. Press Release, Jeff Merkley, Merkley: Crowdfunding Exciting New Opportunity for Small Businesses and Startups (Apr. 5, 2012), <http://www.merkley.senate.gov/news/press-releases/merkley-crowdfunding-exciting-new-opportunity-for-small-businesses-and-startups> [<https://perma.cc/5UDV-DBMB>].

17. JOBS Act § 302(a)(6), 126 Stat. 306, 315 (codified at 15 U.S.C. § 77d(a)(6)).

18. *Id.* § 302(a)(6)(C), 126 Stat. at 315 (codified at 15 U.S.C. § 77d(a)(6)(C)).

19. *Id.* § 302(c), 126 Stat. at 320.

20. Press Release, Sec. & Exch. Comm’n, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013) [hereinafter SEC Crowdfunding Proposal], http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.VNZyV_54rN8 [<https://perma.cc/F3VX-JLMP>].

adopted rules to permit crowdfunding nationally.²¹ With federal action pending for over three years, states began to take the initiative. The lone Kansas exemption ballooned to over twenty-five proposed and enacted statutes.²²

Although the availability of alternative forms of investing and capital-raising is a positive development, these alternatives pose risks if improperly regulated. In a 2013 report on the potential benefits of crowdfunding around the world, the World Bank emphasized that, while “[s]uccessful fraud with crowdfunding has been relatively rare,”²³ it is nonetheless “a legitimate concern.” Indeed, concerns for investor protection were a hot topic during the federal legislation process²⁴—a topic eventually decided in favor of additional investor protection in tandem with including stricter requirements on small businesses.²⁵ By contrast, many state statutes and regulations have been deliberately drafted in ways that seek to create less stringent restrictions than the federal model.²⁶

Legal action at the state and federal levels has legitimized concerns about fraud. First, in 2014, the Washington State Attorney General brought a lawsuit against Altius Management and its president, Ed Nash.²⁷ The Attorney General’s complaint alleged that, despite raising

21. Press Release, Securities & Exch. Comm’n, SEC Adopts Rules to Permit Crowdfunding (Oct. 30, 2015) [hereinafter SEC Crowdfunding Adoption], <http://www.sec.gov/news/pressrelease/2015-249.html> [<https://perma.cc/5U73-LKL2>].

22. See Anthony J. Zeoli, *State of the States—Comparative Summaries of Current Active and Proposed Intrastate Crowdfunding Exemptions (Updated)*, CROWDFUNDINGLEGALHUB.COM <http://crowdfundinglegalhub.com/2015/01/16/state-of-the-states-comparative-summaries-of-current-active-and-proposed-intrastate-crowdfunding-exemptions/> [<https://perma.cc/8S8Q-DDXG>] (last updated Dec. 2015).

23. *Crowdfunding’s Potential for the Developing World*, WORLD BANK (2013), http://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf [<https://perma.cc/4PD9-QV3S>].

24. See Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. 281, 295–97 (2014) (characterizing the legislation process as having “set up a battle between two competing camps: the capital formation camp, led by Republican Congressman McHenry, and the investor protection camp, helmed by Democratic Senator Jeff Merkley”).

25. See *id.* at 297–300. Parsont rehashes the compromise as, on one side, loosening the restrictions of Rule 506 to allow issuers to use the internet to access accredited investors and, on the other, increasing mandatory disclosures required by the eventual crowdfunding legislation. *Id.* at 296–99.

26. See Steven Davidoff Soloman, *S.E.C.’s Delay on Crowdfunding May Just Save It*, N.Y. TIMES DEALBOOK, (Nov. 28, 2014, 2:56 PM), <http://dealbook.nytimes.com/2014/11/18/s-e-c-s-delay-on-crowdfunding-may-just-save-it-2/> [<https://perma.cc/DV5V-2SLL>] (“For good or bad, the states don’t seem to care as much about the fraud issue. Consider Texas, which last month proposed its own crowdfunding rules that are deliberately more liberal than those proposed by the S.E.C.”).

27. Press Release, Washington State Office of the Attorney General, Attorney General Files

over \$25,000 from 810 people on Kickstarter, Altius failed to make good on its promise to provide investors with the advertised playing card game.²⁸ That lawsuit resulted in a default judgment.²⁹ More recently, the Federal Trade Commission (FTC) sued Erik Chevalier and his business, The Forking Path, for not delivering a promised board game.³⁰ After Chevalier raised over \$122,000 from over 1200 backers, he announced that he would not produce the intended board game and would instead issue a refund to his investors.³¹ He failed to provide those refunds.³² The FTC settled with Chevalier, prohibiting him from making future misrepresentations about crowdfunding and imposing a monetary judgment.³³

No doubt, the few instances of fraud that result from traditional crowdfunding represent a small fraction of the total legitimate offerings. Projects on Kickstarter alone have raised over \$2 billion, spread across more than 100,000 projects.³⁴ Nonetheless, the prospect of fraud is real. Perhaps even more important, however, is the concern that even legitimate projects will result in substantial investor losses. Although it is too early to judge whether or how many crowdfunded businesses will succeed, there is reason for concern.³⁵ Angel investing provides a useful comparison. Research shows that angel investors rely on a small number

Lawsuit Against Company Behind Asylum Playing Cards Crowdfunded Project (May 1, 2014), <http://www.atg.wa.gov/news/news-releases/attorney-general-files-lawsuit-against-company-behind-asylum-playing-cards> [https://perma.cc/8JV2-28ML].

28. Complaint for Injunctive and Other Relief at 2, *State v. Altius Mgmt., LLC*, No. 14-2-12425-SEA (King Cty. Super. Ct. filed Apr. 30, 2014), <http://agportal-s3bucket.s3.amazonaws.com/uploadedfiles/AsylumComplaint%202014-05-01.pdf> [https://perma.cc/9RB5-NVCS].

29. Default Judgment, *Altius Mgmt., LLC*, No. 14-2-12425-SEA (King Cty. Super. Ct. filed July 22, 2015), http://agportal-s3bucket.s3.amazonaws.com/uploadedfiles/Another/News/Press_Releases/201507221452.pdf [https://perma.cc/4PLY-CS5X].

30. Press Release, Fed. Trade Comm'n, Crowdfunding Project Creator Settles FTC Charges of Deception (June 11, 2015), <https://www.ftc.gov/news-events/press-releases/2015/06/crowdfunding-project-creator-settles-ftc-charges-deception> [https://perma.cc/4MLT-DGMY].

31. Complaint at 3, *FTC v. Chevalier*, No. 15-cv-01029-AC (D. Or. filed June 10, 2015), <https://www.ftc.gov/system/files/documents/cases/150611chevaliercmpt.pdf> [https://perma.cc/XQ2P-DLBN].

32. *Id.*

33. See Proposed Stipulated Order for Permanent Injunction and Monetary Judgment at 3–5, *FTC v. Chevalier*, No. 15-cv-01029-AC (D. Or. filed June 10, 2015), <https://www.ftc.gov/system/files/documents/cases/150611chevalierstip.pdf> [https://perma.cc/Y5SZ-4C9Z].

34. *Stats*, KICKSTARTER, <https://www.kickstarter.com/help/stats> [https://perma.cc/54AW-BVSN] (last visited Feb. 24, 2016).

35. See generally Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493 (2014) (“The problem with equity crowdfunding is not the extent of disclosure. The problem is that the companies that participate will be terrible prospects.”).

of highly profitable investments to pull most of their portfolio's weight: the top ten percent of investments resulted in seventy-five percent of all returns, while fifty-two percent lost money.³⁶ Because the typical crowdfunding investor lacks the angel investor's expertise, ability to diversify, and active participation in an investment strategy, she is much less likely to find the hidden gems that make angel investing worthwhile.³⁷

What these anecdotes and figures suggest is not that crowdfunding should be abandoned, but that it warrants caution. This Comment explores the range of approaches states have taken to regulate crowdfunding by identifying those provisions that appear insufficiently protective of investors and proposing improvements to better protect investors without overburdening small businesses. Part I provides basic background information, starting with the original state blue sky laws and continuing onto the federal Securities Act of 1933. By looking to the prevailing rationale when those laws were passed, Part I suggests that relaxed regulatory requirements in some new crowdfunding laws fail to live up to historic standards. Part II discusses in some depth several approaches different jurisdictions have taken when attempting to regulate crowdfunding. That Part begins by laying out the provisions contained in the JOBS Act itself and then continues on to explain relevant portions of several state crowdfunding laws. Finally, Part III focuses on two areas. First, it compares the various provisions contained in state statutes with an emphasis on how both individual provisions and the statutes as a whole seek to achieve investor protection. Second, it uses these statutes as a baseline to argue that certain provisions should be included within state-level crowdfunding statutes to adequately guard against investor injury.

I. SECURITIES LAWS IN THE UNITED STATES

In order to appreciate the importance of the changes taking place in the crowdfunding space, it is important to start with a history of securities regulation more generally. This Part begins by discussing state securities laws and then moves to a summary of those laws' federal counterpart. Understanding how the securities laws came about historically and function currently is important for two reasons. The first is technical: because securities laws govern interstate commercial transactions, state laws exist only to the extent allowed by the federal

36. *Id.* at 511.

37. *Id.* at 513–15.

government.³⁸ Briefly discussing this unique interplay is important to understanding how state crowdfunding laws do and should function.

The second reason for describing securities laws in their historical context is more normative. Kansas passed the first blue sky law as a reaction to concerns about overly speculative investments;³⁹ the federal government followed suit a short time later. Other Depression-era financial protections—particularly the Banking Act of 1933 (known as Glass-Steagall)⁴⁰—have been chipped away or repealed altogether, with damaging results.⁴¹ The parallels between banking deregulation and security deregulation are certainly not perfect, and the primary protections provided by the Securities Act and Exchange Act are undoubtedly still in place. Even so, the general principle remains valid: important protections enacted by the people closest to a perceived harm should not be drawn back carelessly. This Part begins with a discussion of where those protections came from.

A. *The Beginnings of Securities Laws in the Kansas Blue Sky*

Early American securities regulation was a creature of the states.⁴² Such regulation often focused on specific industries: the first, passed in 1852 in Massachusetts, required railroad companies to certify that “reasonable parties” subscribed to their stock and paid a threshold of par value.⁴³ Before that, English securities laws placed limits on stockbrokers and the filing of a prospectus with government officials before any company could issue securities to the public.⁴⁴ Even though modern state statutes regulate a wider range of offerings than the early statutes, most continue to focus on the offer and sale of securities rather than attempt to impose subsequent registration requirements.⁴⁵ Despite

38. *See infra* Section I.C.1.

39. *See infra* Section I.A.

40. Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

41. *See generally* Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963 (2009) (discussing how the repeal of Glass-Steagall in the 1990s gave rise to consolidation of the banking and securities industries and resulted in the late-2000’s financial crisis).

42. *See generally* Rick A. Fleming, *100 Years of Securities Law: Examining a Foundation Laid in the Kansas Blue Sky*, 50 WASHBURN L.J. 583, 586 (2011) (reviewing the development of state securities laws).

43. *Id.* at 586.

44. *Id.*

45. JOSEPH C. LONG, 12 BLUE SKY LAW § 1:5 (2012).

changes over time to the form of regulation in state securities law,⁴⁶ much of the focus is still the same now as then: protecting investors from fraudulent offerings.⁴⁷

At the turn of the nineteenth century, America was in a period of intense modernization. The era incubated a number of history-changing inventions. New methods of communication, namely Thomas Edison's invention of the phonograph and motion picture, allowed Americans to access a world previously unheard and unseen.⁴⁸ New means of transportation, from the Wright Brothers' flight to Henry Ford's Model T, allowed Americans to experience that world in new and exciting ways.⁴⁹ For early twentieth century Americans, the sky was quite literally the limit.

Exceptional technological change brought with it additional promises. America's lower classes at the time had suffered through difficult working conditions, limited economic opportunity, and the prospect of premature death.⁵⁰ As these struggles slowly churned, organized labor began to increase in popularity and the middle class started making itself heard.⁵¹ The country had begun to recover from the depression of the 1890s with new, hopefully more stable corporate behemoths.⁵² Widespread growth and the success of heavy industries like rail and manufacturing required access to ever-increasing sources of capital.⁵³

The masses did not want to be left out. An onlooker observed that that "[t]here seems to be something fascinating to the average citizen about a proposition to buy stock in a company that is undertaking to build a railroad, or dig a mine, or plant fields of rice and tobacco"⁵⁴ Partially to tap into this growing demand for returns and partially to

46. *See id.* § 1:7.

47. *See, e.g.,* A.S. Goldmen & Co. v. New Jersey Bureau of Sec., 163 F.3d 780, 781 (3d Cir. 1999) ("The purpose of these so-called 'blue sky' laws was to allow state authorities to prevent unknowing buyers from being defrauded into buying securities that appeared valuable but in fact were worthless.").

48. MICHAEL MCGERR, A FIERCE DISCONTENT: THE RISE AND FALL OF THE PROGRESSIVE MOVEMENT IN AMERICA 234 (2006).

49. *See id.* at 226–28.

50. *See id.* at 14.

51. *Id.* at 32, 39.

52. Daniel T. Rodgers, *The Progressive Era to the New Era, 1900-1929*, GILDER LEHRMAN INST. AM. HIST., <http://www.gilderlehrman.org/history-by-era/essays/progressive-era-new-era-1900-1929> [<https://perma.cc/47LE-RBLV>] (last visited Mar. 28, 2016).

53. Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 352–353 (1991).

54. *Saving the People's Money*, 6 TICKER & INV. DIG. 156, 157 (1910).

make real returns in the face of increasing inflation, business owners began to offer interests in increasingly speculative ventures.⁵⁵ Politicians worried that the public's fascination with investment would lead to overly speculative investment and disproportionate losses.⁵⁶

Accordingly, states wasted little time in crafting local protections. In 1911, Kansas passed the first modern securities statute.⁵⁷ That law allowed the state's bank commissioner to block an offering that failed to provide a "fair, just and equitable plan for the transaction of business."⁵⁸ Many followed Kansas's lead: by 1931, all states but Nevada had enacted similar laws.⁵⁹

Although updated several times over the next few years, Kansas's original blue sky law was relatively straightforward.⁶⁰ At four pages long, the law succinctly governed activities of "investment companies" that offered any of a variety of financial instruments to Kansas residents.⁶¹ An issuer had to submit documents regarding its proposed offering and future activities for review by the state bank commissioner, who could accept or reject based on whether he "deem[ed] it advisable."⁶² This type of review would be dubbed "merit regulation."⁶³

55. See Macey & Miller, *supra* note 53, at 354–56 ("Speculative securities were typically 'hyped' by sales puffery that bordered on misrepresentation—and undoubtedly sometimes crossed the line."). One writer contemporaneously warned the investing public of overhyped schemes and "the delusion of 'easy money.'" Euphemia Holden, *The Delusion of Sudden Riches*, 83 BANKERS MAG. 186, 187 (1911).

56. See *The Kansas Blue Sky Law*, 75 CENT. L.J. 221, 222 (1912) (quoting Kansas bank commissioner J.N. Dolley, drafter of the first blue sky law as saying that "where there has been one dollar invested in mining, oil and gas stocks there has been 98 cents lost.").

57. Act of March 10, 1911, ch. 133, 1911 Kan. Sess. Laws 210.

58. C.A. Dykstra, *Notes on Current Legislation*, 7 AM. POL. SCI. REV. 230, 231 (1913). At the time, Kansas's bank commissioner, J.N. Dolley, was also its most ardent blue sky law advocate. See Fleming, *supra* note 42, at 595–97 (2011). Although this dual role suggests that Dolley's support for securities regulation could have been based on ulterior motives, Fleming argues that, while possible, such an "explanation is far too simplistic because it fails to explain the wide popular appeal of the blue sky law and other banking reforms." *Id.* at 597.

59. Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229, 232 (2003).

60. The term "blue sky law" allegedly comes from a scheme by Chicago salespeople who marketed a rain-making machine to drought-stricken Kansas farmers. Fleming, *supra* note 42, at 585. When the machine inevitably failed, the salesmen left with cash and without fulfilling their promise. From that rouse came the term: "it refers to an investment opportunity in which the promoter promises rain but delivers blue sky." *Id.* at 586.

61. *Id.* at 601.

62. *Id.* at 602.

63. Merit regulation is defined as:

[A] regulatory system that authorizes state administrators to deny registration to a securities offering unless the substantive terms of the offering and the associated transactions (i) ensure a fair relation between promoters and public investors, and (ii) provide public investors with a

B. *The Theories Behind Modern Securities Regulation*

Merit regulation is one of two dominant philosophies of securities regulation. Although less popular than in the years immediately following the adoption of the first blue sky law, major states like California⁶⁴ and Texas⁶⁵ continue to utilize merit-based review. By contrast, a significantly more permissive approach requires no state-level registration and uses antifraud protections alone. Only New York's Martin Act⁶⁶ applies this model. In between, some states have matched the federal approach, which mandates pre-offering disclosure.⁶⁷ A fourth model, and the most popular, combines disclosure requirements with merit review.

For most jurisdictions, one of these philosophies has been inserted within the provisions of the Uniform Securities Act.⁶⁸ Currently used in some fashion in forty-three states and territories,⁶⁹ the Uniform Act was

reasonable relation of risk to return. While merit and disclosure regulation should not be regarded as antitheses, merit regulation differs from disclosure regulation in its direct regulation of the internal structure of a securities issuer, of the relations among insiders and outsiders, and of the terms of the offering.

Mark A. Sargent, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 829 (1986). The underlying substantive goal of merit regulation—to promote an offering's fairness—is reached by, first, preventing promoters from acquiring a company's stock at depressed prices prior to its offering and, second, protecting the public against exploitation from underwriters who seek excessive fees. See Rutheford B. Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553, 563–67 (1985). For an additional discussion of merit regulation, see Ronald J. Colombo, *Merit Regulation via the Suitability Rules*, 12 J. INT'L BUS. & L. 1 (2013).

64. CAL. CORP. CODE § 25140 (West, Westlaw through 2016 Reg. Sess.) (“The commissioner may issue a stop order denying . . . any qualification of an underwritten offering of securities . . . if he or she finds (A) that the order is in the public interest and (B) that the proposed plan of business of the issuer or the proposed issuance or sale of securities is not fair, just, or equitable . . .”).

65. TEX. REV. CIV. STAT. ANN. art. 581-7(1) (West, Westlaw through 2015 Reg. Sess.) (“No dealer or agent shall sell or offer for sale any securities . . . until the issuer of such securities or a dealer registered under the provisions of this Act shall have been granted a permit by the Commissioner.”).

66. N.Y. GEN. BUS. LAW § 343 (McKinney 2016) (“Whenever it shall appear to the attorney-general, either upon complaint or otherwise, that in [the sale of a security], any person . . . shall have employed . . . any [fraudulent scheme], he may in his discretion either require or permit such person . . . to file with him a statement in writing under oath or otherwise as to all the facts and circumstances concerning the subject matter which he believes it is to the public interest to investigate . . .”).

67. See *infra* Section I.B.

68. LONG, *supra* note 45, § 1:7.

69. These jurisdictions include the District of Columbia, U.S. Virgin Islands, and Puerto Rico. A breakdown shows that twenty jurisdictions base their laws on the 1956 Uniform Act, four on the 1985 Act, nineteen on the 2002 act, and ten are not modeled after any version. Pamela M. Heinrich, *U.S. Survey: State Adoption of Uniform Securities Act*, NAT'L ASS'N FOR FIXED ANNUITIES, <http://www.nafa.com/wp/wp-content/uploads/2012/07/20120920-NAFA-Uniform-Security-Act->

promulgated in 1956,⁷⁰ revised first in 1985,⁷¹ and then revised a second time in 2002.⁷² The Uniform Act, as well as all independent blue sky laws other than New York's, employs three primary regulatory elements: securities registration, intermediary regulation, and antifraud enforcement.⁷³ State securities laws, the Uniform Act included, are concerned predominantly with offers and sales of securities as well as the supervision of securities professionals, rather than with ongoing reporting requirements and secondary market transactions.⁷⁴ The drafters of the Uniform Act—the first model legislation of its kind in the securities field⁷⁵—formatted their model in a way that allows adopting states to choose among standalone provisions for any of the three regulatory areas.⁷⁶

Registration of securities, the first area of concern for most states and the topic this Comment focuses on, requires issuers to submit materials to a state administrator. The Uniform Act allows for three different forms of registration, balancing the need to protect investors against a desire to limit redundancy and excess costs for potential issuers.⁷⁷ The first, registration by coordination, allows a registration statement filed pursuant to a federal offering in compliance with the Securities Act to qualify at the state level.⁷⁸ Second, registration by filing is most useful for larger companies which already have shares outstanding.⁷⁹ Finally,

Adoption_At-A-Glance.pdf [https://perma.cc/N2NV-ZNEA] (last updated Oct. 12, 2012).

70. UNIF. SEC. ACT (amended 1958), 7C U.L.A. 748 (2006).

71. UNIF. SEC. ACT (amended 1988), 7C U.L.A. 221 (2006).

72. UNIF. SEC. ACT (amended 2002), 7C U.L.A. 20 (2006).

73. See ROBERT N. RAPP, BLUE SKY REGULATION 1-2 to 1-7 (2003). In this context, “registration” refers to process issuers have to go through in order to sell securities to investors; registration almost always requires submission of designated information to the relevant administrator. *Id.* at 1-3.

74. Mark A. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities*, 46 MD. L. REV. 1027, 1030 (1987).

75. See RAPP, *supra* note 73, at 1-20. Rapp notes that, although the Uniform Sales of Securities Act was released in 1929, it managed to gain minimal traction and the passage of the Securities Act of 1933 rendered it obsolete. *Id.* at 1-20 n.10.

76. The provisions, although now slightly reorganized, were labeled as: Part I for fraudulent practices, UNIF. SEC. ACT §§ 101–02 (amended 1958), 7C U.L.A. 749 (2006); Part II for intermediary registration and regulation, *id.* §§ 201–04, 7C U.L.A. 777; and Part III for registration of securities, *id.* §§ 301–06, 7C U.L.A. 793. The final Part IV contains sections for definitions, exemptions, and criminal and civil penalties among others. *Id.* §§ 401–20, 7C U.L.A. 817.

77. See *The Uniform Securities Act*, 12 STAN. L. REV. 105, 106 (1959) (“[P]aper work would be minimized if the federal prospectus were used by state administrators as their basic source of information.”).

78. UNIF. SEC. ACT § 303 (amended 2002), 7C U.L.A. 81 (2006).

79. *Id.* § 302, 7C U.L.A. 74.

registration by qualification—the most onerous of the three—is provided for issuers unable to qualify under the previous two methods.⁸⁰ Although in these sections the Uniform Act continues to empower administrators to exercise a form of merit review, the revised version has followed the trend ongoing in many states to expand certain exemptions to facilitate offerings in limited circumstances.⁸¹

C. *The Federal Approach to Small-Dollar Securities Regulation: The Securities Act of 1933 and Its Exemptions*

The excitement that led to the passage of state securities laws presents a stark contrast with the misery that preceded the federal securities laws. Rather than the relative prosperity of the early years of the 1900s and the perceived need to protect eager investors, federal securities laws were drafted as a response to the 1929 stock market crash and subsequent Great Depression.⁸² Although the federal securities laws were originally modeled after the merit-based review used in many states, President Roosevelt rejected merit review as overly paternalistic.⁸³

Instead, the Securities Act of 1933⁸⁴ attempts to protect investors by mandating information disclosure and prohibiting fraudulent practices.⁸⁵ Disclosure is achieved through section 5, which requires that prospective issuers file a registration statement for the SEC to review,⁸⁶ file a public statement,⁸⁷ and to wait a mandatory period before securities can be

80. *Id.* § 304, 7C U.L.A. 84.

81. See RAPP, *supra* note 73, at 1-21 n.17 (noting exclusion from merit review for “seasoned” issuers in section 302(a) and an expanded limited offering exemption in section 402(11)). These exemptions, updated in the most recent revision of the Uniform Act to account for the National Securities Markets Improvement Act of 1996, 15 U.S.C. § 77r (2012), are not generally relevant here. For a list of the included exemptions, see RAPP, *supra* note 73, at 7-10 to 7-13.

82. Daniel J. Morrissey, *The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review*, 44 U. RICH. L. REV. 647, 678 (2010).

83. *Id.* at 679. The President made a statement regarding the first version of the Securities Act of 1933, explaining that:

Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information . . .

H.R. REP. NO. 73-85, at 2 (1933).

84. 15 U.S.C. § 77a–77aa.

85. MARC I. STEINBERG, *SECURITIES REGULATION* 163 (5th ed. 2009).

86. 15 U.S.C. § 77f.

87. *Id.* § 77e(c).

sold.⁸⁸ Through these disclosures, legislators hoped to provide investors with enough information to ensure an informed investment decision.⁸⁹ Although the SEC does not verify the truth of the registered information,⁹⁰ section 11 provides the Act with significant teeth to combat fraud.⁹¹

The Securities Act's disclosure requirements and antifraud provisions were a response to a clear problem with state securities regulation. Because blue sky antifraud protections could not reach beyond state borders,⁹² waves of securities fraud victimized investors in the late 1910s and again in the 1920s.⁹³ In addition, a single federal securities regulatory scheme created efficiencies impossible to achieve with a piecemeal system.⁹⁴ Under pure state-based securities laws, when a fraudulent issuer sold securities to the residents of several states, any subsequent lawsuits were likely to result in inconsistent decisions and legal standards.⁹⁵

Even so, Congress understood the need for continued state regulation. Not only did the 1933 Act expressly retain the states' ability to protect local investors,⁹⁶ but it also created an intrastate exemption where state regulations alone would operate.⁹⁷ Indeed, Congress has since expressed a desire for additional federal-state coordination.⁹⁸ To that end, state laws continue to play an important role in ensuring that the entire

88. *Id.* § 77h(a).

89. STEINBERG, *supra* note 85, at 163.

90. *Id.*

91. 15 U.S.C. § 77k.

92. See Daniel J. McCauley, Jr., *Intrastate Securities Transactions Under the Federal Securities Act*, 107 U. PA. L. REV. 937, 941 (1959) ("Federal securities legislation was enacted, among other reasons, to supplement state regulation by closing the door to interstate transactions as to which state regulation was being frustrated."); Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495, 515–16 (1984) (noting that the success of state securities regimes "led unscrupulous promoters to develop schemes to elude the reach of process through the use of interstate facilities.").

93. Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 18 (1983).

94. Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 697–98 (1984).

95. *Id.*

96. 15 U.S.C. § 77r ("[N]othing in this chapter shall affect the jurisdiction of the securities commission . . . of any State over any security or any person insofar as it does not conflict with the provisions of this chapter."); *Id.* § 78bb(a) (providing the same).

97. *Id.* § 77c; see also *infra* Section I.B.1.

98. *Id.* § 77s(d)(1).

regulatory system functions.⁹⁹ Because of state support, federal securities regulators and federal courts have been able to reduce the scope of their investigations and allow state systems to pick up the slack. This has included a trend to reduce the number of securities cases heard in the federal system.¹⁰⁰ In contrast, state courts have tended to expand their definition of what activities qualify for regulation by blue sky laws.¹⁰¹ Not only do local agencies help the SEC shoulder a substantial regulatory burden, but they also provide regulatory innovations useful to the entire system.¹⁰² Equity crowdfunding, the subject of this Comment, provides but one example.

In part because of the added layer of security provided by state-level protections and in part because of its concern with balancing fraud protection with capital formation,¹⁰³ the Commission has created several exemptions from the typical disclosure requirements. Categorized as either “Exempted Securities” in section 3 or “Exempted Transactions” in section 4,¹⁰⁴ issuers using an exemption are not required to follow the section 5 disclosure requirements.¹⁰⁵ The exempted securities listed in section 3 are excluded based on “the intrinsic nature of the issuer or the character of the security itself.”¹⁰⁶ This includes, among others: short-

99. Sargent, *supra* note 74, at 1060–66 (responding in the affirmative to “whether state disclosure regulation plays a positive role in the allocation of regulatory responsibilities between the states and the SEC”).

100. LONG, *supra* note 45, § 1:7. This trend has been similarly facilitated by congressional action, with the passage of Private Securities Litigation Reform Act in 1995 providing one example. See Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273 (1998) (“A consequence of the Act . . . was to shift a significant portion of securities fraud class action litigation from federal to state court.”).

101. LONG, *supra* note 45, § 1:7; see, e.g., *Stanley v. Commercial Courier Serv., Inc.*, 411 F. Supp. 818, 823 (D. Or. 1975) (finding that a franchising scheme was not a security under federal law, but was under Oregon state law).

102. Sargent, *supra* note 74, at 1066.

103. See 15 U.S.C. § 77b(b) (“[T]he Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”).

104. 15 U.S.C. § 77c (Section 3); 15 U.S.C. § 77d (Section 4). In addition to the specific provisions in that section, section 3(b) states that “[t]he Commission may from time to time by its rules and regulations . . . add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall . . . exceed[] \$5,000,000.” *Id.* § 77(c)(b)(1).

105. See *id.* § 77e (exempting the securities listed in “the provisions of section 77c or 77d of this title.”). None of these exemptions, however, protect the issuer against fraud liability prescribed by the Securities Act. *Id.* § 77q.

106. J. WILLIAM HICKS, 7 EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933, at 1-17 (2003). Not all of the securities listed in section 3 are treated as exempted securities: only

term commercial promissory notes;¹⁰⁷ securities issued by nonprofit, religious, educational, or charitable organizations;¹⁰⁸ and securities of building and loan or farmer cooperatives.¹⁰⁹ Because the exemption is seen to apply to the security itself rather than the issuing transaction, an issuer must comply only with the terms of the specific exemption.¹¹⁰ In contrast, the transactional exemption afforded to the rest of section 3 and the entirety of section 4 applies more narrowly. Because that exemption applies to a specific transaction alone, subsequent resale transactions must not only comply with registration requirements, but the issuer must follow the exemption's conditions for the duration of the offering.¹¹¹

Of these two categories, transactional exemptions are more commonly used in the small business context.¹¹² The following exemptions are particularly relevant to facilitating small business capital formation.¹¹³ The first, the "intrastate exemption," was a product of the original Securities Act and expressly maintains state authority to govern securities within state borders. The second and third are regulatory exemptions issued by the SEC based on the discretion extended to it by section 3(b) of the Securities Act, which allows the Commission considerable leeway in dealing with small offerings.¹¹⁴

sections 3(a)(2) through 3(a)(8) receive that special distinction. 15 U.S.C. § 77c(a)(2)–(a)(8). The remaining portions of section 3 are classified as exempt transactions like those in section 4. HICKS, *supra*, at 1-17.

107. 15 U.S.C. § 77c(a)(3).

108. *Id.* § 77c(a)(4).

109. *Id.* § 77c(a)(5).

110. HICKS, *supra* note 106, at 1-17.

111. *Id.* at 1-17 to 1-18. In an intrastate offering, for example, all securities sold must "come to rest" in the hands of state residents. Because this requirement means the actual transaction could last for up to a year after the issuer sells its final security, the issuer does not comply with the exemption's technical requirements until after passing through that resting period. *Id.* at 1-18.

112. See Rutherford B. Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital,"* 31 DEL. J. CORP. L. 77, 92–99 (2006) (discussing the various exemptions available to small businesses: intrastate offerings, private placements, and Regulation D).

113. Other safe harbors not discussed here include Regulation A, *see id.* at 111-21 (discussing use of and prescribing changes for Regulation A), as well as a variety of niche safe harbors not broadly applicable. *See* HICKS, *supra* note 106, at 1-16.1 to 1-17 (listing exempted securities); *id.* at 1-25 to 1-33 (discussing and categorizing exempted transaction).

114. 15 U.S.C. § 77c(b) ("The Commission may . . . add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall . . . [exceed] \$5,000,000.").

1. *The Intrastate Exemption and Rule 147 Safe Harbor*

The intrastate exemption, section 3(a)(11) of the Securities Act,¹¹⁵ carves from the federal disclosure requirements an exemption that requires issuers to comply only with state law. The exemption allows smaller issuers to sell securities through a local financing plan, under a theory that investors would be protected by their proximity to the issuer and that state's blue sky law.¹¹⁶ The requirements to qualify for this exemption include: (1) the issuer must be a resident of or incorporated in the state; (2) the issuer must conduct a substantial amount of its business within the state; (3) the proceeds of the offering must be used within the state; (4) the offerees and purchasers must be residents of that state; (5) securities offered through the transaction must come to rest in persons residing in the state; and (6) the entire securities issuance must be made pursuant to the section 3(a)(11) exemption.¹¹⁷ Failure to comply with each of these requirements defeats the exemption and could result in civil liability and other sanctions for the issuer.¹¹⁸

Although seemingly straightforward, uncertainty regarding how the SEC would define and police the section's terms prompted further explanation. The result was Rule 147,¹¹⁹ adopted in January 1974, which clarifies but does not replace the statutory standard.¹²⁰ With regards to residence of the issuer, Rule 147 repeatedly applies an eighty percent standard: eighty percent of the business's gross revenues during the last fiscal year must come from the state;¹²¹ eighty percent of its assets, along with its principal office, must be located in the state;¹²² and eighty

115. *Id.* § 77c(a)(11).

116. Notice of Adoption of Rule 147 Under the Securities Act of 1933, Securities Act Release No. 5450, 1 Fed. Sec. L. Rep. (CCH) ¶ 2340 (Jan. 7, 1974) [hereinafter Rule 147 Release].

117. HICKS, *supra* note 106, at 4-4. *See generally* Section 3(a)(11) Exemption for Local Offerings, Securities Act Release No. 4434, 1 Fed. Sec. L. Rep. (CCH) ¶2270 (Dec. 6, 1961) (discussing the requirements to qualify for the intrastate exemption).

118. These sanctions can include an injunction prohibiting further distributions of securities without registering, requiring an offer of redemption for all prior securities transactions, and recommendation of criminal prosecution. HICKS, *supra* note 106, at 4-6 n.10.

119. 17 C.F.R. § 230.147 (2016).

120. If any issuer fails to qualify under Rule 147, it is technically possible to qualify under the less-well-defined intrastate exemption. *See* Rule 147 Release, *supra* note 116 ("The rule is a nonexclusive rule. However, persons who choose to rely on section 3(a)(11) without complying with all the conditions of the rule would have the burden of establishing that they have complied with the judicial and administrative interpretations of section 3(a)(11) in effect at the time of the offering.").

121. 17 C.F.R. § 230.147(4)(c)(2)(i).

122. *Id.* § 230.147(4)(c)(2)(ii).

percent of the offering's net proceeds must be used in the state.¹²³ The Rule maintains the requirement that all offerees and purchasers must be state residents, interpreted to mean that the individual's "principal residence" is within state boundaries.¹²⁴ Finally, the rule prohibits purchasers from reselling to anyone not a resident of the state and from reselling securities for the nine months after the final sale of that issue.¹²⁵

2. *Regulation D and Rule 504*

Regulation D was the SEC's response to economic hardship among the American small business community during the 1970s.¹²⁶ During three weeks in the spring of 1978, the Commission held public hearings in order to better "determin[e] the extent to which the burdens imposed on small businesses by the federal securities law could be alleviated consistent with the protection of investors."¹²⁷ The result was three new safe harbors and six total rules that updated the then-existing safe harbors for small issuers.¹²⁸

Regulation D is structured by listing generally applicable requirements first, followed by three substantive safe harbors. Rule 501 contains definitions, including one for "accredited investor," which includes individuals with over \$1 million in net worth outside of their primary residence,¹²⁹ over \$200,000 in income alone, or \$300,000 in income together with a spouse.¹³⁰ Rule 502 restricts the allowed "manner of offering" by prohibiting general solicitation and advertising as well as resale of the purchased securities.¹³¹ Finally, Rule 503 requires the issuer

123. *Id.* § 230.147(4)(c)(2)(iii).

124. *Id.* § 230.147(4)(d)(2).

125. *Id.* § 230.147(4)(e).

126. J. WILLIAM HICKS, 7a EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933, at 7-14 (2003).

127. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers & Sales, Securities Act Release No. 33-6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106 (Mar. 8, 1982).

128. 17 C.F.R. §§ 230.501-.506; *see* Proposed Revision of Certain Exemptions from the Registration Provisions of the Sec. Act of 1933 for Transactions Involving Ltd. Offers & Sales, Securities Act Release No. 6339, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,014, at 84,457 (Aug. 7, 1981) [hereinafter Exemption Revision Release]. Subsequently, the enforcement mechanisms were added in Rules 507 and 508 to complete the series of rules which today make up Regulation D. The goal of the new rules was to "simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between Federal and state exemptions." *Id.* The rescinded exemptions were codified as Rules 146, 240, and 242. *Id.*

129. 17 C.F.R. § 230.501(a)(5).

130. *Id.* § 230.501(a)(6).

to file a notice of offering with the SEC.¹³²

Of the substantive safe harbors, the most relevant to state crowdfunding is Rule 504.¹³³ Derived from the SEC's power in section 3(b), Rule 504 was intended to create a "clear and workable exemption for small offerings by small issuers to be regulated by state 'Blue Sky' requirements."¹³⁴ To that end, the SEC has attempted to coordinate federal and state requirements. Although Rule 504 incorporates the solicitation and resale restrictions noted above, an issuer receives an exemption from those requirements if it either registers its offering pursuant to an applicable blue sky law or offers its securities to accredited investors alone.¹³⁵ The safe harbor, which originally capped its offerings to \$500,000,¹³⁶ now allows for offerings of up to \$1 million within a twelve-month period.¹³⁷

D. *Securities Regulation and Federalism: State Action in a Federally-Dominated Field*

In an area dominated by federal statutes and regulations, states play a diminished but still-important role in encouraging capital formation and protecting investors.¹³⁸ This role has long been expressly recognized in federal law,¹³⁹ with the federal government intending to leverage local experience with securities regulation when it developed its own regulatory system in the 1930s.¹⁴⁰ As noted above, the federal version has emphasized disclosure as a means of investor protection, while many

131. *Id.* § 230.502(c) (prohibiting general solicitation, including "[a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio"); *id.* § 230.502(d).

132. *Id.* § 230.503(a).

133. The two other substantive safe harbors under Regulation D are Rules 505 and 506. Briefly stated, Rule 505 allows an issuer to raise up to \$5 million within a twelve-month period from an unlimited number of accredited investors and up to thirty-five non-accredited investors. Rule 506 allows an issuer to raise an unlimited amount of money from an unlimited number of accredited and up to thirty-five non-accredited investors. *See* HICKS, *supra* note 126, at 7-22 to 7-24.

134. Exemption Revision Release, *supra* note 128.

135. 17 C.F.R. § 230.504(b).

136. Exemption Revision Release, *supra* note 128.

137. 17 C.F.R. § 230.503(b)(2).

138. *See supra* notes 92–98 and accompanying text.

139. *See, e.g.*, 15 U.S.C. § 78bb (preserving, among other things, the right of state securities commissions to "retain jurisdiction under the laws of such State to investigate and bring enforcement actions"); *supra* notes 111–25 and accompanying text (discussing the federal intrastate exemption and the Rule 147 safe harbor).

140. Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 112 (2005).

states employ merit review.¹⁴¹ Despite the added protection against securities fraud and other abuses, the dual system was criticized as inefficient and unnecessarily burdensome on issuers who needed to comply with both federal and state requirements.¹⁴²

Over time, lawmakers began to address state-federal coordination issues by implementing a more uniform system at the state level.¹⁴³ This process included the promulgation of the Uniform Securities Act in 1956,¹⁴⁴ the Uniform Limited Offering Exemption in 1983,¹⁴⁵ and the creation of a Small Corporate Offering Registration (SCOR) form in 1989.¹⁴⁶ Even with these changes, the securities industry voiced dissatisfaction with the slow pace of reform and the system's persistent redundancies.¹⁴⁷ The result of this continued discontent was, among other things, the National Securities Markets Improvement Act (NSMIA), passed in 1996.¹⁴⁸ NSMIA reduced the regulatory burden

141. Compare *supra* Section I.B (discussing merit review used in some states), with *supra* Section I.C (discussing disclosure required by the federal Securities Act); see also Jeffrey D. Chadwick, Comment, *Proving Preemption by Proving Exemption: The Quandary of the National Securities Market Improvement Act*, 43 U. RICH. L. REV. 765, 768 (2009) (“Though theoretically opposed, the two philosophies were designed to work together to avoid the pitfalls that precipitated the 1929 crash.”).

142. See Jones, *supra* note 140, at 112; Chadwick, *supra* note 141, at 769.

143. For a discussion of the changes in state and federal law aimed at increasing uniformity, see Kenneth I. Denos, *Blue and Gray Skies: The National Securities Markets Improvement Act of 1996 Makes the Case for Uniformity in State Securities Law*, 1997 UTAH L. REV. 101, and Ruthford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175 (1997).

144. UNIF. SEC. ACT (amended 1958), 7C U.L.A. 748 (2006).

145. Uniform Limited Offering Exemption, NASAA Rep. (CCH) ¶6201, <http://www.nasaa.org/wp-content/uploads/2011/07/UNIFORM-LIMITED-OFFERING-EXEMPTION.pdf> [https://perma.cc/U53Y-BSK4]. This uniform law was intended to provide a template for state to copy, in order to facilitate coordination of state and federal securities exemptions and thereby benefit small businesses. Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L.Q. 225, 248–49 (1990).

146. See *SCOR Overview*, NORTH AM. SEC. ADMIN. ASS'N, <http://www.nasaa.org/industry-resources/corporation-finance/scor-overview/> [https://perma.cc/D4DY-L5AH] (last visited Jan. 16, 2016) (“The Form was designed for use by companies seeking to raise capital through a public offering of securities exempt from registration with the U.S. Securities and Exchange Commission (SEC) under [Rule 504 and section 3(a)(11), among others].”).

147. Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT'L L. 495, 508 (2003).

148. National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.). State law was also preempted in the 1990s by the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.), which precluded state courts from hearing class actions in connection with a security sold on a national exchange. For a more thorough discussion of the SLUSA, see Selby P. Brown, *Don't Throw the Baby out with the Bath Water: The*

placed on issuers by precluding states from requiring securities registration, conducting merit review, and requiring delivery of pre-offering prospectuses for “covered securities.”¹⁴⁹ These securities include, among others, those of companies listed on national exchanges or NASDAQ, securities sold pursuant to transactions exempt from registration—for example, under the section 4(a)(2) exemption and related Regulation D safe harbor, or under the section 4(a)(6) crowdfunding exemption—and sales made to “qualified purchasers,” as defined by the SEC rule.¹⁵⁰

Even with the enactment of NSMIA and other preemptive federal laws, state securities laws remain an important element of securities regulation. As a legal matter, courts have made clear that Congress did not intend to occupy the field of securities regulation generally,¹⁵¹ and Congress has explicitly stated when it intends to preempt states.¹⁵² As a practical matter, states have been important players in combating fraud.¹⁵³ In the early 2000s, for example, New York used the threat of liability under its Martin Act to compel Merrill Lynch to separate its securities research and investment banking divisions.¹⁵⁴ Regulation of Wall Street is the most prominent, but not the only, example of the importance of state protections. Despite federal securities regulation’s increased presence, state enforcement of securities laws is essential when, for example, an issuer decides to use the safe harbor under Rule 147.¹⁵⁵

Merits of the Intermediate Approach to the Securities Litigation Uniform Standards Act, 66 OKLA. L. REV. 363 (2014).

149. 15 U.S.C. § 77r(a)(1)(A) (2012).

150. *Id.* § 77r(b); see also Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 154 (2010). The SEC later clarified that “qualified purchasers” would be limited to “large accredited investors”—legal entities with assets of at least \$10 million or individuals with at least \$2.5 million in investments or \$400,000 in individual income. Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8828, [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,939, 85,174 (Aug. 3, 2007).

151. See, e.g., *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101, 1107 (4th Cir. 1989); *N. Star Int’l v. Ariz. Corp. Comm’n*, 720 F.2d 578, 582 (9th Cir. 1983).

152. Compare 15 U.S.C. § 77r(a), with *id.* § 77p(b).

153. See Christine A. Bruenn, NASAA President, Testimony Before the United States Senate Committee on Banking, Housing and Urban Affairs: Wall Street Analyst Conflicts of Interest Global Settlement (May 7, 2003), <http://www.nasaa.org/882/wall-street-analyst-conflicts-of-interest-global-settlement/> [https://perma.cc/4SFP-SQKD] (discussing the states’ roles in the investigation of Wall Street practices in the early 2000s).

154. See Karmel, *supra* note 147, at 519–22.

155. See *supra* notes 94–105 and accompanying text.

II. EXISTING CROWDFUNDING LEGISLATION AT THE FEDERAL AND STATE LEVEL

The SEC's goals—to protect investors, maintain efficient markets, and facilitate capital formation¹⁵⁶—are inherently at odds. Mandated disclosure and merit review attempt to provide investors with information and weed out bad actors, but at a significant cost to issuers. Nowhere is that tension more acutely felt than in the small business community, where businesses lack sufficient economies of scale to make up for the cost of a registered offering.¹⁵⁷ Both state and federal securities laws create an environment in which transactional and structural burdens on small-dollar offerings are frequently cost-prohibitive.¹⁵⁸

This problem bears out in actions taken by regulators. On the one hand, it is easy to extol the benefits of strong small business performance. In a recent annual SEC Forum on Small Business Capital Formation, Commissioner Luis Aguilar commented that “the success of small businesses is essential to the sustained growth of our greater economy.”¹⁵⁹ He added that between 1993 and 2013, “[s]mall firms were responsible for 63 percent of the net new jobs created” in America.¹⁶⁰ On the other hand, the SEC has been a reluctant partner in efforts to facilitate small-dollar capital formation. Repeated comments about the importance of this subset of the American economy have been followed up with “[p]recious little attention . . . to the more numerous and difficult concerns faced by small companies seeking to raise capital through exemption from registration.”¹⁶¹ The frustration among the small business community and its supporters culminated in a groundswell of support for the JOBS Act.¹⁶²

156. *What We Do*, U.S. SEC. EXCHANGE COMMISSION, http://www.sec.gov/about/whatwedo.shtml#.VNEgd_54rN8 [<https://perma.cc/4K6G-ZQMC>] (last modified June 10, 2013).

157. Rutheford B. Campbell, Jr., *The New Regulation of Small Business Capital Formation: The Impact-If Any-of the Jobs Act*, 102 KY. L.J. 815, 817–18 (2014) (describing how the limited size of many small business's capital needs results in substantial fixed transaction costs and how securities regulation impedes small-dollar offerings).

158. Campbell, *supra* note 157, at 817–18.

159. Record of Proceedings, 33rd Annual Securities and Exchange Commission Government-Business Forum on Small Business Capital Formation 16 (Nov. 20, 2014), <http://www.sec.gov/info/smallbus/sbforum112014-final-transcript.pdf> [<https://perma.cc/UN9M-KVB8>].

160. *Id.*

161. Cohn & Yadley, *supra* note 10, at 4.

162. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in

This Part discusses statutory crowdfunding legislation and regulation passed at the federal and state levels. The Part begins with a discussion of Title III of the JOBS Act, which allows companies to conduct small-dollar offerings in a limited disclosure regime. It then uses three state-level analogs to demonstrate the range of local alternatives: Indiana's exemption, which allows issuers to raise up to \$2 million; Maryland's exemption, which limits issuers to \$100,000; and a model act promulgated by the North American Securities Administrators Association (NASAA), an association of state securities administrators.

A. *Crowdfunding and the JOBS Act*

Signed into law in April of 2012, the JOBS Act was characterized as “attempt[ing] to create jobs by making it easier for America’s entrepreneurs to raise startup and growth capital.”¹⁶³ Although the Act contains several provisions that concern relatively large private businesses, Title III focuses exclusively on allowing small issuers to conduct offerings over the internet.¹⁶⁴ Known as the CROWDFUND Act,¹⁶⁵ Title III adds an exempted transaction to the Securities Act in a newly created section 4(a)(6).¹⁶⁶

This exemption takes after traditional private crowdfunding platforms like Kickstarter, Indiegogo, and Kiva. Those websites and others connect entrepreneurs with anyone willing to receive an in-kind return, a gradual reimbursement of their original donation, or the satisfaction of supporting a cause in exchange for a small investment.¹⁶⁷ Because the transactions on these websites do not involve a “security” as defined by various Supreme Court opinions,¹⁶⁸ their activities are not covered by securities regulation. Until recently, however, both securities registration requirements and limitations on selling to unaccredited investors all but prohibited most investors from obtaining equity in non-public businesses.¹⁶⁹

scattered sections of 15 U.S.C.).

163. 158 CONG. REC. E517 (daily ed. Mar. 30, 2012) (statement of Rep. McCollum).

164. Jumpstart Our Business Startups Act §§ 301–305, 126 Stat. at 315–23.

165. An acronym for the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012.

166. 15 U.S.C. § 77d(a)(6) (2012).

167. See Bradford, *supra* note 5, at 10–27 (discussing crowdfunding generally and listing five different varieties).

168. See *id.* at 31–41 (discussing how each type of crowdfunding is treated under securities regulation).

169. See *id.* at 24–27.

The Title III exemption was intended to pave the way for equity crowdfunding.¹⁷⁰ One of the more novel elements of Title III is its express endorsement of the “funding portal,” an online tool that mimics the websites used by non-equity, web-based crowdfunding.¹⁷¹ Issuers that engage in equity crowdfunding must utilize an intermediary, in the form of either an online “funding portal” or broker, to facilitate the transaction.¹⁷² In part because these intermediaries function as a funnel for all potential crowdfunding offerings, Title III utilizes them as a source of investor protection and a prophylactic against fraud. Funding portals as an alternative intermediary to a broker is a new addition. Funding portals are exempted from broker-dealer registration requirements established by the Securities Exchange Act of 1934 (Exchange Act),¹⁷³ but they must nonetheless register with the SEC and a self-regulatory organization (SRO).¹⁷⁴ They must also comply with a series of statutory requirements: refrain from offering investment advice; avoid soliciting purchases, sales, or offers of securities; not compensate employees based on sale of securities on its website; not handle investor funds or securities; and follow other rules as determined by the SEC.¹⁷⁵

In addition, funding portals are required to help inform investors about the risks inherent in this type of investment¹⁷⁶ and provide additional education materials.¹⁷⁷ The SEC recognized the importance of

170. See 158 CONG. REC. S2230 (daily ed. Mar. 29, 2012) (statement of Sen. Brown) (“The CROWDFUND Act sets the framework for developing a new market in which entrepreneurs can raise capital and ordinary investors can invest in new ideas.”).

171. A funding portal acts as an intermediary in a crowdfunding transaction but cannot do the following:

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

15 U.S.C. § 78c(a)(80).

172. *Id.* § 77d(a)(6)(C).

173. *Id.* § 78c(h)(1).

174. *Id.* § 77d-1(a)(1), (2). Registered funding portals receive an exemption from the application of local legal requirements to the extent that those requirements are “in addition to or different from the requirements for registered funding portals established by the Commission.” *Id.* § 78o(i)(2)(B). Under its proposed rule, the SEC identified the Financial Industry Regulatory Authority (FINRA) as a particular self-regulatory organization that intermediaries could register with; that specific reference was removed in the final rule. Crowdfunding, 80 Fed. Reg. 71,388, 71,429 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, & 274).

175. 15 U.S.C. § 78c(a)(80).

176. *Id.* § 77d-1(a)(4).

177. *Id.* § 77d-1(a)(3).

education as an investor protection tool.¹⁷⁸ The agency supplemented the Act's statutory language with specific requirements "relating to the risks of investing in securities offered and sold . . . , investors' cancellation rights, resale restrictions and issuer reporting," among others.¹⁷⁹ The rules specify that individual intermediaries may determine the context of materials other than minimum requirements as well as the manner of presentation.¹⁸⁰ Finally, intermediaries must gather information about issuers, including conducting background checks on an issuer's officers, directors, and shareholders with a greater than twenty percent stake in the business.¹⁸¹

Title III then continues with restrictions on issuers. Issuers are limited to raising a maximum of \$1 million of securities within a twelve-month period.¹⁸² The SEC clarified in its final rule that this dollar figure will be based solely on offerings made in reliance on the crowdfunding exemption, despite the statutory language that the limit applies to the "aggregate amount sold to all investors by the issuer."¹⁸³

All issuers must also provide basic information to potential investors.¹⁸⁴ Importantly, disclosure requirements vary based on the amount an issuer wishes to raise: if the amount is less than \$100,000, then the issuer's income taxes for the most recent year as well as financial statements certified by the principal executive officer must be disclosed; if the amount is between \$100,000 and \$500,000, then financial statements must be reviewed by an independent accountant; if the amount is greater than \$500,000, then audited financial statements must be disclosed.¹⁸⁵ Finally, issuers cannot engage in any advertising

178. Crowdfunding, 80 Fed. Reg. at 71,390 (including investor education among the protective functions that intermediaries serve).

179. *Id.* at 71,439.

180. *Id.* The SEC rejected some commenters' suggestions for additional information, including materials about how to evaluate investment in privately held companies. *Id.* at 71,439–40. The SEC reasoned that, although helpful, it was not persuaded that such information "would significantly strengthen the investor protections" provided under the rules. *Id.* at 71,440.

181. 15 U.S.C. § 77d-1(a)(5).

182. *Id.* § 77d(a)(6).

183. Crowdfunding, 80 Fed. Reg. at 71,391 (quoting 15 U.S.C. § 77d(a)(6) (2012)).

184. This information includes: the names of the business's officers, directors, and shareholders with over twenty percent interest, 15 U.S.C. § 77d-1(b)(1)(B), a description of its business along with a business plan, *id.* § 77d-1(b)(1)(C), a description of the intended use of the offering's proceeds, *id.* § 77d-1(b)(1)(E), a description of the business's ownership and capital structure, *id.* § 77d-1(b)(1)(H), and at least annual financial statements to both investors and the SEC, *id.* § 77d-1(b)(4).

185. *Id.* § 77d-1(b)(1)(D).

other than to point potential investors to the funding portal or broker.¹⁸⁶

Title III also attempts to protect investors by limiting their exposure to losses and empowering their ability to fight back against fraudulent issuers. Within a twelve month period, a single individual is limited to investing in one company either: (i) the greater of \$2000 or five percent of their annual income or net worth if their income or net worth is less than \$100,000; or (ii) ten percent of their annual income or net worth, up to \$100,000, if their income or net worth exceeds \$100,000.¹⁸⁷ The Act also prohibits resale to anyone within one year after the date of purchase other than the issuer itself, accredited investors, family members, or as part of a registered offering.¹⁸⁸ Investors are also able to bring their own claims against any issuer¹⁸⁹ that makes a material untrue statement or omits a material fact during the offering or sale of a crowdfunding security.¹⁹⁰

Although Title III sets out more than a bare outline of legal requirements, it also directed the SEC to engage in supplementary rulemaking.¹⁹¹ That rulemaking—required to occur within 270 days after President Obama signed the JOBS Act,¹⁹² or by January 2013—lagged woefully behind schedule. The SEC did not issue a proposed rule until late 2013,¹⁹³ and that proposal finally became official in October 2015.¹⁹⁴ This unanticipated delay prevented the creation of any funding portals or initiation of crowdfunding actions based on the federal exemption.

B. *State-Level Crowdfunding Response*

While federal regulators failed to take action, state legislators had begun to fill the void. Before Congress passed the JOBS Act, only two

186. *Id.* § 77d-1(b)(2).

187. *Id.* § 77d(a)(6).

188. *Id.* § 77d-1(e)(1).

189. Defined as “any person who is a director or partner of the issuer, and the principal executive officer or officers, principal financial officer, and controller or principal accounting officer of the issuer . . . that offers or sells a security in a transaction exempted by the provisions of section 4(6).” *Id.* § 77d-1(c)(3).

190. *Id.* § 77d-1(e)(2)(A).

191. *See, e.g., id.* § 77d-1(a)(5) (requiring intermediaries to “take such measures to reduce the risk of fraud . . . as established by the Commission, by rule”); *id.* § 77d-1(b)(5) (requiring issuers to “comply with such other requirements as the Commission may, by rule, prescribe”).

192. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(c), 126 Stat. 306, 320 (2012) (codified in scattered sections of 15 U.S.C.).

193. SEC Crowdfunding Proposal, *supra* note 20.

194. SEC Crowdfunding Adoption, *supra* note 21.

states had enacted a crowdfunding law. On August 12, 2011 Kansas's "Invest Kansas Exemption" became effective,¹⁹⁵ which Georgia quickly followed with the "Invest Georgia Exemption," effective December 8, 2011.¹⁹⁶ Since then, thirteen other states have passed an exemption, with legislation pending in at least twelve more.¹⁹⁷ The result has been a patchwork of laws with varying disclosure requirements, caps on issuers and investors, and fit within the broader federal framework.¹⁹⁸

The benefit of this patchwork approach is in its diversity, which has allowed for greater experimentation.¹⁹⁹ The synopses included below—of crowdfunding laws passed in Indiana and Maryland, along with the Model Crowdfunding Exemption promulgated by the NASAA—demonstrate the breadth of that diversity among several different criteria, including the use of an online intermediary, the amount issuers may raise in a single offering, and the amount investors may invest.

1. *The "Invest Indiana Crowdfunding Exemption"*

Indiana began allowing crowdfunding after it announced rules governing such offerings on July 1, 2014.²⁰⁰ Like the majority of state crowdfunding laws, Indiana's relies on the intrastate exemption and thus requires all crowdfunding to take place within the state's borders.²⁰¹ Indiana also requires the use of an internet portal.²⁰² That portal must do one of the following: (1) refrain from taking an interest in the sale of posted offerings by not providing investment advice, soliciting purchases or sales of its posted offerings, or tying its own fees or its employees' compensation to the amount of securities sold;²⁰³ or (2) register with either the state as a broker-dealer²⁰⁴ or the federal

195. KAN. ADMIN. REGS. § 81-5-21 (2016).

196. GA. COMP. R. & REGS. 590-4-2-.08 (2016).

197. Zeoli, *supra* note 22.

198. With respect to this last point, although a substantial majority of states base their blue sky crowdfunding law on section 3(a)(11) of the Securities Act, Maine relies on Rule 504 of Regulation D. ME. STAT. tit. 32, § 16304 (West, Westlaw through 2015 First Reg. Sess.). Because so many states rely on the intrastate exemption, this Comment does not address Maine's approach.

199. *See* Soloman, *supra* note 26 ("The states that are filling the void are undertaking the great experiment that Congress should have required in the first place.").

200. Press Release, Office of the Indiana Secretary of State, Secretary of State Connie Lawson Implements Crowdfunding in Indiana (July 1, 2014), [http://www.in.gov/sos/securities/files/Crowdfunding_Rules_Press_Release_\(7.1.14\).pdf](http://www.in.gov/sos/securities/files/Crowdfunding_Rules_Press_Release_(7.1.14).pdf) [<https://perma.cc/AX5L-8X8B>].

201. IND. CODE ANN. § 23-19-2-2(27)(B) (West, Westlaw through 2015 First Reg. Sess.).

202. *Id.* § 23-19-2-2(27)(O).

203. *Id.* § 23-19-2-2.3(c).

204. *Id.* § 23-19-2-2.3(b).

government as a broker-dealer or funding portal.²⁰⁵

Like issuers in the federal scheme, issuers in the state program must disclose certain information to investors upfront²⁰⁶ and must make a notice filing and pay a filing fee to the state.²⁰⁷ Unlike the federal exemption and most other state exemptions, Indiana's crowdfunding legislation allows an issuer to raise up to \$2 million in a twelve-month period if that issuer provides each investor and the state's commissioner with audited financial statements.²⁰⁸ Without audited statements, issuers are limited to raising \$1 million.²⁰⁹ The duration and actual size of the offering is set based on the issuer's election of a minimum dollar amount and a specified duration.²¹⁰ While the offering takes place, the issuer must set up an escrow account with a third-party financial institution,²¹¹ which will be the sole depository for investor funds if and until the offering reaches the minimum threshold amount.²¹² If the offering succeeds, the issuer must continue to provide investors with quarterly reports detailing executive compensation and the business's operational and financial condition.²¹³

Indiana, of course, also protects investors. The law places a hard limit on all investments at \$5000 per unaccredited investor per issuer, regardless of income, unless the investor is accredited.²¹⁴ During the course of an offering prior to reaching the threshold minimum dollar amount, any investor may decide to cancel her investment.²¹⁵ Finally, the statute does not comment on any resale restrictions.

2. *Maryland's Crowdfunding Law*

On May 15, 2014, Maryland Governor Martin O'Malley signed that

205. *Id.* § 23-19-2-2(27)(O)(v); *see* 15 U.S.C. § 77d-1 (2012) (federal funding portal registration requirement); *id.* § 78o (federal broker-dealer registration requirement).

206. Required disclosure includes descriptions of: the company and its business plan; the intended use of the offering's proceeds; the identity of officers, directors, major shareholders; and the terms and conditions of the securities offered. IND. CODE ANN. § 23-19-2-2(27)(L).

207. *Id.* § 23-19-2-2(27)(F)(i).

208. *Id.* § 23-19-2-2(27)(C)(ii).

209. *Id.* § 23-19-2-2(27)(C)(i).

210. *Id.* § 23-19-2-2(27)(H).

211. *Id.* § 23-19-2-2(27)(F)(iv).

212. *Id.* § 23-19-2-2(27)(F)(v). Although this escrow requirement is not contained in the JOBS Act itself, the SEC's rulemaking specifically requires creation of an escrow account. Crowdfunding, 80 Fed. Reg. 71,388, 71,449 (Nov. 16, 2015).

213. IND. CODE ANN. § 23-19-2-2(27)(P).

214. *Id.* § 23-19-2-2(27)(E).

215. *Id.* § 23-19-2-2(27)(F)(vi).

state's crowdfunding law, the Maryland Intrastate Small Business Exemption.²¹⁶ The statute itself, however, sets out only a skeletal framework. Like Indiana's law, the Maryland exemption relies on the federal intrastate exemption.²¹⁷ Most of the similarities between the states' statutes end there. Neither Maryland's statute nor the order promulgated by its Securities Division²¹⁸ requires issuers to utilize an online portal or other intermediary. Maryland's offering limit, \$100,000,²¹⁹ and its limit on how much purchasers may invest in a given offering, \$100,²²⁰ are by far the lowest of any enacted or proposed state exemption.²²¹ Particularly unusual is that the order limits offerings in Maryland to permanently nontransferable promissory notes,²²² rather than equity interests.²²³

The Securities Division's supplemental materials provide a set number of additional requirements and limitations. All issuers must fill out a disclosure form containing basic, relatively limited information summarizing the nature of their business, the duration of the proposed offering, and the amount the issuer intends to raise.²²⁴ The Division also provides a form that each issuer must distribute to potential investors with information including a list of both generic and company-specific risk factors,²²⁵ a sheet detailing the intended use of the offering's proceeds, and a description of the company's directors and employees with a greater than ten percent interest in the company.²²⁶ The general nature of the information required in these disclosures makes them less burdensome than in other states,²²⁷ which is appropriate given the law's lower per-company and per-investor ceilings.

216. MD. CODE ANN., CORPS. & ASS'NS § 11-601 (West, Westlaw through 2015 Reg. Sess.).

217. *Id.* § 11-601(16)(i).

218. IN THE MATTER OF: MARYLAND INTRASTATE SMALL BUSINESS EXEMPTION, MD. SEC. COMMISSIONER (2014) [hereinafter MARYLAND ORDER], <http://www.oag.state.md.us/securities/MISBEOrder.pdf> [<https://perma.cc/KKG8-JA3B>].

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

220. *Id.* § 11-601(16)(iv).

221. *Cf. Zeoli, supra* note 22.

222. MARYLAND ORDER, *supra* note 218.

223. *Id.* The order allows "[t]he Commissioner [to] extend by order the exemption under this regulation to other types of securities" consistent with the public interest. *Id.*

224. *Id.*

225. *Id.*

226. *Id.*

227. Masai McDougall, *Maryland Securities Commissioner Finalizes Rules for Intrastate Crowdfunding*, CROWDFUND INSIDER (Oct. 20, 2014), <http://www.crowdfundinsider.com/2014/10/53317-maryland-securities-commissioner-finalizes-rules-intrastate-crowdfunding/> [<https://perma.cc/5M9J-DTL7>].

3. *The Model Crowdfunding Exemption*

The NASAA began promoting a state-led effort to establish new crowdfunding rules prior to the passage of the JOBS Act.²²⁸ Although Congress clearly did not heed the organization's suggestion that "states should be the primary regulator of small business capital formation, including crowdfunding offerings,"²²⁹ the NASAA nonetheless promulgated its own Model Crowdfunding Act to help guide state regulators.²³⁰ The Model Act uses some similar safeguards to the Indiana rule, but is significantly more cautious with regards to total offering amount and per-investor limits.²³¹

In many ways, the Model Act splits the difference between the Indiana and Maryland crowdfunding exemptions. Companies would be limited to raising \$500,000 in any twelve-month period, and prior to beginning the offering must set a target amount and period.²³² If the amount raised fails to reach the stated goal within the provided timeframe, all proceeds must be returned to the investors.²³³ Companies relying on the exemption must also notify their home state's Securities Administrator that the offering is taking place and disclose basic, unaudited financial information prepared in accordance with generally accepted accounting principles.²³⁴ The Act limits individuals to \$1000 investments for any given company, and at any given time an individual may only invest up to \$2000 if their annual income does not exceed \$50,000, four percent of their annual income if they earn between \$50,000 and \$100,000, and eight percent for individuals whose earnings exceed \$100,000.²³⁵

Similar to Title III and Indiana's exemption, the Model Act utilizes online intermediaries as a way to ensure issuer compliance and help facilitate investor protection. Companies cannot advertise any details of

228. William Beatty, *Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies, Part II*, NORTH AM. SEC. ADMIN. ASS'N, (May 1, 2014), <http://www.nasaa.org/30660/legislative-proposals-enhance-capital-formation-small-emerging-growth-companies-part-ii/> [<https://perma.cc/32KJ-2PLN>].

229. *Id.*

230. *Model Crowdfunding Exemption*, NORTH AM. SEC. ADMIN. ASS'N, <https://s3.amazonaws.com/wac6web/docs/NASAAmodel.html> [<https://perma.cc/BS96-BZWJ>] (last visited Apr. 27, 2016).

231. *Id.*

232. *Id.*

233. *Id.*

234. *Id.*

235. *Id.*

their offering other than to point potential investors to an intermediary's website.²³⁶ Intermediaries must help protect investors by providing access to the company's financial disclosures, informing investors that the entirety of their investment is subject to loss, and conducting background checks on all companies and company management.²³⁷ The Model Act also requires issuers to help ensure that per-investor limits are followed, for both individual offerings and for aggregate per-investor limits.²³⁸

III. ANALYSIS OF CROWDFUNDING EXEMPTIONS AND SUGGESTIONS FOR CHANGES

State securities regulators are in an exceptionally good position to protect investors against abuses in the context of small-dollar offerings.²³⁹ In his recent written testimony before the House Committee on Financial Services, NASAA President William Beatty not only emphasized that "states have a more direct interest [than the federal government] in these offerings," but continued on to warn that certain, more lenient crowdfunding provisions could "critically undermine the potential success of equity-based crowdfunding."²⁴⁰ Mr. Beatty focused on several areas in particular: per-investor limits; issuer financial disclosure; civil liability for fraudulent misrepresentations or omissions; and maintenance of state-level protections.²⁴¹ Under the logic of existing securities regulation, these types of protections are even more important in offerings directed at retail investors because those investors lack the sophistication to fully understand the investment or wherewithal to hire an expert. Investing in small businesses is a risk-laden proposition

236. *Id.*

237. *Id.*

238. *Id.*

239. Beatty, *supra* note 228.

240. *Id.* Similar concerns were voiced in comments to the SEC's proposed crowdfunding rules. *See, e.g.*, Letter from Tom Quaadman, Vice President, U.S. Chamber of Commerce, to Elizabeth M. Murphy, Secretary, Sec. & Exch. Comm'n 1 (Feb. 3, 2014) <https://www.sec.gov/comments/s7-09-13/s70913-216.pdf> [<https://perma.cc/MK2V-WKRN>] ("While Crowdfunding will provide new opportunities for retail investors to engage with the capital markets, the [Chamber of Commerce] also believes that strong investor protections are needed to provide a level playing field grounded in certainty."); Letter from William Francis Galvin, Secretary of the Commonwealth of Mass., to Elizabeth M. Murphy, Secretary, Sec. & Exch. Comm'n 1 (Feb. 3, 2014) <https://www.sec.gov/comments/s7-09-13/s70913-213.pdf> [<https://perma.cc/5G36-BFDJ>] ("Because crowdfunding offerings will involve significant numbers of small and unsophisticated purchasers, it is crucial that the SEC's crowdfunding rules protect vulnerable investors.").

241. *See* Beatty, *supra* note 228.

regardless of the context,²⁴² but offerings conducted over the internet²⁴³ and to inexperienced investors²⁴⁴ are even more fecund soils for fraud and loss.²⁴⁵

Concerns about the downsides of reduced regulation must be balanced against the costs those regulations impose on businesses. Regulations make sense only where the harm they prevent is greater than the cost of compliance,²⁴⁶ and thus whether a particular provision is appropriate should account for both its cost and potential benefits.²⁴⁷ Professor C. Steven Bradford attempted to balance these concerns in an article written prior to the passage of the JOBS Act.²⁴⁸ Although that discussion was in the context of federal crowdfunding regulation, many of those similar concerns apply to the state-level context as well, based on the similar goals of state and federal securities regulation—encouraging capital formation while limiting investor harm. This Part frequently references Professor Bradford’s recommendations with respect to existing state crowdfunding exemptions and the new federal regulations, with a focus on the statutes discussed above. To that end, this final Part discusses each of the three parties to a crowdfunding offering—the issuer, the intermediary, and the investor—in the context of how each is, and should be, limited.

242. See *Frequently Asked Questions*, SMALL BUS. ASS’N (Mar. 2014), https://www.sba.gov/sites/default/files/advocacy/FAQ_March_2014_0.pdf [<https://perma.cc/7KP7-CQCZ>] (“About half of all new establishments survive five years or more and about one-third survive 10 years or more.”).

243. Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 77–78 (1998) (“[T]he Internet may be less effective at selling securities because of consumer perception of risk, because of the absence of personalized marketing, and because it is difficult for consumers to evaluate and verify the quality of the information provided.”).

244. See Bradford, *supra* note 5, at 109–12 (suggesting that a substantial portion of the American public lacks financial literacy).

245. See *generally id.* at 104–16 (2012) (elaborating on the potential risks to investors in the crowdfunding context based on problems of small business vulnerability and lack of investor sophistication).

246. C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 23 (2001) (“We should not pay a million dollars to prevent a thousand dollar loss. Registration should be required only when the expected gain from registration exceeds its expected cost.”).

247. See *id.* at 23–29 (summarizing studies about the costs of registering a securities offering and offering some rationale for related benefits).

248. Bradford, *supra* note 5, at 117.

A. *Restrictions on Issuers*

An offering's success begins and ends with the issuer. Because small business investments in particular raise concerns regarding fraud, self-dealing, and vulnerability to market forces,²⁴⁹ certain precautions should be taken. These precautions are especially important when the investor base lacks the resources or sophistication to fully appreciate the nature of an investment. This Section discusses the two primary limits placed on issuers interested in crowdfunding—per-offering limits and disclosure requirements—as well as other important protections like the use of per-offering floors and escrow accounts. Following the reasoning argued by Professor Bradford,²⁵⁰ and the model adopted by the JOBS Act, the regulatory burden placed on issuers should track the total offering amount.

The dangers of fraud and undue speculation increase in step with an offering's size and the participating investors' relative vulnerability.²⁵¹ Although the size of a crowdfunded offering is dwarfed by traditional initial public offerings (IPOs),²⁵² limits to offering size can help reduce the chance for excessive investor losses. Currently, the most lenient jurisdictions limit their crowdfunding exemption to either \$2 million, a threshold set by Indiana and several other states,²⁵³ or the outlier \$4 million allowed in Illinois.²⁵⁴ This higher limit contrasts with the \$100,000 ceiling in Maryland and \$250,000 in Oregon.²⁵⁵

Of course, a specific dollar limit will always be somewhat arbitrary: any one threshold will always be more than some companies intend to raise and less than others need. More important than finding the best

249. *See id.* at 105–09.

250. *Id.* at 142.

251. *Compare* 17 C.F.R. § 230.504 (2016) (exempting offerings up to \$1,000,000 to all investors regardless of whether they are accredited, sophisticated, or otherwise), *with id.* § 230.506 (exempting an unlimited offering so long as investors are either accredited or sophisticated); *see also infra* Section III.C (discussing the vulnerability of and enacted protections for investors).

252. The median IPOs for 2012, 2013, and 2014 were \$94.3, \$107.4, and \$96.0 million respectively. WILMERHALE, 2015 IPO REPORT 2 (2015), https://www.wilmerhale.com/uploadedFiles/Shared_Content/Editorial/Publications/Documents/2015-WilmerHale-IPO-Report.pdf.

253. IND. CODE ANN. § 23-19-2-2(27)(C)(ii) (West, Westlaw through 2015 First Reg. Sess.); 950 MASS. CODE REGS. § 14.402(B)(13)(o)(4) (2016); MICH. COMP. LAWS ANN. § 451.2202a(1)(c) (West, Westlaw through 2015 Reg. Sess.); WIS. STAT. ANN. § 551.202(26)(c)(1) (West, Westlaw through 2015).

254. 815 ILL. COMP. STAT. ANN. 5/4(S)(2) (West, Westlaw through 2015 Reg. Sess.).

255. MD. CODE ANN., CORPS. & ASS'NS § 11-601(16)(iii) (West, Westlaw through 2015 Reg. Sess.); OR. ADMIN. R. 441-035-0090 (2016).

ceiling is matching the regulatory burden placed on companies to the amount raised.²⁵⁶ Basic economics suggests that a law that regulates a company raising \$50,000 to the same extent as one raising \$1 million disproportionately burdens the smaller company.²⁵⁷ Federal lawmakers attempted to balance burdens and benefits by incorporating tiered disclosure requirements into the JOBS Act.²⁵⁸ Not so for all states. Some states that employ a tiered disclosure scheme have done so in a less granular fashion. Indiana drew a line at \$1 million, with everything below that requiring unaudited financials and everything above requiring audited numbers.²⁵⁹

B. *Restrictions on Intermediaries*

The traditional, non-equity crowdfunding campaign is conducted through an online platform.²⁶⁰ The SEC has noted that a registered intermediary acts as “[o]ne of the key investor protections” used in the JOBS Act.²⁶¹ Although the JOBS Act and many states envision channeling equity crowdfunding through online websites, such a requirement is far from uniform.²⁶² States have addressed online crowdfunding portals in one of three ways: (i) specifying that all crowdfunded offerings must be conducted through such a platform; (ii) allowing, without requiring, offerings to be conducted online; or (iii) refraining from specifying one way or another. This Comment argues that required use of a portal is not only beneficial to businesses, but also

256. Bradford, *supra* note 5, at 118–20 (discussing how the ceiling on offerings under an exemption should be related to the total regulatory burden, and stating that a larger exemption “requires stronger assumptions about the cost of registration, the risk of loss, and the extent to which registration reduces that risk.”).

257. See C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L.J. 591, 614–22 (1996) (examining the then-existing regulatory structure and intermediate disclosure requirements set forth by the SEC via Regulation D).

258. See *supra* notes 184–86 and accompanying text.

259. See *supra* notes 208–09 and accompanying text. Indiana’s Securities Division released temporary rules pursuant to the state’s statute, but those rules simply reference the statutory disclosure language without imposing additional requirements. IND. SEC. DIV., EMERGENCY RULE § 5 (2015), <http://www.in.gov/legislative/iac/20151216-IR-710150429ERA.xml.pdf> [<https://perma.cc/665X-3VKN>].

260. See *supra* notes 167–69 and accompanying text (discussing non-equity crowdfunding websites).

261. Crowdfunding, 80 Fed. Reg. 71,388, 71,390 (Nov. 16, 2015).

262. See *supra* note 171 (noting that the JOBS Act endorses online portals). Compare IND. CODE ANN. § 23-19-2-2(27)(O) (West, Westlaw through 2015 First Reg. Sess.) (requiring use of an online portal), with MD. CODE ANN., CORPS. & ASS’NS § 11-601(16) (West, Westlaw through 2015 Reg. Sess.) (not requiring use of an online portal).

protects investors.

Because funding platforms run the risk of being seen as public solicitation, it is important to outline their legality before considering the benefits of a funding platform requirement. Federal securities exemptions begin with a baseline prohibition against all public solicitation in connection with an exempted offering.²⁶³ Under the theory that public solicitation would risk unnecessarily exciting investors, public advertisements and offers to investors are permitted only in registered, “public” offerings.²⁶⁴ This restriction was developed over time through judicial decision and SEC regulation to combat perceived dangers in public solicitation.²⁶⁵ Beginning with the Supreme Court’s decision in *SEC v. Ralston Purina*,²⁶⁶ courts attempted to look to the type of offerees at which solicitations were directed rather than examine the breadth of advertising.²⁶⁷ In principle, the SEC agreed that the determination of whether an offering should be public should be based on the extent of the offeree’s required knowledge and the offeree’s relationship with the issuer. The reality has been a general restriction on solicitation without regard to the type of advertising used or the danger posed.²⁶⁸

Prior to the SEC’s recent crowdfunding regulations, online intermediaries occupied something of an uncomfortable middle ground. The Commission had allowed internet portals to operate without providing much clarity as to what constituted appropriate or inappropriate solicitation.²⁶⁹ Notwithstanding blurry lines at the margins

263. See 17 C.F.R. § 230.502 (2016) (prohibiting “general solicitation or general advertising” for offerings made pursuant Regulation D).

264. See Non-Public Offering Exemption, Securities Act Release No. 4552, 1 Fed. Sec. L. Rep. (CCH) ¶ 2770 (Nov. 6, 1962) [hereinafter Private Offering Exemption], <https://www.sec.gov/rules/final/33-4552.htm> [<https://perma.cc/W5BD-G6E8>] (discussing the *Ralston Purina* decision and the SEC’s interpretation of what constitutes a public offering).

265. See Stuart R. Cohn, *Securities Markets for Small Issuers: The Barrier of Federal Solicitation and Advertising Prohibitions*, 38 U. FLA. L. REV. 1, 8–10 (1986) (discussing the development of the SEC’s prohibition on solicitation).

266. 346 U.S. 119 (1953).

267. *Id.* at 127 (“The focus of inquiry should be on the need of the offerees for the protections afforded by registration.”); see Cohn, *supra* note 265, at 10. Wealthy investors or individuals with a particular expertise are excluded from these prohibitions. 17 C.F.R. § 230.506.

268. Compare Private Offering Exemption, *supra* note 264 (“[T]he number of persons to whom the offering is extended is relevant only to the question whether they have the requisite association with and knowledge of the issuer which make the exemption available.”), with Cohn, *supra* note 265, at 11 (“[T]he SEC has succeeded in creating an impregnable rule against public solicitation which replaces a judgment based upon consideration of the circumstances of the case.”).

269. Compare Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, 1 Fed. Sec. L. Rep. (CCH) ¶ 3200 (Oct. 6, 1995) [hereinafter Online Delivery Release] (“The

or in certain circumstances, restrictions on general solicitation apply to internet activity just like any other type of communication.²⁷⁰ Accordingly, state crowdfunding laws and the SEC's rules pursuant to the JOBS Act appropriately allow online platforms to operate in this space within certain limits.

Under the federal law, funding portals are expressly regulated and allowed to replace traditional broker-dealers as intermediaries.²⁷¹ In addition, the JOBS Act expressly preempts states from enacting more restrictive laws for funding portals registered with the SEC.²⁷² Because the federal law preempts only those funding portals registered with the SEC, states would be free to enact more (or less) strict requirements for funding portals that engage in crowdfunding within that state alone.

Indiana's law, for example, requires that offers be "made exclusively through one (1) or more Internet web sites,"²⁷³ while the Model Rule states that "[a]ll offers and sales of securities in reliance upon this exemption shall be made through an intermediary's website."²⁷⁴ As discussed above,²⁷⁵ if an Indianan crowdfunding website is registered as a broker-dealer under the Exchange Act,²⁷⁶ if it is registered as a funding portal under the Securities Act, or if it meets specific criteria that track the federal portal requirements, it need not register with the state as a broker-dealer. State-level portal requirements are important despite the JOBS Act because businesses may look to take advantage of a state's higher dollar threshold, like with Indiana's \$2 million limit, or other unique features, like with Maryland's law allowing for reduced reporting requirements.

Even at the state level, a centralized online portal has several regulatory and capital-raising benefits. First, as an important aid for investor protection, online portals encourage transparency by facilitating

placing of the offering materials on the Internet would not be consistent with the prohibition against general solicitation or advertising in Rule 502(c) of Regulation D."), with Bradford, *supra* note 5, at 64–65 (citing examples of SEC no-action letters and stating that "the SEC staff has approved several web-based electronic matching systems").

270. See Online Delivery Release, *supra* note 269 (rejecting a hypothetical situation where a company makes common stock, sold in a private placement under Rule 506, available on an internet site to persons who first provide the company with certain information).

271. See *supra* notes 171–75 and accompanying text.

272. 15 U.S.C. § 78o(i)(2) (2012).

273. IND. CODE ANN. § 23-19-2-2(27)(O) (West, Westlaw through 2015 First Reg. Sess.).

274. *Model Crowdfunding Exemption*, *supra* note 230.

275. See *supra* notes 185–90 and accompanying text.

276. IND. CODE ANN. § 23-19-2-2(27)(O)(v); see also *id.* § 23-19-2-2.3.

communication between potential investors.²⁷⁷ The entire investor cohort will benefit from their collective ability to gather and share information with the group, allowing the knowledgeable to guide the uninformed.²⁷⁸ The benefits of group intelligence have been well documented.²⁷⁹ Crowds are often more effective than lone experts at making decisions, including in the context of business performance.²⁸⁰ Of course, this benefit comes with some baggage. For example, it is possible that some people will (and do) invest simply because they follow others who they presume have found a winner.²⁸¹ This herd mentality is the type of problem initial blue sky laws attempted to address.²⁸²

Furthermore, as the gatekeeper through which all issuers must pass, intermediaries can assist in identifying those issuers who provide reason for concern. For example, the final rules adopted by the SEC require an intermediary to reject issuers who the intermediary has “reasonable basis for believing” that the issuer or its officers would be subject to disqualification as bad actors.²⁸³ These prohibitions—similar to those under Rules 262 and 506²⁸⁴—cover disqualifying events including, among other things, the issuer’s felony or misdemeanor convictions within the last five years and injunctions within the last five years as a

277. Bradford, *supra* note 5, at 134.

278. *Id.* But see Fisch, *supra* note 243, at 77–79 (warning that differences between online and traditional IPOs give rise to concern, including the trouble investors have when information over the internet, the passive nature of internet offerings, and the lack of investment bankers to find and educate investors).

279. See generally JAMES SUROWIECKI, *THE WISDOM OF CROWDS* 3–22 (2004) (discussing the benefits of group wisdom and citing several studies on the subject). Surowiecki, comparing the intelligence of a single expert against the wisdom of a large, diverse group, writes that “[w]e know that the group’s decision will consistently be better than most of the people in the group, and that it will be better decision after decision, while the performance of human experts will vary dramatically depending on the problem they’re asked to solve.” *Id.* at 34.

280. *Id.* at 33–34 (2004) (citing an analysis by Wharton professor J. Scott Armstrong stating that “above a low level . . . ’expertise and accuracy are unrelated”).

281. In his book, Surowiecki discusses what economists call “information cascades,” where people look to others’ habits as a way to determine whether a course of action is legitimate or safe. See SUROWIECKI, *supra* note 279, at 50–63. Although potentially beneficial, information cascades can result in bubbles. *Id.* at 57.

282. See *supra* notes 54–59.

283. Crowdfunding, 80 Fed. Reg. 71,388, 71,479 (Nov. 16, 2015).

284. 17 C.F.R. § 230.262 (2016); *id.* § 230.506(d). These “bad actor” rules disqualify an issuer from conducting an offering in certain circumstances, including if the issuer or any directors, officers, or ten percent owners are subject to a criminal conviction or an injunction related to securities violations. See *Process for Requesting Waivers of “Bad Actor” Disqualification Under Rule 262 of Regulation A and Rules 505 and 506 of Regulation D*, SEC. EXCHANGE COMMISSION, <https://www.sec.gov/divisions/corpfin/guidance/262-505-waiver.htm> [https://perma.cc/D5E3-E5ME].

result of a false filing with the SEC or other securities-related conduct.²⁸⁵ Although many states have similar bad actor disqualifications, not even those who require internet portals use them to fulfill this function. For example, Indiana incorporates Rule 262 as its bad actor disqualifier, but simply says that its exemption “does not apply if an issuer or person affiliated with the issuer . . . is subject to disqualification . . . contained in . . . Rule 262.”²⁸⁶ Requiring intermediaries to help protect investors will save regulatory costs and encourage transparency.

Second, using online portals can provide a platform through which smaller, less well-known businesses can access investors they would not have otherwise been able to reach.²⁸⁷ In a typical IPO, issuers receive help from underwriters or other parties familiar with the investment market.²⁸⁸ Although many sources of financing are available short of a full-scale offering,²⁸⁹ often small business owners lack the network and sophistication to market and sell their securities efficiently.²⁹⁰ Requiring, or merely allowing, use of an internet platform may help those businesses access a broader range of potential investors.²⁹¹

Finally, because online portals act as gatekeepers, they can be used as a means of educating investors. Federal lawmakers understood this. The JOBS Act requires intermediaries to provide “investor education materials,” and the SEC’s rulemaking reaffirmed the importance of investor education.²⁹² Unfortunately, even those states that require offerings to pass through an online intermediary do not require those intermediaries to provide education materials.²⁹³ Without an online intermediary requirement, a means of educating potential investors in the same manner is much more difficult.

285. Crowdfunding, 80 Fed. Reg. at 71,479–80.

286. IND. CODE ANN. § 23-19-2-2(27)(N) (West, Westlaw through 2015 First Reg. Sess.).

287. Heminway & Hoffman, *supra* note 11, at 931–32.

288. Kurtis Urien & David Groshoff, *An Essay Inquiry: Will the Jobs Act’s Transformative Regulatory Regime for Equity Offerings Cost Investment Bankers’ Jobs?*, 1 TEX. A&M L. REV. 559, 573 (2014); see WILLIAM M. PRIFTI, 1 SECURITIES PUB. & PRIV. OFFERINGS § 5:29 (2015) (describing the role of finders—parties “paid to find funding sources for companies or underwriters”—and their relationship to broker-dealer regulations specified in the securities laws).

289. See generally John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 ARIZ. ST. L.J. 861 (2005) (describing different forms of debt and equity financing available to new businesses, including venture capital and angel investors).

290. Campbell, *supra* note 112, at 89.

291. Heminway & Hoffman, *supra* note 11, at 931.

292. 15 U.S.C. § 77d-1(a)(3) (2012); see *supra* notes 176–80 and accompanying text.

293. See, e.g., IND. CODE ANN. § 23-19-2-2(27)(O) (West, Westlaw through 2015 First Reg. Sess.) (requiring use of an online intermediary but not mentioning provision of education materials).

C. *Restrictions on Investors*

Investor protections imposed by current crowdfunding exemptions are as disparate as issuer limitations. Several states, including Maryland and Indiana, have instituted an absolute ceiling on the amount an investor may contribute to any single offering.²⁹⁴ Although ceiling benefits from simplicity, it does nothing to tailor how much an individual can invest to how much they could afford to lose.²⁹⁵ Indeed, a loss equal to the total investment amount allowed by some state laws could be potentially devastating.²⁹⁶ In contrast, other states use a “greater of” system like Washington State, limiting investors to the greater of an income percentage or a dollar amount.²⁹⁷ By linking per-investment limits to an investor’s income, the Washington version creates a ceiling more attuned to what an investor can afford to lose.

Another distinguishing factor among states is whether the cap applies to how much an individual can invest in different offerings. For example, even though Indiana requires that an “issuer [can] not accept more than five thousand dollars (\$5,000) from any single purchaser unless the purchaser is an accredited investor,”²⁹⁸ the statute is silent on whether a single individual could repeatedly invest \$5000 with any number of different companies. By comparison, Washington State expressly limits “[t]he aggregate amount sold to any investor by one or more issuers during the twelve-month period preceding the date of the sale”²⁹⁹ to the amount discussed above. In effect, an Indiana investor

294. *E.g.* ALA. CODE § 8-6-11(a)(14)(d) (West, Westlaw through 2015 Second Spec. Sess.) (\$5000 limit for unaccredited investors); IND. CODE ANN. § 23-19-2-2(27)(E) (same); ARIZ. REV. STAT. ANN. § 44-1844 (West, Westlaw through 2015 First Reg. Sess.) (\$10,000 limit for unaccredited investors); GA. COMP. R. & REGS. 590-5-2-.08 (2016) (same); MD. CODE ANN., CORPS. & ASS’NS § 11-601(16)(iv) (West, Westlaw through 2015 Reg. Sess.) (\$100 limit for all investors).

295. Bradford, *supra* note 5, at 127.

296. *See, e.g.*, GA. COMP. R. & REGS. 590-4-2-.08 (limiting all unaccredited investors to \$10,000).

297. WASH. REV. CODE § 21.20.880 (2016) (limiting investors with annual income less than \$100,000 to the greater of \$2000 or five percent of their income and investors with annual income over \$100,000 to the lesser of \$100,000 or ten percent of their income); *see also, e.g.*, FLA. STAT. ANN. § 517.0611 (West, Westlaw through 2015 First Reg. Sess.) (limiting investors with annual income or net worth less than \$100,000 to the greater of \$2000 or five percent of annual income or net worth and if income or net worth over \$100,000 then to the lesser of \$100,000 or ten percent of income or net worth).

298. IND. CODE ANN. § 23-19-2-2(27)(E).

299. WASH. REV. CODE § 21.20.880(1)(g). Even some tiered investor limits seem potentially troublesome. Washington, D.C., sets a cap of \$10,000 for anyone with an income of less than \$100,000 and \$25,000 for anyone who makes less than \$200,000. D.C. MUN. REGS. tit. 26-B,

with a \$40,000 income could invest \$5000 as many times as he wanted, while a similarly situated Washington investor would be limited to investing her pot of \$2000 in one company or spreading it among several.

Of course, these differing approaches present benefits and drawbacks. First, a per-investment limit would be most effective if directly tailored to the investor's individual circumstances; a limit as a percentage of income serves as a more efficient proxy.³⁰⁰ Even though a percentage-of-income limit is more difficult to administer than a flat amount in that it requires either verification or self-certification, that difficulty is justified as a means of protecting investors.³⁰¹ Furthermore, a tailored limit promotes policy goals expressed through securities regulation in other areas: the JOBS Act itself applies a "percentage of" ceiling.³⁰²

Second, if the goal of a per-investor limit is to protect unsophisticated investors from too much exposure, then investors should be limited in the total amount they can invest per year, not simply per company.³⁰³ In its comments that accompanied the SEC's final crowdfunding rules, the Commission noted the importance of "minimizing an investor's exposure to risk in a crowdfunding transaction" through conservative investment limits.³⁰⁴ Although a per-year limit could potentially result in fewer dollars flowing to startups, the lack of any annual limit fails to protect against investor injury.³⁰⁵

CONCLUSION

The SEC's slow response in implementing crowdfunding provisions pursuant to the JOBS Act helped initiate a wave of state-level legislation. This piecemeal approach has created an opportunity for different jurisdictions to experiment with a wide variety of regulatory schemes. Based on a review of these laws in the context of historical

§ 250.2(c)(i) (2016).

300. See Bradford, *supra* note 5, at 127–30.

301. See *id.*

302. See *supra* note 187 and accompanying text.

303. See Bradford, *supra* note 5, at 126–31 (discussing the various forms an investment cap could take and arguing for an annual limit).

304. Crowdfunding, 80 Fed. Reg. 71,388, 71,394 (Nov. 16, 2015). The SEC interpreted an ambiguity in the JOBS Act's language that applied limits "if either the annual income or the net worth of the investor is less than \$100,000." 15 U.S.C. § 77d-1(b)(1)(D)(i) (2012). The SEC resolved the ambiguity—a lack of specificity about what to do when either income or net worth was less than \$100,000—by applying a "lesser of" test. Crowdfunding, 80 Fed. Reg. at 71,394.

305. See Bradford, *supra* note 5, at 131.

securities exemptions, there are some precautions states can and should take in order to protect small-dollar investors. The measures specifically advocated for in this Comment include tiered disclosure requirements that increase to match the offering size, scaled per-investor limits that place a ceiling on how much any one individual can invest, required use of online portals, and limitation of solicitation throughout the offering. Whatever limitations are put in place, the SEC's overarching goals should remain paramount: protecting investors, maintaining efficient markets, and facilitating capital formation. In the crowdfunding context, that means balancing "exciting new opportunities for small businesses and startups"³⁰⁶ against President Roosevelt's admonition that securities sales "shall be accompanied by full publicity and information."³⁰⁷ As states continue to encourage small business investment and pass this newest type of "blue sky" law, the best reminder might be the term's namesake: "an investment opportunity in which the promoter promises rain but delivers blue sky."³⁰⁸

306. Press Release, Jeff Merkley, *supra* note 16.

307. H.R. REP. NO. 73-85, at 2 (1933).

308. Fleming, *supra* note 42, at 586.