

Strict in the Wrong Places: State Crowdfunding Exemptions' Failure To Effectively Balance Investor Protection and Capital Raising

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ABSTRACT

In 2012, Congress passed the Jumpstart Our Business Startups Act, which created an exemption from securities registration for crowdfunded capital raises. Although it was not until May of 2016 that the Securities and Exchange Commission's rules implementing this exemption took effect, many states used the interim period to enact crowdfunding exemptions of their own.

Although most of these exemptions aim to increase small businesses' access to capital while still providing adequate investor protection, the exemptions differ greatly in their individual applications. Consequently, a comparison of these exemptions provides a useful analysis of effective regulation in an area of the law new to all players. This Article provides a survey of several state crowdfunding exemptions, focusing on critical characteristics that affect the success of the offering. This Article argues that many of the existing state exemptions fail to effectively help companies raise capital or protect investors against fraud, but instead are overly restrictive in their financial restraints while being too lenient in their investor protection measures. It then suggests a state exemption framework intended to better serve the companies and investors utilizing crowdfunding exemptions.

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INTRODUCTION

Equity crowdfunding is a new form of capital raising that relies on many individuals contributing to a company via the internet in exchange for equity in the company.¹ The popularity of equity crowdfunding has increased in recent years, due at least in part to the combined effect of two

1. See *infra* Part II.

independent trends.² The first of these is the revived emphasis on small business growth in the United States.³ According to the U.S. Small Business Administration, “[s]mall businesses provide[d] 55% of all jobs and 66% of all net new jobs since the 1970s,”⁴ making small businesses an integral part of economic growth in the United States. Unfortunately, small businesses were exceptionally affected by the financial crisis of 2007, experiencing a 60% decline in jobs from December 2007 until February 2010.⁵ As a result, both regulators and consumers recognized the importance of supporting small and local businesses, evidenced by the wave of pro-small business legislation and consumer initiatives.⁶ This emphasis on small businesses has continued, even after many small businesses have recovered from the effects of the financial crisis.⁷

The second trend affecting the popularity of equity crowdfunding is the success of other forms of crowdfunding, particularly for new consumer products. Online portals, such as Kickstarter,⁸ have demonstrated that ordinary people are willing, perhaps too willing, to invest their money in new ventures. Over \$2 billion has been raised on Kickstarter alone since its launch in 2009.⁹ These types of crowdfunding campaigns differ from equity crowdfunding, as investors generally receive a product rather than an investment interest in exchange for their funds.¹⁰ Nevertheless, the

2. See *Small Business, Big Impact!*, U.S. SMALL BUS. ADMIN., <https://www.sba.gov/content/small-business-trends-impact> [<https://perma.cc/5BY3-BSEX>] (last visited May 3, 2016).

3. See *id.*

4. *Id.*

5. Brayden McCarthy, *What Happened to America's Small Businesses During the Financial Crisis? Six Years After the Start of the Crisis, We Look Back in Nine Charts*, FUNDERA (Sept. 16, 2014), <https://www.fundera.com/blog/2014/09/16/happened-americas-small-businesses-financial-crisis-six-years-start-crisis-look-back-10-charts/> [<https://perma.cc/4NE2-N2QW>].

6. See, e.g., Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.); *Small Business Saturday*, AM. EXPRESS, <https://www.americanexpress.com/us/small-business/shop-small/> [<https://perma.cc/JQL4-SGQR>] (last visited May 4, 2016) (describing “Small Business Saturday” as a “showing your love for the small businesses in your community”).

7. Frank Newport, *U.S. Small-Business Owners Most Optimistic Since 2008*, GALLUP (Aug. 21, 2013), <http://www.gallup.com/poll/164069/small-business-owners-optimistic-2008.aspx> [<https://perma.cc/2GQK-HQFG>]. But see McCarthy, *supra* note 5.

8. *The Kickstarter Fulfillment Report*, KICKSTARTER, <https://www.kickstarter.com/?ref=nav> [<https://perma.cc/52UE-JDQZ>] (last visited May 4, 2016).

9. *Kickstarter Basics: Kickstarter 101*, KICKSTARTER, https://www.kickstarter.com/help/faq/kickstarter+basics?ref=faq_nav#Kick [<https://perma.cc/8D5A-W8UQ>] (last visited May 4, 2016).

10. See *infra* Part II.

success of these campaigns has persuaded many that the same results are possible when contributions are made in exchange for equity as well.

Lawmakers at both the federal and state levels have embraced the idea that crowdfunding could help promote small business growth.¹¹ Yet securities registration laws, known for being onerous on small businesses, posed a major obstacle for small businesses seeking to raise funds through crowdfunding.¹² The result has been the enactment of numerous crowdfunding exemptions enabling certain companies to raise capital from smaller investors without meeting traditional registration requirements.¹³ Although Congress was an early proponent of crowdfunding, passing an exemption in 2012,¹⁴ the Securities and Exchange Commission's (SEC) delay in implementing the exemption prevented companies from utilizing the exemption thus far.¹⁵ However, the delay at the federal level did not prevent states from considering and passing their own crowdfunding exemptions from state security registration laws. To date, twenty-eight states have passed crowdfunding exemptions.¹⁶ Numerous other states have considered such exemptions,¹⁷ but only three have considered and rejected crowdfunding exemptions.¹⁸ Perhaps due to the quickness in

11. *See infra* Parts III and IV.

12. *See infra* notes 28–30 and accompanying text.

13. *See infra* Parts III and IV.

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

15. The SEC, after much delay, issued final rules on the crowdfunding exemption on October 30, 2015. *See SEC Adopts Rules to Permit Crowdfunding: Proposes Amendments to Existing Rules To Facilitate Intrastate and Regional Securities Offerings*, U.S. SEC. & EXCHANGE COMMISSION (Oct. 30, 2015), <http://www.sec.gov/news/pressrelease/2015-249.html> [<https://perma.cc/6AFG-4YPG>]. The new rules and forms will become effective 180 days after they are published in the Federal Register, but the forms enabling funding portals to register with the SEC became effective on January 29, 2016. *Id.*

16. The twenty-eight states are: Alabama, Arizona, Colorado, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Montana, New Jersey, Nebraska, Oregon, South Carolina, Tennessee, Texas, Vermont, Virginia, Washington, and Wisconsin. *See infra* Part IV.

17. *See, e.g.*, H.B. 5577, 2014 Reg. Sess. (Conn. 2014).

18. The three states are California, North Carolina, and Utah. In North Carolina, the original crowdfunding legislation (JOBS Act) passed in the State House almost unanimously, but failed to make it out of the Senate; however, a new bill, based on the original JOBS Act, has been “reviewed and approved by the NC Secretary of State Securities Division, the NC Commerce Department, and the NC JOBS/PACES Act business team, and is now awaiting action by the General Assembly.” *2015 Can Be the Year for Intrastate Crowdfunding in North Carolina*, N.C. PACES ACT (Mar. 9, 2015), <http://jobsnc.blogspot.com/2015/01/investment-crowdfunding-is-expanding.html> [<https://perma.cc/P2VF-VVF3>]; *see also* S.B. 481, 2015 Reg. Sess. (N.C. 2015). California had a similar experience, with one crowdfunding exemption dying in the 2014 legislative

which these state exemptions were enacted, they differ greatly in their requirements and scope. Consequently, a comparison of these exemptions provides a useful analysis of effective regulation in an area of the law new to all players.

Though the merits of equity crowdfunding have been the focus of much discussion, this Article argues that, when properly regulated, the benefits of such exemptions can outweigh the concerns associated with them. This Article therefore considers the state exemptions through a lens of general acceptance of equity crowdfunding. Under this approach, this Article argues that many of the existing state exemptions fail to effectively help companies raise capital or protect investors against fraud, but instead are overly restrictive in their financial restraints while being too lenient in their investor protection measures.

Analysis proceeds in six parts. Part I briefly delineates the securities registration laws, including the federal and state regulatory scheme, existing prior to the enactment of crowdfunding exemptions. Part II provides background on crowdfunding, examining the different forms of crowdfunding as well as the purported benefits and disadvantages of crowdfunding. Part III then describes some of the early proposals for crowdfunding exemptions, including the federal exemption, in order to show the basic structure of a crowdfunding exemption, as well as how such exemptions have developed over time. Part IV surveys a number of existing and proposed state-level exemptions, analyzing the exemptions based on critical characteristics. Part V, focusing on these critical characteristics, identifies flaws in the state exemptions and possible improvements. Finally, Part VI suggests a state exemption framework intended to maximize the utility of a crowdfunding exemption, while still reducing the risk of fraud.

I. BACKGROUND OF SECURITY REGISTRATION LAWS

The 1933 Securities Act marked the first step in regulating securities by the federal government.¹⁹ The Act has two basic objectives: first, to

session, only to have another introduced in the 2015 session. See JD Alois, *California Legislation for Equity Crowdfunding Climbs Sacramento Once Again*, CROWDFUND INSIDER (Apr. 1, 2015, 5:48 PM), <http://www.crowdfundinsider.com/2015/04/65393-california-legislation-for-equity-crowdfunding-climbs-sacramento-once-again/> [<https://perma.cc/N5GN-DZ6T>]; Assemb. B. 2096, 2014 Leg., Reg. Sess. (Cal. 2014).

19. Securities Act of 1933, 15 U.S.C. § 77a–77aa (2012); see also Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1741–42 (2012).

“require that investors receive financial and other significant information concerning securities being offered for public sale;” and second, to “prohibit deceit, misrepresentations, and other fraud in the sale of securities.”²⁰ The Act was based on the theory that full information and disclosure would be the most effective means of investor protection.²¹ To achieve these goals, the Act restricted how companies could raise funds by prohibiting any offering or public sale of a security unless it is registered with the SEC or it meets a statutory exemption.²² Registration generally requires providing “a description of the company’s properties,” business, and management, “a description of the security to be offered for sale,” and audited financial statements.²³

The 1934 Securities Exchange Act then created the SEC to regulate the securities industry and imposed reporting requirements for certain companies.²⁴ Companies that are registered under the 1933 Act, that have securities widely traded in secondary markets, or that meet certain thresholds of assets or shareholders must meet these reporting requirements.²⁵ The 1934 Act also imposed requirements on intermediaries that facilitate the sale of securities.²⁶ In 1946, the United States Supreme Court explained that a security is “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party,” in what became known as the *Howey* definition of a security.²⁷

While investor protection is a primary goal of these policies, the federal government recognized that such requirements could impede other important policies. Security registration is a time-consuming and expensive process that can severely limit access to funding, particularly for

20. *The Laws that Govern the Securities Industry*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/about/laws.shtml> [<https://perma.cc/B9FK-AUMT>] (last modified Oct. 1, 2013).

21. Hazen, *supra* note 19, at 1741–42 (citing LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY* 92 (1934)).

22. Securities Act of 1933, Pub. L. No. 73-22, § 5(a), 48 Stat. 74, 77 (current version at 15 U.S.C. § 77e (2012)).

23. *The Laws that Govern the Securities Industry*, *supra* note 20.

24. *Id.* Securities Exchange Act of 1934, Pub. L. 73-291, § 4(a), 48 Stat. 881, 885 (current version at 15 U.S.C. § 78d(a) (2012)).

25. Hazen, *supra* note 19, at 1741–42. The JOBS Act increased the number of shareholders to trigger registration requirements to 2,000 shareholders of record, provided that less than 500 of them are unaccredited investors. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012) (codified as amended in scattered sections of 15 U.S.C.).

26. 15 U.S.C. § 78o (2012).

27. SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

small businesses.²⁸ In fact, the SEC estimated that “the average cost of achieving initial regulatory compliance for an initial public offering is \$2.5 million, followed by an ongoing compliance cost, once public, of \$1.5 million per year.”²⁹ Even on smaller registrations, “[a]ccounting, legal and other expenses . . . can easily exceed \$50,000.”³⁰

These high costs are in tension with the “widely recognized [idea] that small businesses are an important part of the U.S. economy and that there is a value in encouraging small businesses to get started.”³¹ In recognition of this value, Congress and the SEC have created exemptions from SEC registration. These exemptions retain the emphasis on investor protection, but impose fewer restrictions in certain cases, such as when investors are considered capable of protecting themselves. The federal exemptions, as well as many state registration exemptions, distinguish between accredited and non-accredited investors. An accredited investor includes: (1) certain institutional investors, such as banks, broker-dealers, insurance companies, and investment companies; (2) corporations or trusts with total assets in excess of \$5,000,000; (3) any director, executive officer, or general partner of the issuer; (4) any entity in which all of the equity owners are accredited investors; (5) any natural person whose net worth exceeds \$1,000,000; or (6) any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 for those years.³² Companies are often subject to fewer restrictions when securities are sold exclusively or mainly to accredited investors. Section 4(a)(5), for example, exempts offerings and sales of securities made exclusively to accredited investors if the total offering price is less than \$5 million.³³

28. Hazen, *supra* note 19, at 1744; Rutheford B. Campbell, Jr., *Regulation A: Small Businesses’ Search for “A Moderate Capital”*, 31 DEL. J. CORP. L. 77, 91–92 (2006).

29. Crowdfunding, Securities Act Release No. 33-9470, Exchange Act Release No. 34-70741, 78 Fed. Reg. 66,428, 66,509 (proposed Nov. 5, 2013) (citing IPO TASK FORCE, REBUILDING THE IPO ON-RAMP 9 (Oct. 20, 2011), http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf [<https://perma.cc/Y8K4-74LG>]).

30. Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 909 (2011) (quoting Campbell, Jr., *supra* note 28, at 90).

31. Hazen, *supra* note 19, at 1744.

32. 17 C.F.R. § 230.215 (2014). Either the individual’s net worth or joint net worth with that individual’s spouse may be used. *Id.* § 230.215(e) (providing further detail on how to calculate net worth).

33. Securities Act of 1933 § 4(a)(5), 15 U.S.C. § 77d(a)(5) (2012); *see also* 15 U.S.C. § 77c(b)(1); *see also* *Small Business and the SEC*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/info/smallbus/qasbsec.htm#reg> [<https://perma.cc/SS4R-27TR>] (last modified Feb. 27, 2014).

The most common registration exemptions are those for private offerings, offerings of limited size, intrastate offerings, and securities of municipal, state, and federal governments.³⁴ The section 4(a)(2) private offering exemption simply provides that “transactions by an issuer not involving any public offering” do not need to comply with the federal registration requirements.³⁵ Since this brief provision does not provide issuers with much guidance, Regulation D provides safe harbors, which, if met, can ensure that an issue will be considered private and thus exempt from registration.³⁶ The first Regulation D safe harbor is Rule 504, which exempts some companies that offer and sell less than \$1,000,000 of their securities within a twelve-month period.³⁷ Rule 504 does not restrict the total number of investors, and general solicitation is only permitted when certain conditions are met.³⁸ Rule 505 permits a company to sell up to \$5,000,000 of its securities in any twelve-month period to an unlimited number of accredited investors and up to thirty-five other persons, provided there is no general solicitation or advertising and other disclosure requirements are met.³⁹

There are two exemptions under Rule 506.⁴⁰ The first, Rule 506(b), provides that a company may be exempt so long as no general solicitation or advertising is used to market the securities, the securities are sold to thirty-five or fewer sophisticated, non-accredited investors (although the securities may be sold to an unlimited number of accredited investors), and certain disclosure and financial statement requirements are met.⁴¹ Under Rule 506(c), a company may use broad solicitation and advertising in the offering if all investors are accredited and the company has taken

34. *Registration Under the Securities Act of 1933*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/regis33.htm> [<https://perma.cc/DS4H-3QLK>] (last modified Sept. 2, 2011).

35. Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(a)(2).

36. 17 C.F.R. § 230.501–508 (2014); *see also Regulation D Offerings*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/regd.htm> [<https://perma.cc/4QEY-R46P>] (last modified Oct. 28, 2014).

37. 17 C.F.R. § 230.504 (2014); *see also Rule 504 of Regulation D*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/rule504.htm> [<https://perma.cc/E2RR-4FVA>] (last modified Oct. 27, 2014).

38. *Id.*

39. 17 C.F.R. § 230.505 (2014); *see also Rule 505 of Regulation D*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/rule505.htm> [<https://perma.cc/LZ7R-AMWL>] (last modified Oct. 27, 2014).

40. 17 C.F.R. § 230.506(b) (2014); *see also Rule 506 of Regulation D*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/rule506.htm> [<https://perma.cc/T55Q-Z4K4>] (last modified Oct. 6, 2014).

41. 17 C.F.R. § 230.506(b); *see also Rule 506 of Regulation D*, *supra* note 40.

reasonable steps to verify the investors are accredited.⁴² Neither rule, however, restricts the total amount that a company can raise in the exempt offering.⁴³ Under Regulation A, on the other hand, small offerings of securities up to five million dollars within a twelve-month period are exempt from registration.⁴⁴

The intrastate offering exemption is perhaps most important to the state crowdfunding exemptions, as many state exemptions rely on it to avoid federal registration requirements.⁴⁵ To qualify for this exemption, a company must be registered in the applicable state, carry out a significant amount of its business in that state, and make offers and sales of the securities only to residents of that state.⁴⁶ Rule 147 provides guidance to help ensure that a company meets these requirements.⁴⁷

The SEC also imposes restrictions on the number of shareholders that a company can have without registering. The JOBS Act, discussed in more detail below, increased this number from 500 to 2,000 shareholders of record, provided that not more than 499 of those shareholders are non-accredited investors.⁴⁸ Though a large number, this restriction is significant in the context of crowdfunding, which, by definition, relies on a large number of investors for success.

Finally, states also have their own regulatory schemes governing securities, known as Blue Sky Laws.⁴⁹ These laws are in addition to the federal laws, and companies must comply with registration requirements of both. State securities and registration laws can add even more costs to the registration process and, in order for a company to be fully exempt from state and federal registration, it must fit into exemptions in both schemes.

II. BACKGROUND OF CROWDFUNDING

Due to the transaction costs and burdens of SEC registration, many small companies and startups are forced to pursue funding through other

42. 17 C.F.R. § 230.506(c); *see also* Rule 506 of Regulation D, *supra* note 40.

43. *See* 17 C.F.R. § 230.506(b); *see also* Rule 506 of Regulation D, *supra* note 40.

44. 17 C.F.R. § 230.251; *see also* *Small Business and the SEC*, *supra* note 33.

45. *See, e.g.*, ALA. CODE § 8-6-11(a)(14)b (Supp. 2015) (providing that the crowdfunding exemption is available to companies that “meet the requirements of the federal exemption for intrastate offerings in section 3(a)(11)”).

46. Securities Act of 1933, § 3(a)(11), 15 U.S.C. § 77c(a)(11) (2012); *see also* *Small Business and the SEC*, *supra* note 33.

47. 17 C.F.R. § 230.147 (2014).

48. Jumpstart Our Business Startups (JOBS) Act § 501, Pub. L. No. 112-106, 126 Stat. 306, 325 (2012).

49. *Id.*

means. However, other common sources of capital, such as bank lending and retained earnings, are often also unavailable for these types of companies.⁵⁰ In response to this funding void, crowdfunding has emerged as an alternative form of financing for small businesses and start-up companies.⁵¹ Rather than rely on wealthy investors or financial institutions, crowdfunding is instead based on the idea that a company can raise money by accepting small investments from a large number of people—the crowd.⁵² Though the term “crowdfunding” is new,⁵³ the theory behind it is not, and most forms of traditional fundraising resemble crowdfunding.⁵⁴

While crowdfunding is generally done over the internet,⁵⁵ it could feasibly be completed through other means as well. However, use of the internet has significant benefits over other means in the crowdfunding context: it is inexpensive, instantaneous, and able to reach a far greater geographic scope than in-person or mail solicitation.⁵⁶ As a result of these benefits and the previous success of online crowdfunding campaigns,⁵⁷ it seems likely that most crowdfunding campaigns will be completed via the internet in the future and thus the remainder of this Article will focus on online crowdfunding.⁵⁸ The following sections briefly survey the various types of crowdfunding, followed by a comparison of the purported benefits and disadvantages of crowdfunding.

50. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 5 (2012).

51. *Id.*

52. *Id.*

53. *Id.* at 11 (citing KEVIN LAWTON & DAN MAROM, *THE CROWDFUNDING REVOLUTION* 66 (2010)) (noting that the first use of the term “crowdfunding” was in 2006).

54. *Id.* at 11 (comparing politicians’ campaign finances to crowdfunding).

55. *Title III: Equity & Debt Crowdfunding*, NAT’L CROWDFUNDING ASS’N, <http://www.nlcfa.org/#!/equity-crowdfunding/cldq> [https://perma.cc/2QFM-ZDFV?type=image] (last visited May 10, 2016) (“For startup companies looking to raise debt or equity from the sale of securities, crowdfunding refers to raising such funds, primarily over the internet, in smaller amounts from a larger pool of investors [through] intermediaries.”).

56. *See id.*; Sang Lee, *5 Benefits of Raising Capital Online Through Equity Crowdfunding*, HUFFINGTON POST, http://www.huffingtonpost.com/sang-lee/5-benefits-of-raising-cap_b_5669144.html [https://perma.cc/B9NZ-7Q3R] (last updated Oct. 12, 2014).

57. *See Crowdfunding 101*, NAT’L CROWDFUNDING ASS’N, <http://www.nlcfa.org/#!/crowdfunding-101/ch6q> [https://perma.cc/FMC6-G59G] (last visited May 10, 2016); Tanya Prive, *What is Crowdfunding and How Does It Benefit the Economy?*, FORBES (Nov. 27, 2012, 10:50 AM), <http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy/> [https://perma.cc/5JLU-K9MZ].

58. As discussed below, many of the state crowdfunding exemptions are designed to be used via internet offerings. *See infra* Part IV.

A. Types of Crowdfunding

Crowdfunding can take various forms depending on what the crowd receives in exchange for its contributions.⁵⁹ Reward-based crowdfunding is perhaps the most popular, or at least the most familiar, form.⁶⁰ In this model, an investor contributes funds and, in exchange, is promised a pre-determined reward, such as the product the fundraising-company is manufacturing or some other small token.⁶¹ Popular websites like Kickstarter or Indiegogo typically operate on this model.⁶² Although the reward could be a right or other intangible benefit (such as the right to purchase the product at a discounted price), the reward is not a financial return or other interest that would resemble a security, and thus these types of campaigns are not subject to securities regulation.⁶³

The second form of crowdfunding, known as debt crowdfunding or peer-to-peer lending, occurs when individuals provide debt financing to a company or individual with the expectation that their funds will be returned to them, sometimes with or without interest.⁶⁴ When receiving interest, and thus a profit, on the loan made, the transaction resembles a security and thus might be subject to securities registration in some situations.⁶⁵

There are also instances of donation crowdfunding, where the donor simply makes a charitable donation to a project with no expectation of anything in return.⁶⁶ There are a number of websites that make this type of funding available to individuals and companies.⁶⁷ While most of these involve donations to charitable and non-profit institutions, for-profit entities can also receive funds in this way.⁶⁸ Again, since donors do not

59. *The Ultimate Crowdfunding Guide*, CROWDFUND INSIDER, <http://www.crowdfundinsider.com/the-ultimate-crowdfunding-guide/> [<https://perma.cc/7VPQ-BZWC>] (last visited May 10, 2016).

60. *Id.*

61. See Bradford, *supra* note 50, at 16. Bradford treats this category as two types of crowdfunding: reward crowdfunding and pre-purchase crowdfunding. *Id.*

62. See KICKSTARTER, <https://www.kickstarter.com/?ref=nav> [<https://perma.cc/84L8-TKP4>] (last visited May 10, 2016); INDIEGOGO, <https://www.indiegogo.com> [<https://perma.cc/2RXR-5AHH>] (last visited May 10, 2016).

63. See Bradford, *supra* note 50, at 16–17.

64. *Id.* at 20–22; see also *How Does an Online Credit Marketplace Work?*, LENDING CLUB, <https://www.lendingclub.com/public/how-peer-lending-works.action> [<https://perma.cc/7KX3-7NPG>] (last visited May 10, 2016).

65. See Bradford, *supra* note 50, at 35–41 (discussing factors affecting whether debt crowdfunding would be subject to securities registration laws).

66. *Id.* at 15.

67. See, e.g., GLOBAL GIVING, www.globalgiving.org [<https://perma.cc/Z9ER-ZZ5V>] (last visited May 10, 2016).

68. See Bradford, *supra* note 50, at 15.

receive anything in exchange for their donations, there are no securities and thus no registration requirements as a result of organizations receiving funding in this manner.

The final form of crowdfunding, and emphasis of this Article, is equity crowdfunding. “Equity crowdfunding offers investors a share of the profits or return of the business they are helping to fund.”⁶⁹ Although a significant number of crowdfunding sites worldwide offer stock to investors,⁷⁰ these sites are less popular in the United States due to the security registration issues they raise.⁷¹ It is clear that the incentive offered to investors under this model meets the *Howey* definition of a security⁷² and, therefore, these types of crowdfunding campaigns must meet SEC requirements, either by registering or fitting into an applicable exemption. A number of crowdfunding sites restricted to accredited investors are in operation in the United States,⁷³ and some states with crowdfunding exemptions also have crowdfunding sites in place.⁷⁴

Despite the differences in these various forms of crowdfunding, they present many of the same advantages and disadvantages to those seeking funding and those seeking to contribute. But, as the focus of this Article and the only form of crowdfunding not yet widely accepted in the United States, the following discussion focuses on those advantages and disadvantages most relevant to equity crowdfunding.

B. Benefits of Crowdfunding

Although equity crowdfunding remains largely untested in the United States, its proponents often cite the success of the other types of crowdfunding as evidence of its promise as a viable source of funding for companies that might otherwise struggle to raise capital. “Finding funding is particularly difficult for businesses seeking to raise funds in the \$100,000 to \$5 million range.”⁷⁵ For example, start-up companies lack earnings and other indicators of success, making it difficult to receive investments, and they may not have the collateral needed to obtain bank loans.⁷⁶ Likewise,

69. *Id.* at 24.

70. *See, e.g.*, SEEDRS, <https://www.seedrs.com> [<https://perma.cc/48E4-ZGK8>] (last visited May 10, 2016) (U.K.-based equity crowdfunding platform).

71. *See* Bradford, *supra* note 50, at 24.

72. SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

73. *See, e.g.*, ANGEL LIST, <https://angel.co/> [<https://perma.cc/9KZH-J8MZ>] (last visited May 10, 2016).

74. *See, e.g.*, TRUCROWD TEXAS, <https://texas.trucrowd.com> [<https://perma.cc/X6ZL-SBXX>] (last visited May 10, 2016).

75. Bradford, *supra* note 50, at 100.

76. *Id.* at 102.

many small and local businesses may lack the resources to pursue significant outside investments. In fact, one study found that, of the over 500,000 start-up companies launched each month in the United States, only 0.91% are funded by angel investors and only 0.05% are funded by venture capital.⁷⁷ Instead, most startups are funded through friends and family (38% of startups) and personal savings and credit (57% of startups).⁷⁸ Proponents of crowdfunding regard it as a means to take advantage of this trend by allowing companies to receive more money from those groups that already invest in them.

A crowdfunding exemption would not only increase the capital that can be raised from those that a business-owner personally knows, but also through anyone with access to the online funding portal. “Most people seeking to fund businesses and projects, especially younger entrepreneurs, do not have relationships with enough entities and individuals to create a stable source of venture capital without third-party assistance.”⁷⁹ Use of the internet helps to solve this problem by removing the geographic barriers that small or local companies face in obtaining funding.⁸⁰ This is particularly important since “major sources . . . tend to be concentrated in certain [geographic regions], such as Silicon Valley.”⁸¹ Some also believe that online crowdfunding not only allows a company to reach more investors, but specifically enables it to reach investors who previously were not involved in business funding, allowing companies to access an “untapped source of small business capital.”⁸²

Since small businesses and start-up companies already play a vital role in the U.S. economy,⁸³ facilitating funding to these companies is likely to have a positive effect on the economy through job creation and economic growth. Small businesses employ over half of the country’s private workforce,⁸⁴ but they nevertheless struggle to obtain necessary capital.

77. Laura Entis, *Where Startup Funding Really Comes From (Infographic)*, ENTREPRENEUR (Nov. 20, 2013), <http://www.entrepreneur.com/article/230011> [<https://perma.cc/T3KF-HWKL>]. Although venture capital firms fund such a small amount of start-up companies, they actually contribute the most dollars to start-up companies because their investments are so large. *See id.*

78. *Id.*

79. Heminway & Hoffman, *supra* note 30, at 931.

80. *See* Nate Nead, *5 Reasons Why Investors Are Getting Sucked Into Crowdfunding*, CROWDFUND, <http://crowdfund.co/5-reasons-why-investors-are-getting-sucked-into-crowd-funding/> [<https://perma.cc/6XR4-H99A>] (last visited May 10, 2016).

81. Bradford, *supra* note 50, at 101.

82. Heminway & Hoffman, *supra* note 30, at 931.

83. *Small Business, Big Impact!*, *supra* note 2.

84. *Fast Facts on Small Business*, HOUSE COMM. ON SMALL BUS., http://smallbusiness.house.gov/uploadedfiles/april_recess_small_biz_talking_pts.pdf

Crowdfunding may help to “generate the capital small businesses need to commence or continue operations, which in turn, fuels economic growth.”⁸⁵

Some also believe that crowdfunding will actually increase information in the marketplace, both for companies and investors. From the company’s perspective, crowdfunding provides a form of market-based research, allowing owners to gauge the public’s response to a new product prior to production.⁸⁶ This enables companies to determine the likelihood of success and make improvements before significant funds are used.⁸⁷ While this is certainly more relevant in the consumer goods context, crowdfunding can still be a viable source of information for young companies in other contexts. Crowdfunding, especially when solicited online, provides a relatively inexpensive method to determine a venture’s appeal to investors.⁸⁸ From the investor’s perspective, crowdfunding leads to increased information as the use of the internet increases the “knowledge of the crowd” and helps individual investors to make wiser investment decisions.⁸⁹

In addition to increasing the potential to raise funds, crowdfunding also enables companies to avoid the high costs of SEC registration in that it involves lower costs than traditional securities offerings.⁹⁰ The costs of SEC registration are generally not proportional to the size of the offering,⁹¹ so even companies that only seek to raise a small amount of capital bear

[<http://perma.cc/8KD7-27YB>] (last visited May 10, 2016). Because the SBA has such an expansive definition of a small business, including “an independent business having fewer than 500 employees,” this statistic likely includes businesses that most people would not think of as “small.” *Id.*

85. Heminway & Hoffman, *supra* note 30, at 932.

86. KRISTOF DE BUYSERE ET AL., A FRAMEWORK FOR EUROPEAN CROWDFUNDING 10 (2012), http://www.europecrowdfunding.org/files/2013/06/FRAMEWORK_EU_CROWDFUNDING.pdf [<http://perma.cc/GC8M-AJZC>] (referring to pre-sales crowdfunding to measure demand).

87. *Id.*

88. Although many crowdfunding portals do charge fees to list projects for investment, many charge based on the amount of funds raised, attempting to make costs proportional to offering size. See, e.g., *Frequently Asked Questions from Entrepreneurs: How Much Does it Cost To Be Listed on CircleUp?*, CIRCLEUP, <https://circleup.com/entrepreneur-education/faq/#faq128> [<https://perma.cc/5NTX-Q6NL>] (last visited May 10, 2016) (“CircleUp will generally assess a commission based on a percentage of the total amount raised.”).

89. John S. Wroldsen, *The Crowdfund Act’s Strange Bedfellows: Democracy and Start-Up Company Investing*, 62 U. KAN. L. REV. 357, 374–401 (2013) (discussing the importance of the wisdom of the crowd in crowdfunding campaigns).

90. Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1467 (2013).

91. Campbell, Jr., *supra* note 28, at 91–92.

substantial costs to do so through traditional means. Although crowdfunding sites often charge fees for companies to use them, they are often based on the amount of money raised or number of contributors, allowing smaller companies to spend less.⁹² Finally, because registration laws are often complicated and unfamiliar to the general public, many companies that violate them do so unknowingly.⁹³ Crowdfunding has been considered a compromise by regulators to provide a sort of safe harbor for companies that need to raise funds and have investors willing to do so.⁹⁴

In response to concerns of fraud, proponents of crowdfunding often point to the lack of fraud in existing forms of crowdfunding—both rewards-based crowdfunding in the United States and equity crowdfunding in countries that currently allow it.⁹⁵ However, in spite of these benefits and the purported success in existing campaigns, many remain skeptical about the potential for crowdfunding.

C. Concerns with Crowdfunding

A major concern with crowdfunding, and particularly a new exemption targeting small-scale investors, is the risk of fraud. The utilization of online platforms for crowdfunding campaigns increases this risk, as promoters and issuers of crowdfunding campaigns are able to hide behind the anonymity of the internet.⁹⁶ Internet crowdfunding “may be less transparent and more intangible to investors and regulators”⁹⁷ due in part to

92. See, e.g., *Frequently Asked Questions from Entrepreneurs*, *supra* note 88 (“CircleUp will generally assess a commission based on a percentage of the total amount raised.”).

93. See, e.g., Joseph M. Campos, *You Don’t Have To Know the Securities Laws To Be Criminally Guilty of a Willful Violation*, COMPANYCOUNSEL.NET (Jan. 21, 2010), <http://companycounsel.net/2010/01/21/you-dont-have-to-know-the-securities-laws-to-be-criminally-guilty-of-a-willful-violation/> [<http://perma.cc/9BCK-3ZWM>].

94. See Jaime Brockway, *The State that Paved the Way for Equity-based Crowdfunding*, BEACON (Sept. 11, 2014, 8:08 PM), <https://www.beaconreader.com/jaime-brockway/the-state-that-paved-the-way-for-equity-based-crowdfunding> [<http://perma.cc/PB6D-V67C>] (discussing how the drafter of the Kansas crowdfunding exemption wrote the bill after “witnessing several small businesses ‘accidentally’ violate the registration exemption under which they were operating”).

95. Jason Best & Sherwood Neiss, *Crowdfunding Delayed Again, Blasted as a ‘Top Danger’*, VENTUREBEAT (Aug. 22, 2012, 5:10 PM), <http://venturebeat.com/2012/08/22/crowdfunding-delayed-again-blasted-as-a-top-danger/> [<http://perma.cc/DD7N-N6XV>] (noting the lack of fraud in the U.K. and Australia, as well as a scam on Kickstarter that was shut down).

96. Heminway & Hoffman, *supra* note 30, at 933; Hazen, *supra* note 19, at 1769 (“[S]ocial media technologies increase rather than decrease the potential for fraud.”).

97. Heminway & Hoffman, *supra* note 30, at 933.

the “fast-moving markets” of the internet, where prices can lag and investors can quickly suffer unexpected losses.⁹⁸ The ability to use the internet for little or even no cost and still reach a wide scope of people makes fraud even easier.⁹⁹ Considering these factors and the general difficulty in regulating the internet, it is not surprising that the internet is a “common vehicle for securities fraud.”¹⁰⁰ And further adding to this concern of fraud is that small businesses, the companies most likely to use a crowdfunding exemption, “may be disproportionately involved in securities fraud.”¹⁰¹

At least one scholar has also expressed concern that, despite this increased risk of fraud, private enforcement of anti-fraud and other regulations would be lacking in the crowdfunding context.¹⁰² Because crowdfunding involves so many investors, each with such a small financial stake, these investors are unlikely to sue crowdfunding promoters for fraud or inadequate disclosure or pricing.¹⁰³ For each individual investor, the costs of an attorney may very well be more than the amount he or she contributed to a crowdfunding campaign.¹⁰⁴ Further, some believe that these small dollar amounts will also make class action suits impractical, since the total amount recoverable will also be a small amount.¹⁰⁵ If investors are less likely to take action, it is not clear how cases of wrongdoing would attract the attention of regulators either.¹⁰⁶ The SEC must already prioritize its enforcement actions and often does so based on factors such as the number of investors harmed or the message such enforcement would send to the public.¹⁰⁷ Thus, it seems unlikely that crowdfunding campaigns would be the large-scale, high profile cases targeted by public regulators.

98. *Tips for Online Investing*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/investor/pubs/onlinetips.htm> [<http://perma.cc/8WQ6-DXU9>] (last modified Aug. 1, 2007).

99. Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 58 (1998).

100. Heminway & Hoffman, *supra* note 30, at 935.

101. *Id.* at 935–36.

102. See Alan R. Palmiter, *Pricing Disclosure: Crowdfunding’s Curious Conundrum*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 373 (2012).

103. *Id.* at 415–16.

104. *Id.*

105. *Id.* at 416–18 (arguing that the dollar cap for crowdfunding offerings would result in limited damages awards which would not justify the attorneys’ fees involved in such a suit); see also, *infra* Part IV-2 (discussing existing limits on the total amount that a company can raise in a crowdfunding campaign).

106. Palmiter, *supra* note 102, at 418–20.

107. *Id.* at 418–19.

Further, many believe that the general public lacks sufficient financial knowledge to wisely invest in crowdfunding campaigns.¹⁰⁸ Crowdfunding provides people with the opportunity to invest in companies without consulting experts and with limited information about a company or its managers. The SEC has warned that, “[a]lthough online trading saves investors time and money . . . making wise investment decisions takes time.”¹⁰⁹ Even if adequate information is available to investors, there is concern that it will be disregarded because of the ease with which purchases and trades can occur. Further, the SEC recently conducted a study finding that “U.S. retail investors [generally] lack basic financial literacy.”¹¹⁰ Combining this investor illiteracy with easier trading makes crowdfunding an especially risky environment.

Adding to this risk is the fact that “[c]ompanies with small capitalizations present disproportionate risks of . . . business failure.”¹¹¹ This increased rate of failure means that investors are likely to lose all of their investment in many cases.¹¹² There are also concerns with the pricing of securities in crowdfunding campaigns, since there are no underwriters or institutional investors negotiating the offering price.¹¹³

Although the concerns regarding crowdfunding are undoubtedly serious, none of them appear to be insurmountable. In fact, concerns of fraud and mispricing could be resolved, or at least mitigated, if crowdfunding is properly regulated to address those issues. Enforcement does pose unique challenges, as ineffective enforcement would render the most-stringent regulations ineffective. However, state-level regulators may actually be in a better position to monitor crowdfunding raises since the issuers and investors will be confined to a smaller geographic region to monitor. And, through regulation of funding portals, states can impose an additional monitoring device on issuers by forcing portals to oversee the companies that use them.

Further, the increased risks associated with small business investment should not cause regulators to “ban, thwart, or unduly constrain securities offerings by small business issuers,”¹¹⁴ especially if the benefits of small businesses are as substantial as generally thought. Instead, the increased

108. *See, e.g., id.* at 413.

109. *Tips for Online Investing, supra* note 98.

110. U.S. SEC. & EXCH. COMM’N, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS iii (2012), <https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf> [<https://perma.cc/49TH-EU69>].

111. Fisch, *supra* note 99, at 58.

112. Heminway & Hoffman, *supra* note 30, at 933–34.

113. Palmiter, *supra* note 102, at 390.

114. Heminway & Hoffman, *supra* note 30, at 936.

risks of small businesses investments should lead to increased investor education and company regulation so that companies and the economy can experience the benefits of an increase in capital availability.

In conclusion, the disadvantages of crowdfunding, though significant, can be reduced through proper regulation. Rather than prohibit crowdfunding entirely, this Article suggests altering existing crowdfunding schemes to mitigate these problems, while still permitting companies and the economy to experience the benefits of crowdfunding.

III. EARLY CROWDFUNDING EXEMPTIONS FROM SECURITIES REGULATION

Considering the success of reward-based crowdfunding and small businesses' difficulty in capital-raising, it is not surprising that many groups began to call for and suggest legal changes that would enable equity crowdfunding to meet small businesses' financing needs. In 2010, the Sustainable Economies Law Center (SELC) petitioned the SEC to create a registration exemption for "any low-risk public ownership of locally owned microbusinesses."¹¹⁵ Other organizations and legal scholars also suggested a number of proposals for small business crowdfunding exemptions.¹¹⁶

Many of the early crowdfunding exemption proposals were modest.¹¹⁷ The SELC proposal, for example, suggested limiting exempt investments to only \$100 per investor, based on the belief that, by limiting any investor to only \$100, such an investment would be low-risk.¹¹⁸ One scholar suggested an investor limit of \$1,000 per six-month period¹¹⁹—significantly more, but still intended to limit the maximum loss. Companies were also subject to strict limits on how much they could raise under these early proposals: one proposal suggested limiting companies to

115. *SELC and the CROWDFUND Act*, SUSTAINABLE ECON. L. CTR., <http://www.theselc.org/selc-and-the-crowdfund-act> [<http://perma.cc/DP9Y-VR8M>] (last visited May 10, 2016) ("By low-risk, I mean that no person can hold more than \$100 worth of any one stock. By local ownership, I mean that only residents within a state can buy, hold, and sell stock shares. And by microbusinesses, I mean any business with a total stock valuation on issuance of less than \$250,000." (quoting Michael Shuman, *Local Stock Exchanges and National Stimulus*, 5 COMMUNITY DEV. INV. REV. 81, 83 (2009))).

116. See Hazen, *supra* note 19, at 1750–51 (citing Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission To Approve a Small Offering Exemption*, 13 U. PA. J. BUS. L. 973, 1000–01 (2011)) (describing proposals); Bradford, *supra* note 50.

117. See, e.g., *SELC and the CROWDFUND Act*, *supra* note 115.

118. *Id.*

119. Pope, *supra* note 116, at 1000–01.

only raising \$250,000 per year,¹²⁰ while another suggested \$250,000 per six-month period.¹²¹ The SELC proposal effectively imposed a company limit through the “microbusiness” requirement, which requires that the business have a total stock valuation on issuance of less than \$250,000.¹²² These proposals are much smaller in scope than those eventually passed, both from the investor and company’s perspective. However, the proposals nevertheless laid a foundation for, and perhaps inspired, the federal and state exemptions.¹²³

With this background, Congress passed the Jumpstart Our Business Startups Act (JOBS Act) in 2012 to facilitate the availability of capital for small businesses.¹²⁴ Among other things, the JOBS Act created a new classification of “emerging” companies, which are those that have under \$1 billion in revenue, under \$1 billion in nonconvertible debt, and are not registered with the SEC as a large accredited filer.¹²⁵ Title III of the JOBS Act, the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 (CROWDFUND Act), created a new SEC registration exemption for these emerging companies.¹²⁶ It allows emerging companies to raise up to one million dollars annually from non-accredited investors, with the total amount depending on the level of financial disclosures provided.¹²⁷ The CROWDFUND Act also limits the amount that an issuer can accept from any single investor annually: for investors with a net worth less than \$100,000, the issuer may only sell securities aggregately valued at “the greater of \$2,000 or 5 percent of the annual income or net worth of such investor,” and if an investor’s net worth is greater than or equal to \$100,000, then the issuer may sell securities

120. Bradford, *supra* note 50, at 91–93.

121. Pope, *supra* note 116, at 1000–01.

122. SELC and the CROWDFUND Act, *supra* note 115.

123. *Id.* (“The Sustainable Economies Law Center played a key role in initiating the campaign for the CROWDFUND Act”); *Exemption Framework*, STARTUP EXEMPTION, <http://www.startupexemption.com/exemption-framework#axzz3XTOjGJbA> [<http://perma.cc/UJS9-3XJJ>] (last updated Oct. 27, 2011) (describing Startup Exemption’s proposed crowdfunding framework).

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

125. *Id.* § 101(a).

126. *Id.* § 301.

127. *Id.* § 302(a). “For example, the full \$1 million is available to companies only if their financial statements are audited by an independent public accountant, whereas a company may raise under \$100,000 by providing little more than an income tax statement and unaudited financials.” James J. Williamson, Comment, *The JOBS Act and Middle-Income Investors: Why It Doesn’t Go Far Enough*, 122 YALE L.J. 2069, 2074 (2013) (discussing Jumpstart Our Business Startups (JOBS) Act § 302(a)–(b)).

aggregately valued at “10 percent of the annual income or net worth . . . not to exceed a maximum aggregate amount sold of \$100,000.”¹²⁸ In many ways, the exemption is similar to previously existing exemptions that are limited to use by companies below certain thresholds.

The CROWDFUND exemption also requires that all offerings be conducted through third-party intermediaries registered as either a broker or funding portal, pursuant to section 4A(a).¹²⁹ Intermediaries must register with the SEC,¹³⁰ as well as with a self-regulatory organization that assists the SEC in overseeing security transaction activities.¹³¹ Though brokers and funding portals both facilitate securities transactions, there are significant differences in the regulation and permitted activities for each.¹³² However, both types of intermediaries are able to facilitate transactions via the internet.¹³³

While many were hopeful that the CROWDFUND Act “would provide startup companies and other small businesses with a new way to raise capital from ordinary investors in a more transparent and regulated marketplace,”¹³⁴ the exemption is yet to be used due to the SEC’s delay in issuing final rules. The JOBS Act imposed a December 31, 2012 deadline for the SEC to enact rules implementing the exemption, but the SEC did

128. Jumpstart Our Business Startups (JOBS) Act § 302(a).

129. *Id.* § 302(a), 304(b).

130. 15 U.S.C. § 77d-1(a)(1) (2012).

131. *Id.* § 77d-1(a)(2).

132. A Broker is “any person engaged in the business of effecting transactions in securities for the account of others.” 15 U.S.C. § 78c(a)(4)(A) (2012). A funding portal, on the other hand, includes “any person acting as an intermediary in a transaction involving the offer or sale of securities.” *Id.* § 78c(a)(80). Funding portals are more limited in the activities they may do. They do not:

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

Id.

133. For a more in-depth look at funding portals and broker dealers under the CROWDFUND Act, see Shekhar Darke, Note, *To Be or Not To Be a Funding Portal: Why Crowdfunding Platforms Will Become Broker-Dealers*, 10 HASTINGS BUS. L.J. 183, 193 (2014).

134. 157 Cong. Rec. S188, 8458 (daily ed. Dec. 8, 2011) (statement of Sen. Merkley).

not issue notice of a proposed rulemaking until November 2013¹³⁵ and the final rules were not issued until October 30, 2015.¹³⁶ While the rules, titled “Regulation Crowdfunding,” mean that interstate crowdfunding will soon be a reality, the rules did not become effective until May of 2016.¹³⁷ Until the rules take effect (and perhaps longer, as companies and regulators adapt to the new rules), crowdfunders will have to continue utilizing state exemptions in order to raise capital in this way.

IV. STATE EXEMPTIONS

Perhaps inspired by the CROWDFUND Act or frustrated by the SEC’s delay, many states have implemented their own crowdfunding exemptions from state security registration laws.¹³⁸ To date, twenty-eight states have passed crowdfunding exemptions,¹³⁹ while numerous others are

135. *Rules Governing the Offer and Sale of Securities Through Crowdfunding Under Section 4(a)(6) of the Securities Act*, REGINFO.GOV, <http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201410&RIN=3235-AL37> [<http://perma.cc/MQ4N-TEN3>] (last visited May 17, 2016).

136. See Crowdfunding, Securities Act Release No. 33-9974, Exchange Act Release No. 34-76324, 80 Fed. Reg. 71,387 (proposed Nov. 16, 2015); see also Press Release, SEC. & EXCH. COMM’N., SEC Adopts Rules To Permit Crowdfunding (Oct. 30, 2015), <http://www.sec.gov/news/pressrelease/2015-249.html> [<http://perma.cc/GZN3-GZ63>].

137. See *id.*; see also *Client Alert: Regulation Crowdfunding*, WYRICK (Wyrick, Robbins, Yates & Ponton, LLP, Raleigh, N.C.), (Nov. 5, 2015), http://www.wyrick.com/documents/newsPdfs/ClientAlert_RegulationCrowdfunding.pdf [<http://perma.cc/7W5U-2PEP>].

138. Kansas, for example, passed its crowdfunding exemption prior to JOBS Act in 2011. KAN. ADMIN. REGS. § 81-5-21 (Supp. 2015).

139. The twenty-eight states include: Alabama, ALA. CODE § 8-6-11(a)(14) (Supp. 2015); Arizona, ARIZ. REV. STAT. ANN. § 44-1844(D) (Supp. 2015); Colorado, COLO. REV. STAT. § 11-51-304(6) (2015); COLO. CODE REGS. § 51-3.3 (2015); Florida, H.B. 275, 2015 Leg., Reg. Sess. (Fla. 2015); Georgia, GA. COMP. R. & REGS. § 590-4-2-.08 (2012); Idaho, IDAHO CODE § 30-14-203 (2013); Illinois, H.B. 3429, 99th Gen. Assemb., Reg. Sess. (Ill. 2015); Indiana, IND. CODE § 23-19-2-2(27) (2015); Iowa, IOWA CODE §§ 502.202, 502.605 (2015); Kansas, KAN. ADMIN. REGS. § 81-5-21 (2016); Kentucky, KY. REV. STAT. ANN. §§ 292.410–415 (West 2015); Maine, ME. REV. STAT. ANN. tit. 32, § 16304.6-A (2015); Maryland, MD. CODE. ANN., CORPS. & ASS’NS § 11-601(16) (LexisNexis 2014); Massachusetts, 950 MASS. CODE REGS. 14.402(B)(13)(o) (2015); Michigan, MICH. COMP. LAWS § 451.2202(y) (Supp. 2015); Minnesota, MINN. STAT. § 80A.461 (2014); Mississippi, 1-14 MISS. CODE R. §§ 2.04, 7.21 (LexisNexis 2015); Montana, MONT. CODE. ANN. § 30-10-105 (West 2015); Nebraska, NEB. REV. STAT. § 8-1111 (2015) (as amended by L.B. 226, 104th Leg., First Sess. (Neb. 2015)); New Jersey, S.B. 712, 216th Leg., Reg. Sess. (N.J. 2014); Oregon, OR. REV. STAT. § 59.035 (2013) (and related regulations); South Carolina, H.B. 3088, 2015 Leg., 121st Sess. (S.C. 2015); Tennessee, TENN. CODE. ANN. § 48-1-103(a)(13) (Supp. 2012); Texas, 7 TEX. ADMIN. CODE. § 139.25 (2015); Vermont, 21-030 VT. CODE R. § 007 (2015); Virginia, VA. CODE ANN. § 13.1-514 (2011);

considering such exemptions. Due to the changing landscape of state crowdfunding exemptions, this Article focuses on a limited number of existing state exemptions, rather than surveying all proposed or passed state exemptions. This Part surveys fifteen of the existing state crowdfunding exemptions, looking first at the general requirements that many exemptions have in common, then turning to the more specific, substantive restrictions that dictate the size and scope of exempt offerings.

One general requirement that all states share is that, in order to utilize the state exemption, the crowdfund offering must also meet the requirements of a federal exemption to avoid triggering any federal registration requirements.¹⁴⁰ In most states, the intrastate offering exemption of section 3(a)(11) of the Securities Act is the chosen exemption.¹⁴¹ Therefore, in addition to the state's crowdfunding exemption requirements, a company must also meet the requirements of 3(a)(11): the company must be registered and carry out a significant amount of its business in that state and the company can only offer and sell securities to residents of that state.¹⁴² Although these requirements are implicit through reference to the intrastate offering exemption, most states nevertheless explicitly have these requirements listed in the crowdfunding exemption.¹⁴³ Maine requires an offering to fit the exemption requirements of Rule 504 of Regulation D, allowing a company to raise up to one million dollars annually, but the effect—exemption from federal registration—is the same.¹⁴⁴

Further, most states also require companies utilizing the exemption to file a notice with the state's securities commissioner (or equivalent office).¹⁴⁵ Although companies are able to avoid the time and expense of traditional registration, the state still requires some form of notice about a company's capital raising.¹⁴⁶ Generally, this notice simply requires the company to claim the exemption and provide relevant background

Washington, WASH. REV. CODE § 21.20.880 (2014); and Wisconsin, WIS. STAT. § 551.202 (2013–14); see also Michael Davidson, *Colorado Lawmakers Set Stage for Equity Crowdfunding*, XCONOMY (Feb. 25, 2015), <http://www.xconomy.com/boulder-denver/2015/02/25/colorado-lawmakers-set-stage-for-equity-crowdfunding/> [http://perma.cc/P9JY-3LCB]. Due to this uncertainty, Colorado's exemption is disregarded for the remainder of this Article.

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

141. See, e.g., *id.* Maine relies on Rule 504 of Regulation D instead. ME. REV. STAT. ANN. tit. 32, § 16304.6-A(D).

142. *Small Business and the SEC: Intrastate Offering Exemption*, *supra* note 33.

143. See, e.g., ALA. CODE § 8-6-11(a)(14).

144. ME. REV. STAT. ANN. tit. 32, § 16304.6-A(D).

145. See, e.g., MICH. COMP. LAWS § 451.2202(y) (Supp. 2015).

146. *Id.*

information about the company, such as its address, owners, and the depository institution that will hold investor funds.¹⁴⁷ Some states also require that companies provide recent financial statements¹⁴⁸ or the targeted minimum and maximum amounts to be raised in the offering.¹⁴⁹ While these notice filings may be time-consuming and often require the payment of a fee,¹⁵⁰ they are undoubtedly less demanding than typical state registration requirements.

Another common, yet unsurprising, characteristic among the state exemptions is the applicability to online offerings and sales. Some states require that the offering be completed exclusively through a website and provide guidelines on how such a site can be operated.¹⁵¹ Other states do not explicitly require that offerings be completed online, but show that use of the internet is permissible, such as Michigan, which permits an issuer to advertise an offering through a website.¹⁵² Although some states do not specifically mention the internet in the statutory exemption,¹⁵³ none of the surveyed statutes forbid use of the internet in the offering.

Apart from these requirements, the state exemptions generally resemble each other only in form. Most of the exemptions address similar categories of requirements that determine what crowdfunding will look like in that particular state. Much like the federal exemption, the state laws address issues such as how much money is raised, from whom it is raised, and disclosure requirements. However, the specific limits imposed within these categories vary greatly across the states.

One notable exception to this general form is Idaho, which permits crowdfunding in certain circumstances, but does not have a statutory exemption.¹⁵⁴ Instead, the availability of crowdfunding is determined on a case-by-case basis by the Idaho Department of Finance.¹⁵⁵ The Idaho Code permits a rule or order to exempt a security, transaction, or offer from

147. See, e.g., TENN. CODE ANN. § 48-1-103(a)(13)(A)(v) (Supp. 2012).

148. ME. REV. STAT. ANN. tit. 32, § 16304.6-A(E)(5).

149. OR. ADMIN. R. 441-035-0110(2)(d) (updated as of Feb. 15, 2016), http://arcweb.sos.state.or.us/pages/rules/oars_400/oar_441/441_035.html [<https://perma.cc/K5ET-RJJH>].

150. OR. ADMIN. R. 441-035-0110(1) (imposing a \$200 filing fee).

151. See IND. CODE § 23-19-2-2(27)(O) (2015).

152. MICH. COMP. LAWS § 451.2202(3) (Supp. 2015).

153. See, e.g., ALA. CODE § 8-6-11(a)(14) (Supp. 2015).

154. See Peter Clough, *These States Won't Wait for the JOBS Act*, EARLY INVESTING (Mar. 27, 2015), <http://earlyinvesting.com/jobs-act-these-states-wont-wait/> [<http://perma.cc/V56X-D6J4>].

155. IDAHO CODE § 30-14-203 (2013).

securities registration.¹⁵⁶ Although the exemptions are issued in the form of orders, they often contain requirements that resemble other states' statutory exemptions, including restrictions on the total amount that can be raised in the issue and the total amount that can be accepted from a single investor, as well as other disclosure requirements.¹⁵⁷ Due to its unique exemption form, Idaho is disregarded for the remainder of this Article.

For the remaining states with crowdfunding exemptions, the following four categories of exemption requirements will be addressed: (1) the annual investment limit per investor; (2) the annual maximum capital raise per company; (3) required disclosures to investors; and (4) required investor certifications or acknowledgements. Following this overview of these requirements in the states, the next Part will address the deficiencies that exist in some or all of the states regarding these various requirements.

A. Annual Investment Limit Per Investor

Like the federal exemption, most of the state exemptions impose a maximum dollar amount that any single investor may annually contribute to a company's capital raise. This ceiling is designed to limit the exposure that an investor has to a single company's risk, at least on an annual basis. Also like the federal exemption, most states distinguish between accredited and non-accredited investors in limiting the amount of an annual investment. Nine states adopted the federal definition of "accredited investor" and none of them impose an annual investment limit on accredited investors, but instead only restrict a non-accredited investor's purchase.¹⁵⁸ Kansas, one of the first states to enact an exemption, allows non-accredited investors to invest up to \$1,000 annually.¹⁵⁹ Four states impose a \$5,000 limit on annual purchases by non-accredited investors,¹⁶⁰ while four states double this amount, allowing non-accredited investors to purchase up to \$10,000 in securities from a company annually.¹⁶¹

156. *Id.*

157. *See, e.g.*, Treasure Valley Angel Fund, LLC, Blue Sky L. Rep. (CCH) ¶ 21,729, 2014 WL 4063439 (Jan. 20, 2012).

158. ALA. CODE § 8-6-11(a)(14); GA. COMP. R. & REGS. § 590-4-2-.08(1)(d) (2012); IND. CODE § 23-19-2-2(27) (2015); KAN. ADMIN. REGS. § 81-5-21(a)(4) (Supp. 2015); ME. REV. STAT. ANN. tit 32, § 16304.6-A.C (2015); MICH. COMP. LAWS § 451.2202(y) (Supp. 2015); TENN. CODE. ANN. § 48-1-103(a)(13)(A)(iii) (Supp. 2012); 7 TEX. ADMIN. CODE. § 139.25(e) (2015); WIS. STAT. § 551.202(13) (2013–14).

159. KAN. ADMIN. REGS. § 81-5-21(a)(4).

160. ALA. CODE § 8-6-11(a)(14)(d); IND. CODE § 23-19-2-2(27); ME. REV. STAT. ANN. tit. 32, § 16304.6-A(C); 7 TEX. ADMIN. CODE. § 139.25(e).

161. GA. COMP. R. & REGS. § 590-4-2-.08(1)(d); MICH. COMP. LAWS § 451.2202(y)(iv); TENN. CODE. ANN. § 48-1-103(a)(13)(A)(iii); WIS. STAT. § 551.202(26)(d).

However, a few states do not distinguish between accredited and non-accredited investors, and instead impose annual investment limits on all purchasers. Maryland is one such state and, in addition to treating all investors equally, imposes the lowest annual investment limit of just \$100.¹⁶² Washington and Massachusetts likewise abandon the accredited investor status and instead distinguish investors based on net worth and annual income.¹⁶³ In Washington, investors with a net worth or annual income less than \$100,000 may annually invest the greater of \$2,000 or 5% of his net worth or income,¹⁶⁴ while investors whose net worth or annual income is greater than \$100,000 may annually invest up to 10% of net worth or income (up to a maximum investment of \$100,000).¹⁶⁵ Massachusetts' exemption imposes almost identical restrictions.¹⁶⁶

As these numbers show, the annual investor limits vary greatly between states, ranging from \$100 to \$10,000 and potentially more in a state like Washington. With this great disparity, some context is needed to determine which of these numbers, if any, are reasonable limitations and what effect they will have on investor contributions. Such context is hard to develop because there are currently very few opportunities for non-accredited investors to engage in equity crowdfunding. However, looking at current crowdfunding trends, one possibility is that these limitations may not actually matter. In the past, those earning over \$100,000 per year were more likely to invest in startups through crowdfunding.¹⁶⁷ And one equity crowdfunding platform, CircleUp, reported that, although the average investment depends on the deal, it is typically five figures.¹⁶⁸ These numbers are likely skewed due to the

162. MD. CODE ANN., CORPS. & ASS'NS § 11-601(16)(iv) (LexisNexis 2014).

163. See 950 MASS. CODE REGS. 14.402(B)(13)(o) (2015); WASH. REV. CODE § 21.20.880 (2014).

164. WASH. REV. CODE § 21.20.880.

165. *Id.*

166. 950 MASS. CODE REGS. 14.402(B)(13)(o)(5). The only difference between Massachusetts' and Washington's limits is that Massachusetts imposes the smaller limit if both net worth and annual income are below certain thresholds, but the larger limit can be utilized if either annual income or net worth is above a certain threshold. The Washington statute provides that the lower limit applies if either net worth or annual income is below a certain threshold, but that the higher limit applies if either net worth or annual income is above that threshold. Thus, based on the statutory language alone, it is not clear what limit would be applied to an investor whose net income was below the threshold and annual income was above the threshold.

167. *Crowdfunding Statistics*, FUNDABLE, <https://www.fundable.com/crowdfunding101/crowdfunding-statistics> [<https://perma.cc/XD5K-S9UQ>] (last visited May 17, 2016).

168. Ryan Caldbeck, *Why an Equity Crowdfunding Site Could Become the Largest Marketplace in the World*, FORBES (Nov. 11, 2013, 12:43 PM), <http://www.forbes.com/sites/>

limited opportunities available to non-accredited investors, but they do indicate important trends: unsurprisingly, people with higher incomes are more likely to invest, and those people invest significant amounts of money in the campaigns they support. Therefore, it is very possible that the people most likely to invest in crowdfunding campaigns will be accredited investors and, in many states, not be subject to any annual investor limits.

Even for non-accredited investors, the limits may also be irrelevant in many situations. Since non-accredited investors are able to contribute to reward-based crowdfunding, the typical contribution to those campaigns may provide insight on how appropriate the exemption limitations are. In recent years, the average contribution to these campaigns was estimated to be between seventy and eighty dollars,¹⁶⁹ and on Kickstarter the most common contribution was just twenty-five dollars.¹⁷⁰ If these numbers generally reflect the amount that investors are willing to contribute to new ventures, then even Maryland's limit of one hundred dollars will not prevent investors from contributing as much as they would like. In other states where the limits are thousands of dollars, most investors will not even approach the maximum contribution amount—thus making such limits irrelevant to most investors. But reward-based crowdfunding is not a perfect comparison either, as investors likely limit their contribution to the perceived value of the reward received, often a consumer good. Investors may be more willing to contribute more funds in exchange for equity and the opportunity to receive a more significant financial return.

Campaign finance provides another useful context to compare to these investment limits. Campaign contributions are donations and thus a contributor has no expectation of receiving a financial return on his or her

ryancaldbeck/2013/11/11/why-an-equity-crowdfunding-site-could-become-the-largest-mark
etplace-in-the-world/ [https://perma.cc/UD5Y-YUT7].

169. *Crowdfunding*, MARK ALLEN COACHING, <http://www.triathlonbusinessintl.com/assets/files/Crowd%20Funding%20Mark%20Allen.pdf> [http://perma.cc/GCQ2-BFQF] (average contribution on Kickstarter was \$70, with \$25 being the most common amount); Will Haines, *Indiegogo Insight: Average Contribution Amount Through Email Is Higher Than Other Referral Sources*, INDIEGOGO (Mar. 22, 2012), <https://go.indiegogo.com/blog/2012/03/indiegogo-insight-average-contribution-amount-through-email-is-higher-than-other-referral-sources.html> [https://perma.cc/RJ9G-5KA7] (“The average contribution amount in response to a direct email is \$90 [whereas] the average contribution in response to other forms of outreach (i.e. [F]acebook post) is \$67.”); *Crowdfunding Campaigns: Risks for Startups*, MARS (Dec. 17, 2013), <http://www.marsdd.com/mars-library/crowdfunding-campaigns-risks-for-startups/> [http://perma.cc/R5UP-QRS2] (average contribution is roughly \$70); Scott Thompson, *The Average Crowdfunding Contribution Is \$80: What That Means for Platform Owners*, CROWDFORCE (Oct. 28, 2012), <http://crowdforce.co/average-crowdfunding-contribution-is-80/> [http://perma.cc/ACC4-HY58] (average was \$80 from 2007 to 2012).

170. MARK ALLEN COACHING, *supra* note 169.

contribution, apart from some perceived financial benefit from having a certain candidate elected or policies implemented. In effect, campaign contributions represent a scenario in which an investor loses all the funds contributed to a crowdfunding campaign. Interestingly, the government is more comfortable allowing individuals to spend money with no chance of return than allowing spending in crowdfunding, where there is at least a chance of a financial gain, however small it may be. For example, in 2015, an individual can contribute up to \$2,700 per candidate per federal election (with primaries, runoffs, and general elections each being considered a separate election).¹⁷¹ This number is independent of contributions to PACs (\$5,000 per year), to state/district/local party committees (\$10,000 per year, combined), to national party committees (\$33,400), and to Additional National Party Committee Accounts (\$100,200 per year).¹⁷² States are also generous in their campaign finance limits: Alabama imposes no limits on campaign contributions, Georgia allows contributions up to \$6,300 to statewide candidates and \$2,500 to legislature candidates per election, and Maryland even allows contributions of \$4,000 per candidate per election cycle.¹⁷³ Although campaign finance raises free speech issues that are generally not present in the investment context¹⁷⁴ and has different objectives than financial investments, these numbers nevertheless show a major inconsistency in how the government regulates individual spending.

A simple comparison of the investor limits confirms this inconsistency. States like Massachusetts and Washington limit an investor to spending either 5% or 10% of annual income on a crowdfunding investment (depending on income level).¹⁷⁵ However, the other states either treat all investors similarly regardless of income, or only distinguish between those with incomes above and below \$200,000. The investment limits seem arbitrary when the proportion of income that a state allows an investor to spend is compared: the most common limit, \$5,000, for

171. *Contributions*, FED. ELECTIONS COMMISSION, <http://www.fec.gov/pages/brochures/contrib.shtml> [<http://perma.cc/6HJV-9SL4>] (last updated Feb. 2015).

172. *Id.* Additional national party committee accounts refers to “a national party committee’s accounts for: (i) the presidential nominating convention; (ii) election recounts and contests and other legal proceedings; and (iii) national party headquarters buildings.” *Id.*

173. *State Limits on Contributions to Candidates*, NAT’L CONF. ST. LEGISLATURES, http://www.ncsl.org/Portals/1/documents/legismgt/Limits_to_Candidates_2012-2014.pdf [<http://perma.cc/Q4TD-RDAK>] (last updated Oct. 2013).

174. *See, e.g., How Spending Money Became a Form of Speech*, AMEND. GAZETTE <http://www.amendmentgazette.com/how-spending-money-became-a-form-of-speech/> [<http://perma.cc/X77Q-LMY2>] (last visited Nov. 26, 2015).

175. 950 MASS. CODE REGS. § 14.402(B)(13)(o) (2015); WASH. REV. CODE § 21.20.880(1)(g)(ii) (2014).

example, only represents 2.5% of a \$200,000 income, but 10% of a \$50,000 income. The failure to consider income level beyond the accredited investor threshold disregards the varying effects that such investments can have on individuals' finances, despite the intended purpose behind these limitations: investor protection. These investor limitations appear even more arbitrary when compared alongside the capital-raising limitations imposed on companies.

B. Annual Maximum Capital Raise Per Company

The state exemptions also limit the total amount that a company can annually raise in reliance on a crowdfunding exemption. Like the numerous other exemptions that impose this limit, it is intended to restrict the size of the offering. For exemptions that distinguish between accredited and non-accredited investors, this maximum amount is generally exclusive of sales to accredited or institutional investors.¹⁷⁶ Thus, companies in some states are able to annually raise more capital than the exemption's limit, provided such additional financing is obtained from sources other than non-accredited investors or through capital raises under other exemptions.

Seven states allow a company to raise up to \$1,000,000 annually under the crowdfunding exemption.¹⁷⁷ Indiana, Massachusetts, and Wisconsin alter the maximum raise amount based on the financial information provided to investors.¹⁷⁸ The Wisconsin statute, for example, provides that "if the issuer has undergone and made available to each prospective investor and [state regulators] the documentation resulting from a financial audit of its most recently completed fiscal year which complies with generally accepted accounting principles" may receive up to \$2,000,000 annually under the exemption.¹⁷⁹ Issuers that have not made

176. WIS. STAT. § 551.202(26)(c)(1) (2013–2014) (providing that "the sum of all cash and other consideration to be received for all sales of the security in reliance on the exemption under this subsection, excluding sales to any accredited investor, certified investor, or institutional investor, does not exceed the following amount . . .").

177. ALA. CODE § 8-6-11(a)(14)(c) (Supp. 2015); GA. COMP. R. & REGS. § 590-4-2-.08(1)(c) (2012); KAN. ADMIN. REGS. § 81-5-21(a)(3) (Supp. 2015); ME. REV. STAT. ANN. tit. 32, § 16304.6-A.B (2015); TENN. CODE ANN. § 48-1-103(a)(13)(A)(ii) (2012); 7 TEX. ADMIN. CODE § 139.25(d) (2015); WASH. REV. CODE § 21.20.880(1)(f).

178. WIS. STAT. § 551.202 (26)(c)(1)(a)-(b); IND. CODE § 23-19-2-2(27) (2015); 950 MASS. CODE REGS. § 14.402(B)(13) (2015).

179. WIS. STAT. § 551.202 (26)(c)(1)(b).

such an audit available may only receive up to \$1,000,000.¹⁸⁰ Indiana and Massachusetts utilize similar language to impose the same annual caps.¹⁸¹

Michigan has the highest annual capital raise amounts at \$5,000,000.¹⁸² Michigan incorporates this amount by reference to federal law, so it is subject to further increase in the future.¹⁸³ Oregon limits companies to \$250,000 per year,¹⁸⁴ and again, Maryland is at the conservative end of the spectrum, limiting a company's annual sales to just \$100,000.¹⁸⁵

In addition to capping the maximum amount that can be raised, some states require that companies reach minimum targets in order to receive any of the funds raised. Massachusetts, for example, requires a company to establish a minimum offering amount, which cannot be less than 30% of the maximum target amount set by the company.¹⁸⁶ The statute then mandates, "If the minimum offering amount is not met within one year of the earlier of the commencement of the offering or the first posting of the offering on the internet, the issuer shall return all funds to investors."¹⁸⁷ Maine likewise requires that all proceeds of the offering remain in a separate bank account until the minimum offering amount is reached and that such proceeds be returned to investors if the minimum amount is not reached within one year.¹⁸⁸

The annual maximum capital raise is important because it basically tells a company whether the crowdfunding exemption is the right method to raise capital. Some companies will require more capital than the maximum allows and thus a different exemption or registration is a better option for them. A number of states also specify that the crowdfunding exemption cannot be used with any other exemptions¹⁸⁹ and, as a result, a company is restricted by the amount in the crowdfunding exemption, even if new financing needs arise.

180. *Id.*

181. IND. CODE § 23-19-2-2(27) (2015); 950 MASS. CODE REGS. § 14.402(B)(13)(o) (2015).

182. MICH. COMP. LAWS § 451.2202(y)(iii) (Supp. 2015).

183. *Id.*

184. OR. ADMIN. R. 441-035-0090(6) (updated as of Feb. 15, 2016), http://arcweb.sos.state.or.us/pages/rules/oars_400/oar_441/441_035.html [<https://perma.cc/K5ET-RJJH>].

185. MD. CODE ANN., CORPS. & ASS'NS. § 11-601(16)(iii) (LexisNexis 2014).

186. 950 MASS. CODE REGS. § 14.402(B)(13)(o) (2015). The maximum must also be disclosed to investors in the offering materials. *Id.*

187. *Id.*

188. ME. REV. STAT. ANN. tit. 32, § 16304.6-A.F (2015).

189. *See, e.g.*, ALA. CODE § 8-6-11(a)(14)(k) (Supp. 2015); TENN. CODE. ANN. § 48-1-103(a)(13)(B)(i) (2012).

With maximum capital raises ranging from \$100,000 to \$5,000,000, it is difficult to determine what would be a reasonable limit to impose on a small or new company that can only raise funds from state residents. The legislative intent behind these restrictions undoubtedly matters: if the limits were actually intended to be restrictive then they will be much lower than if they are simply upper limits for extreme circumstances, which most companies would never approach. However, because each state actually included such a limit, it seems clear that it was intended to be restrictive in some way. But, even if states had very different perceptions of what types of companies would use the exemptions and for what purposes, the large range in limits indicates that some states may be too restrictive or not actually restrictive at all.

For comparison, on Kickstarter, “[m]ost successfully funded projects raise less than \$10,000”¹⁹⁰ and, though Indiegogo’s statistics are not as publicly available, it seems clear the average goal reached on Indiegogo is less than \$5,000.¹⁹¹ These numbers may be useful for companies seeking to use crowdfunding for a single project, as many of those on reward-based crowdfunding sites are. For these types of companies, the maximum capital raise limits are likely insignificant because they are sufficiently high to not interfere with a company’s goals.

However, for companies and investors with larger and longer-term plans, these numbers are likely underestimates of how much capital is needed. The average size of existing equity-based crowdfunding projects is much larger than reward-based crowdfunding, with estimates ranging from \$85,000 to over \$100,000.¹⁹² As these ranges in estimates show, determining what is “normal” for crowdfunding campaigns is not easy.

190. *Stats*, KICKSTARTER, <https://www.kickstarter.com/help/stats> [<https://perma.cc/U4MQ-CMSW>] (last visited May 17, 2016); see also Matt Ward, *Kickstarter vs Indiegogo and How To Decide for Your Crowdfunding Campaign*, ART KICKSTART (Sept. 23, 2014), <http://artofthekickstart.com/kickstarter-vs-indiegogo-and-how-to-decide-for-your-crowdfunding-campaign/> [<http://perma.cc/JJS2-HCGU>] (stating that the average successful Kickstarter campaign raised \$6,548).

191. *Indiegogo Insight: 87% of Campaigns That Reach Their Goal Exceed It*, INDIEGOGO BLOG (Dec. 8, 2011), <http://go.indiegogo.com/blog/2011/12/indiegogo-insight-87-of-campaigns-which-reach-their-goal-exceed-it.html> [<http://perma.cc/4Z8P-GHWL>] (stating that “the average goal reached on Indiegogo is around \$3700”); Ward, *supra* note 190 (stating that the average successful campaign was \$2,250 in 2013).

192. See, e.g., *Crowdfunding: One Size Doesn’t Fit All*, SOMOLEND (July 26, 2012), <http://blog.somolend.com/2012/07/26/crowdfunding-one-size-doesnt-fit-all/> [<http://perma.cc/P9LY-NQLE>] (“As of May 2012, the average equity-based crowdfunding project raised \$84,597.”); Jonathan Sandlund, *Investment Crowdfunding: Average Transaction Sizes*, THECROWDCAFE (Jan. 24, 2013), <http://www.thecrowdcafe.com/investment-crowdfunding-average-transaction-size/> [<http://perma.cc/2EEJ-BUQF>] (estimating that the average equity crowdfunding campaign raised approximately \$112,000).

One crowdfunding organization compared two different crowdfunding platforms to show how amounts raised depend on the type of companies and investors targeted. Seedrs, a U.K. crowdfunding platform available to all investors and focused on technology startups had a median capital raise amount of \$48,000.¹⁹³ CircleUp, on the other hand, is a U.S.-based platform only accessible to accredited investors and focused on emerging-growth consumer product companies.¹⁹⁴ The median raise on CircleUp was over \$800,000, with campaigns ranging between \$500,000 to \$2,300,000.¹⁹⁵ Compared with these numbers, many of the states' limits (particularly those around one million dollars) seem more reasonable and consistent with allowing companies to raise significant amounts of money, without becoming too large of an offering.

The annual maximum capital raise also works in conjunction with the annual limits imposed on individual investors. A company seeking to take full advantage of a crowdfunding exemption can easily compare the maximum amount it can annually raise to the maximum amount it can accept from each investor in order to calculate a target number of investors. For example, in Georgia, a company can raise up to \$1,000,000 through the crowdfunding exemption and can only accept up to \$10,000 from each non-accredited investor.¹⁹⁶ Thus, in order to raise the maximum amount from the fewest number of investors, a Georgia company would need to accept \$10,000 from one hundred investors, making one hundred the "target number of investors." For the states with existing exemptions, the target number of investors ranges from 100 to 1,000 investors.¹⁹⁷

In reality this ratio is probably not very useful to companies, which would ideally plan their crowdfunding campaigns based on their specific financial needs, the amount of ownership they are willing to give up, and

193. *Id.*

194. *Id.*

195. *Id.*

196. GA. COMP. R. & REGS. § 590-4-2-.08(1) (2012).

197. Georgia and Oregon have a target number of investors of 100. GA. COMP. R. & REGS. § 590-4-2-.08(1); OR. ADMIN. R. 441-035-0090 (2015). Alabama, Maine, and Texas have a target number of investors set at 200. ALA. CODE § 8-6-11(a)(14) (Supp. 2015); ME. REV. STAT. ANN. tit. 32, § 16304.6-A (2015); 7 TEX. ADMIN. CODE. § 139.25(i)(2) (2015). Michigan has a target number of 500. MICH. COMP. LAWS § 451.2202(y)(iv) (Supp. 2015). Kansas, Maryland, and Tennessee each have target numbers of 1,000. KAN. ADMIN. REGS. §§ 81-5-21(a)(3)-(4) (Supp. 2015); MD. CODE ANN., CORPS. & ASS'NS. § 11-601(16)(iii) (LexisNexis 2014); TENN. CODE ANN. § 48-1-103(a)(13)(A) (2012). The remaining states—Indiana, Massachusetts, and Wisconsin—have varying investor caps (based on annual income or net worth) or varying maximum capital raise amounts (based on financial information provided to investors). IND. CODE § 23-19-2-2 (2015); 950 MASS. CODE REGS. § 14.402(B)(13) (2015); WIS. STAT. § 551.202 (2013–2014).

other business considerations. However, for purposes of determining the attainability of the statutory maximum capital raises, this target number of investors is useful—it essentially tells a company the size of the crowd needed to raise as much capital as possible under the exemption. This target number is exclusive of accredited investors in most states, but is nevertheless useful since the annual maximum capital raise is also generally exclusive of accredited investors.

How feasible is it that an unregistered company—likely utilizing a crowdfunding exemption due to the unavailability of traditional financing options—will be able to convince one hundred or more non-accredited investors to contribute to their company? This answer seems to range from unlikely to impossible. For example, on CircleUp, the average deal involves fewer than twenty-five investors.¹⁹⁸ Obviously, when investors are accredited (as on CircleUp) and are able to invest much larger sums of money, fewer investors are necessary, so this does not necessarily mean that more investors is not an option. However, in 2014, one study estimated that “440 is the average number of backers in a rewards crowdfunding campaign, compared to 96 investors on average in equity crowdfunding campaigns.”¹⁹⁹ If these statistics are accurate predictions for the future, obtaining the target number of investors will be very difficult in many states.

In some states, companies cannot raise the maximum amount without triggering federal registration requirements. Although the JOBS Act increased the number of shareholders that a company could have without registering from 500 to 2,000, it also specified that a company could not have more than 499 non-accredited investors as shareholders without registering.²⁰⁰ In states like Kansas, Maryland, Michigan, and Tennessee, where the target investor number is at least 500, companies cannot legally raise the annual maximum amount exclusively from non-accredited investors. Without significant contributions from accredited investors, companies in these states (especially those with target numbers of 1,000) will not come close to raising the maximum amount possible. States may also have their own limitations on the number of investors that trigger

198. Lora Kolodny, *Crowdfunding 101: Q&A with CircleUp CEO Ryan Caldbeck*, CROWDFUNDBEAT, <http://www.crowdfundbeat.ca/crowdfunding-101-qa-with-circleup-ceo-ryan-caldbeck/> [<http://perma.cc/D8VE-C6TH>] (last visited May 17, 2016).

199. Irene Tordera, *Crowdfunding: 84% of Investors Are Male, but Women Are More Successful*, CROWD VALLEY (Feb. 6, 2014), <http://www.crowdvalley.com/news/crowdfunding-84-of-investors-are-male-but-women-are-more-successful> [<http://perma.cc/VEV4-FPS5>].

200. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012).

registration requirements, perhaps further limiting the attainability of these maximum capital raises. It is not clear why states would impose limitations that, even under an ideal situation where investors contribute as much as possible, a company could not reach the maximum capital raise permitted under the exemption.

C. Required Disclosures to Investors

Even when exempt from securities registration, federal and state laws generally require that certain disclosures be provided to investors and regulators. For state crowdfunding exemptions, the required disclosures to investors vary.²⁰¹ At a minimum, each state requires disclosures to ensure that an offering remains exempt. Specifically, the disclosure must state that the securities are subject to resale restrictions and that the purchased securities are not registered with the SEC or state securities commission.²⁰² A number of states seek to make this point more explicit by requiring the disclosure to state that the investor must rely on his own examination of the offering and the risks involved.²⁰³ Most states also require that general information about the company, such as its name, address, and owners, be provided to investors.²⁰⁴

Some states also emphasize the illiquid nature of the securities purchased, stating that there may never be a ready market for the securities²⁰⁵ or that an investor may be required to bear the financial risks of the investment for an indefinite period of time.²⁰⁶ Maine perhaps has the most thorough investor disclosures, requiring all of this information, as well as information regarding the securities' price (or method of determining price) and the ownership and capital structure of the company, including valuation methods.²⁰⁷ The disclosure must also include information about the risks related to minority ownership in the company, including the issuance of additional shares and asset sales.²⁰⁸

With any disclosure, there is a balance between providing sufficient information for adequate decision-making and providing a small enough amount of information so that it is actually read. The SEC and other

201. *See supra* note 197 and accompanying text.

202. *See, e.g.*, KAN. ADMIN. REGS. § 81-5-21(a)(9) (Supp. 2015).

203. IND. CODE § 23-19-2-2(27)(H) (2015).

204. *See, e.g.*, 950 MASS. CODE REGS. § 14.402(B)(13)(o)(11) (2015).

205. 7 TEX. ADMIN. CODE. § 139.25(i)(2) (2015).

206. WIS. STAT. § 551.202 (26)(h) (2013–14); ME. REV. STAT. ANN. tit. 32, § 16304.6-A.E (2015).

207. ME. REV. STAT. ANN. tit. 32, § 16304.6-A.E.

208. *Id.*

regulatory agencies focus on comprehensive disclosures, sometimes overlooking that fact that “if the users do not process information effectively, it is not clear what good mandating disclosure does.”²⁰⁹ In determining how much disclosure is sufficient rather than too much, the purpose of the disclosures is key. In the context of securities laws, “[d]isclosure is merely the chosen means to the end of informed investor decision making.”²¹⁰ And, for crowdfunding specifically, the end is informed decision making regarding risky investments by non-accredited investors.

As the varying detail of the exemption disclosures show, states reached different conclusions about how much information was appropriate. Most of the crowdfunding disclosures, particularly the more thorough ones, emphasize the risk and lack of regulation over the investments involved. In fact, a disclosure statement such as Maine’s reads more like a warning than a general disclosure. Yet, given the goal of these disclosures and the unfamiliarity with crowdfunding, such warning may be necessary. Prior to crowdfunding exemptions, non-accredited investors had very few opportunities to invest in private securities and even fewer opportunities to do so on online platforms. As the SEC Study Regarding Financial Literacy Among Investors found, “U.S. retail investors lack basic financial literacy,”²¹¹ which indicates that the average crowdfund investor may not be aware of certain risks, such as those associated with minority ownership. As a result, more detailed and informative disclosures, such as Maine’s, and perhaps even more measures might be necessary in crowdfunding issues.

D. Required Investor Certifications

Although all states require that certain disclosures regarding the company and its securities be provided to investors, a few states have taken this a step further to require that investors actively certify an understanding of certain risks or restrictions. These certifications seem to acknowledge that investors do not always read disclosure statements and are apparently intended to be an additional level of investor protection.

Each of the four states with such certifications require an investor to acknowledge, either by manual or electronic signature, that the investor is aware that the investment is risky, that the investor may lose all of his

209. Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U.L.Q. 417, 418 (2003).

210. *Id.* at 431.

211. See U.S. SEC. & EXCH. COMM’N, *supra* note 110, at iii.

investment, and that he can afford to do so.²¹² For example, Washington's exemption has a relatively simple investor certification which requires that all investors certify the following statement: "I acknowledge that I am investing in a high-risk, speculative business venture, that I may lose all of my investment, and that I can afford the loss of my investment."²¹³ Oregon's certification includes language similar to this, but also adds language whereby the investor affirmatively represents she is a state resident and understands that the offering "has not been reviewed by the State, and no authority has expressed an opinion on the merits or accuracy of this offering."²¹⁴

Indiana and Wisconsin have identical investor certifications, which are more thorough than the previous two. In addition to the acknowledgment of risk and lack of review by regulators, these certifications also state that the purchased securities are illiquid, with no ready market and therefore it may be difficult or impossible to sell or otherwise dispose of them and, accordingly, the investor "may be required to hold this investment indefinitely."²¹⁵ The certification also notes the potential for tax liability as a result of the purchase.²¹⁶

Most of the information contained in these certifications is also contained in the required disclosures to investors, but by separating certain pieces of information into a format requiring certification, these states seem to indicate that certain disclosures are even more important. It is not clear that signatures, particularly those done electronically, will guarantee that investors read the information in the certifications, but it does seem the chances of investors reading them are increased (as compared to general disclosures). Further, any additional cost or time that such certifications add to a transaction is likely small.

E. Problems with Current Exemptions

Although crowdfunding has the potential to provide a valuable new source of funding to companies, the existing state exemptions fail to fully utilize crowdfunding's potential in a way that sufficiently protects non-accredited investors. Each state's exemption has its merits, but

212. IND. CODE § 23-19-2-2(27)(I) (2015); OR. ADMIN. R. 441-035-0120(4) (updated as of Feb. 15, 2016), http://arcweb.sos.state.or.us/pages/rules/oars_400/oar_441/441_035.html [<https://perma.cc/K5ET-RJJH>]; WASH. REV. CODE § 21.20.880(1)(h) (2014); WIS. STAT. § 551.202 (26)(i) (2013–2014).

213. WASH. REV. CODE § 21.20.880(1)(h).

214. OR. ADMIN. R. 441-035-0120(4).

215. IND. CODE § 23-19-2-2(27)(I); WIS. STAT. § 551.202 (26)(i).

216. IND. CODE § 23-19-2-2(27)(I); WIS. STAT. § 551.202 (26)(i).

generally, the state exemptions leave room for improvement. In particular, the annual investment limit per investor, the maximum capital raise for companies, and the required disclosures and certifications each present challenges to companies and investors seeking to participate in crowdfunding. In addition to these already discussed categories, there are several other problems that should also be addressed regarding anti-fraud and enforcement in online crowdfunding.

i. Annual Investment Limit Per Investor

The annual limit on how much an investor can contribute to a single company's capital raise appears to be a useful restriction in minimizing the investor's risk exposure. However, there are two significant problems with these restrictions in most states which, considered together, indicate that there is a more efficient way to limit investors' risk exposure. First, the annual investment limits are extremely low in many states, making it difficult for small companies to effectively take advantage of the exemptions. Second, despite these extremely low limits, the restrictions nevertheless fail to provide adequate investor protection.

The annual limits per investor, as previously noted, range between one hundred and ten thousand dollars annually.²¹⁷ These limits undoubtedly restrict the total loss that a non-accredited investor can sustain from one investment, at least on an annual basis. However, they also place significant burdens on companies seeking to raise large amounts through a crowdfunding exemption, particularly in states where the investor limit is around two thousand dollars or less. The lower the investment limit, the more investors that a company must convince to invest in order to raise the same amount of money. Based on the target number of investors for most states, companies theoretically have to get hundreds of investors to contribute in order to raise substantial money.²¹⁸ Reaching out to hundreds of investors individually is time-consuming and has costs, but the same is true even in states that permit general solicitation.

In Oregon, for example, a company or crowdfunding platform may engage in general advertising or solicitation, so long as the advertisements are provided to regulators in advance and only contain certain information, and each person viewing the advertisement "affirmatively certif[ies] that they are an Oregon resident" prior to viewing the materials.²¹⁹ Some of these obstacles can be easily resolved: many state funding portals require

217. *See supra* notes 158–66 and accompanying text.

218. *See supra* note 197 and accompanying text.

219. OR. ADMIN. R. 441-035-0130(1)–(2) (updated as of Feb. 15, 2016), http://arcweb.sos.state.or.us/pages/rules/oars_400/oar_441/441_035.html [<https://perma.cc/K5ET-RJJH>].

residence certification before entering the site.²²⁰ Nevertheless, there are still costs associated with such advertising and solicitation. Companies cannot simply rely on the internet or a crowdfunding platform to attract investors for them either, as many state exemptions provide that an internet site cannot solicit purchases, sales, or offers to buy the securities if not registered as a broker-dealer²²¹—an expensive process that new crowdfunding sites may want to avoid.²²² The fact that equity crowdfunding campaigns generally do not average one hundred investors provides additional evidence of the difficulty in obtaining investments.²²³

Further, existing crowdfunding sites typically charge companies to use their portals, a trend likely to continue since most state exemptions permit an online crowdfunding portal to charge for its services.²²⁴ CircleUp, for example, does not charge companies to apply to be listed, but once a company is listed (and able to raise funds), it pays \$500 to establish an escrow account and CircleUp will assess a commission based on a percentage of the total amount raised.²²⁵ Fundable, a site that utilizes equity and reward-based crowdfunding, charges companies \$179 per month (\$2,148 per year) to fundraise,²²⁶ while EarlyShares takes a fee of 10–20% in an equity campaign.²²⁷ With these numbers, companies would have to obtain numerous contributions just to cover the costs of listing the campaign on an internet site.

Finally, as previously noted, the investor limits seem arbitrary based on the large range across the states and the general failure to consider an investor's income level. Most states do not distinguish among investors' income beyond the accredited and non-accredited threshold, although there is clearly a difference in the effect that an equal contribution has on investors with different incomes.

220. See, e.g., TRUCROWD TEX., <https://texas.trucrowd.com/> [<https://perma.cc/S2MV-XU7N>] (last visited May 17, 2016).

221. See, e.g., WIS. STAT. § 551.205(1)(b)(2) (2013–2014).

222. Darke, *supra* note 133.

223. Tordera, *supra* note 199.

224. See, e.g., WIS. STAT. § 551.205(1)(b)(2)(e) (providing that the internet site operator charges “a fixed amount for each offering, a variable amount based on the length of time that the securities are offered on the Internet site, or a combination of such fixed and variable amounts”).

225. *Frequently Asked Questions from Entrepreneurs*, *supra* note 88.

226. *Pricing and Fees*, FUNDABLE, <https://www.fundable.com/faq/pricing-and-fees> [perma.cc/DLX2-B2NZ] (last visited May 17, 2016).

227. *Early Shares Review*, BEST CROWDFUNDING WEBSITES, <http://best-crowdfunding-websites.com/review/earlyshares/> [[http://perma.cc/655K-B6ZY](https://perma.cc/655K-B6ZY)] (last visited May 17, 2016).

Considering all of these problems and the general obstacles that crowdfunding companies likely face in obtaining funding, this Article suggests increasing the annual investment limit per company to a specified percentage of an investor's annual income, or at least raising the investor limit in all states to a minimum of five thousand dollars.

With investment limits as low as they currently are, it seems investors would be adequately, if not overly, protected from excessive losses in crowdfunding campaigns. But, even in states with extremely low annual investment limits (such as Maryland's \$100 limit), it does not appear this is the case. While the annual limit will limit the amount that an investor can lose in a single company, it fails to protect investors from sustaining great losses from several companies even if effectively enforced. None of the examined exemptions limit the amount that an investor can aggregate invest across multiple crowdfunding raises, therefore, an investor could invest the maximum annual amount in several companies. The Texas State Securities Board recognized this problem and warned investors against it: "An issuer can't accept more than \$5,000 from a non-accredited investor Investors enticed by the new opportunity to invest in startups could, however, seriously dent their bank accounts by putting \$5,000 each into a number of offerings."²²⁸ And, in a state like Maryland, where the investor limit was undoubtedly made very low for the purpose of investor protection, it is even easier for an investor to contribute the maximum amount to multiple companies.

There are a number of reasons why legislators may not have included such an aggregate investment maximum in their statutes. Logistically, regulating the number of companies that a single investor can purchase from would be difficult and it is not clear who would have the burden of tracking this information. Further, the act of monitoring individuals' investment decisions is likely an unpopular one, as it involves monitoring how private individuals spend their money. Finally, legislators may have thought such a limit was unnecessary. Because companies that cannot obtain traditional institutional financing typically obtain funding from friends and family,²²⁹ the same may be true in the crowdfunding context. Despite the ability to purchase from numerous and distant companies through online crowdfunding, investors may decline to invest in companies that they do not have a personal connection with and, as a result, most investors will only purchase from a limited number of companies.

228. *Information for Investors: Crowd Wisdom or "The Madness of the Crowds"?*, TEX. ST. SEC. BOARD, <https://www.ssb.texas.gov/texas-securities-act-board-rules/texas-intrastate-crowdfunding/information-investors> [<https://perma.cc/T8K8-Z355>] (last updated Apr. 19, 2016).

229. See Entis, *supra* note 77.

However, even if this logic proves to be true, relying on it does not seem like an adequate investor protection, as it essentially relies on the unpopularity of an exemption to serve as its regulation.

If state regulators need to warn investors against over-investing in crowdfunding campaigns, a more effective method of preventing this problem would be to simply impose an aggregate investment limit on non-accredited investors' annual contributions to crowdfunding campaigns. This could be accomplished by either imposing a maximum number of crowdfunding campaigns to which a single investor may contribute or imposing an aggregate dollar limit on an investor's annual crowdfunding contributions. Both of these alternatives, discussed below, could work in conjunction with an increased annual investor limit per company.

In sum, the investor limits create serious obstacles for companies utilizing a crowdfunding exemption, but provide limited benefit in investor protection.

ii. Annual Maximum Capital Raise

The annual maximum capital raise for companies ranges from \$100,000 to \$5,000,000 across the states. Considering that existing crowdfunding campaigns involving accredited investors do not generally raise amounts approaching \$5,000,000,²³⁰ this particular limit appears to be high enough to not actually serve as a restriction on most companies. However, the difficulty in discerning what is a reasonable annual maximum capital raise indicates a problem with the current limits: one size does not in fact fit all companies. Not only do different industries require different financing needs, but even companies within similar industries present different amounts of funding based on their specific goals and needs. And companies at different business phases will likely have different funding needs.

Even considering these differences, the maximum capital raises in some states are so low that it is not clear which companies would actually have significant funding needs met by the exemption. The crowdfunding exemption is intended to be less expensive than traditional registration, but there are still costs involved. If a company can only raise a few hundred thousand dollars, yet still has to endure the same costs—including things such as filing notice, providing disclosures, paying funding portals and other advertising fees, etc.—it is not clear that claiming the exemption is even worth the effort. The company may instead choose to claim a

230. Kolodny, *supra* note 198 (“The average company on CircleUp raises close to \$1 million.”).

different exemption with higher capital-raising limits or, if possible, relocate to another state with more flexible exemptions.²³¹

Imposing different limits based on a company's industry or specific needs would be nearly impossible to implement logistically and some states likely consider lower limits a necessary element to prevent or minimize fraud. To address these concerns while still tailoring the maximum raise to better fit companies' needs, states could alter the maximum capital raise amount depending on the financial information and disclosures provided to investors. Effectively doing so would also require improving existing disclosure requirements.

iii. Disclosures

Currently, the required state disclosures to investors range from containing merely the information required by federal law to remain exempt, to more detailed warnings about illiquidity and minority ownership. Crowdfunding is new territory for both companies and investors, and thus it seems that more disclosure is better for a number of reasons. First, the lack of financial literacy among retail investors²³² indicates that many of the problems unique to small, private companies may also be unfamiliar. Because all investments contain some level of risk, investors may not appreciate the increased risk unique to small businesses and start-up companies. Second, the ability to invest in crowdfunding campaigns online enables investors to quickly make purchases without consulting others. Because investors may not take the time to consult others or do independent research, it is important that sufficient information is readily available at the time of investment.

Disclosures that only provide information about resale restrictions and lack of registration do not seem sufficient to help unsophisticated investors make informed decisions. Investors may not be fully aware of what this information means or may not appreciate the significance of it without further context. For example, these disclosures indicate that securities may be transferable at some point in the future, but fail to warn that even if transfer is legally possible, there may never be a market for such securities. In order to provide full information to investors, states should adopt disclosure requirements that include information not only about the risks of the investment, but also the illiquid nature of the securities, specific risks

231. Changing states, under most exemptions, would require changing the state of incorporation and principal place of business, so would really only make sense if the company were confident it could raise enough money to offset all of these costs.

232. See U.S. SEC. & EXCH. COMM'N, *supra* note 110, at iii.

regarding that company, and other information regarding investments in small, private companies.

In addition to the substantive problems with the disclosures, the state exemptions also generally do not address the delivery or format of disclosures, beyond indicating that the information should be provided prior to the purchase of securities.²³³ However, the delivery of disclosures is always important, and this is especially true as the amount of information provided increases.²³⁴ For example, the SEC found that investors generally favor “layered” disclosure, whereby “key information is sent or given to the investor and more detailed information is provided online and, upon request, is sent in paper or by e-mail.”²³⁵ This form of disclosure enables investors to choose the type and amount of information they wish to review, as well as the format (online or hardcopy, etc.) in which they view it.²³⁶ If states increase the amount of information provided to investors, they should likewise implement requirements governing the format and delivery of such disclosures in order to ensure that they are both read and understood.

iv. Certifications

Currently, only four states require investors to make a certification of their understanding of the investment and disclosures. When investors are able to make purchases online, there is no way to ensure that disclosures are read or investments are fully understood. However, most of the state exemptions do not impose any requirements to even try to increase the likelihood of disclosures being read. Regulators can never guarantee that all disclosures will be read and understood, but requiring certification seems like a simple way to increase the likelihood. Even with the brief disclosures that most states currently require, certifications would be helpful, but if states improve their disclosures to include more detailed information, certifications will be even more important.

The states that currently require investor certifications can also improve. These exemptions provide little guidance on the delivery or

233. Maine, for example, provides that the disclosure shall be provided to investors and potential investors. ME. REV. STAT. ANN. tit. 32, § 16304.6-A(E) (2015).

234. U.S. SEC. & EXCH. COMM’N, *supra* note 110, at ii–iv (finding that investors prefer clear, concise, and understandable language, and “wherever possible, the use of a summary document containing key information about an investment product or service”).

235. *Id.* at iv n.4 (quoting U.S. SEC. & EXCH. COMM’N, ENHANCED DISCLOSURE AND NEW PROSPECTUS DELIVERY OPTION FOR REGISTERED OPEN-END MANAGEMENT INVESTMENT COMPANIES 60–61 (Jan. 13, 2009), <https://www.sec.gov/rules/final/2009/33-8998.pdf> [<https://perma.cc/FK78-DMSB>]).

236. *Id.*

format of such certifications. When transactions are completed exclusively online, certifications could feasibly be completed through single clicks (such as “I Accept” buttons). Because issuers and funding portals both have an incentive to encourage more investing, there is reason to make certifications inconspicuous and easy to accept. States should impose more specific requirements about the format of certifications, perhaps by requiring investors to type signatures or whole certifications, or by banning simple one-click certifications.

v. *Other Problems*

In addition to these problems, the state exemptions also fail to address the concerns of fraud and the lack of securities law enforcement in crowdfunding. This is particularly problematic since many of the state exemptions explicitly reference securities sales via the internet, a medium with an increased risk of fraud and inadequate enforcement. While many states passed statutory provisions or rules regulating the online platforms, the exemptions generally fail to regulate issuers in the online context.

Apart from the notice requirements to state regulators, there is little evidence of screening by the state prior to a company beginning its crowdfunding campaign. Even with the notice requirement, it is not clear how much screening state regulators could do since many exemptions simply require that the notice be filed sometime before the offering begins²³⁷ and others only require that it be ten days before²³⁸—leaving very little time for regulators to extensively review the company before it begins accepting money. In order to help prevent fraud, states can provide more time for regulatory screening of companies prior to the offering and can also mandate that funding portals have some responsibility for the companies they list by requiring pre-listing screening.

Related to these concerns of fraud, the state exemptions also fail to address the concerns regarding a lack of enforcement when laws are broken in crowdfunding campaigns. Because individual investors may have very little money at stake and, in some states, the aggregate amount invested may also be very small, there are concerns that wrongdoing will go unchecked by both investors and regulators. This problem may be mitigated to some extent if investors are able to invest more money, but allowing investors to lose more money is not a solution to the enforcement problem.

Again, more regulation is likely the best solution to this problem, but state entities can also pass some of this responsibility to funding platforms.

237. See, e.g., TENN. CODE ANN. § 48-1-103(a)(13)(A)(v) (2012).

238. See, e.g., MICH. COMP. LAWS § 451.2202(y)(ii) (Supp. 2015).

States can require funding platforms to regularly monitor the companies they list and also hold them financially responsible for certain actions that occur on their platforms.

VI. SUGGESTED CHANGES

Based on the specific problems pointed out in the previous Part, this Part suggests specific changes to help improve the state exemptions.

A. Raise the Investor Limit Per Company and Impose an Aggregate Limit

Most states fail to distinguish among investors with income levels below \$200,000, although these investors are undoubtedly in different financial situations. The state exemptions should alter the investor limits per company to more accurately reflect income levels. States could adopt provisions like that in Massachusetts, which distinguishes investment size based on whether income is above or below \$100,000.²³⁹ Or, states could impose a flat percentage applicable to all non-accredited investors, such as 5% of annual income. Although either change would require additional regulation in order to confirm income levels, such certifications are already required when distinguishing between accredited and non-accredited investors. The burden could be on investors and funding platforms to certify that non-accredited investors have the appropriate income level for the investments they wish to make. However, because income levels can change from year to year, such regulation and certification may be simpler if the Massachusetts approach is taken. This way, investors need only certify that they meet one of a few income thresholds, rather than states requiring a determination of an investor's exact income every year. By imposing requirements like that in Massachusetts, states can enable investors to support small businesses while still limiting losses attributable to a single company to a reasonable amount.

Then, to better protect investors against numerous unsuccessful crowdfunding campaigns, states could implement an aggregate crowdfunding investment limit. These limits could take one of two forms: (1) they could restrict the aggregate amount that each investor can annually contribute to all crowdfunding campaigns; or alternatively, (2) they could restrict the number of crowdfunding campaigns to which each investor can contribute, regardless of dollar amount.

The first option, limiting each investor's aggregate investment amount, would give investors flexibility in selecting numerous companies to invest in, but would be logistically challenging. States could impose a

239. 950 MASS. CODE REGS. § 14.402(B)(13)(o) (2015).

flat maximum investment amount, as most exemptions currently do in their annual investment limits per company. A state like Tennessee, for example, that limits each investor to contributing \$10,000 to a company annually,²⁴⁰ could impose an aggregate investment limit of \$50,000 per investor. Tennessee investors could then contribute the maximum amount to each of five crowdfunding companies or smaller amounts to numerous companies. However, this solution fails to adequately distinguish among investors who, though all non-accredited, have different financial situations.

Considering these complications, the second alternative, limiting the total number of crowdfunding campaigns to which a single investor can contribute annually, would likely be simpler to administer. Based on the exemption's annual investment limit, states could impose a maximum number of companies in which investors should reasonably be permitted to invest. Funding platforms could be responsible for monitoring this information, which could be easily done by assigning each investor a unique identification number (or using one that already exists, such as social security number). Since the amount that an investor can contribute to a single company would depend on income level, using the same number of campaigns for all investors would still have the result of distinguishing individuals based on income.

B. Alter Maximum Capital Raise Based on Disclosures

Crowdfunding exemptions could also be made more effective by altering the annual maximum capital raise based on the financial disclosures provided by a company. Indiana, Massachusetts, and Wisconsin already have such provisions and allow companies to raise up to \$2,000,000 if audited financial statements are provided, and \$1,000,000 if not.²⁴¹ Such a change more accurately reflects the fact that, although disclosure is a critical part of preventing fraud, companies have different needs and goals. By distinguishing companies based on their provided disclosures, companies are able to raise additional capital at the cost of more disclosure, while companies that do not need as substantial funding can avoid such costs. The exact dollar limits and level of disclosure may vary by state, depending on the investor limit, state economy size, and type of companies expected to utilize the exemption.

240. TENN. CODE ANN. § 48-1-103(a)(13)(A)(iii) (\$10,000 is the limit for non-accredited investors).

241. IND. CODE § 23-19-2-2(27) (2015); MASS. CODE REGS. § 14.402(B)(13)(o)(4) (B)(2015); WIS. STAT. § 551.202 (2013–2014).

Regulating crowdfunding capital raises in this way may seem restrictive, considering most federal exemptions do not impose such requirements. But, since a crowdfunding offering can only reach residents of that company's state, the total amount that could be raised would likely be less than that of a federally exempt company, making smaller limits more appropriate. More importantly, because fraud is a major concern in the crowdfunding context,²⁴² it is reasonable to impose more stringent disclosure requirements in order to limit the opportunity for fraud.

C. Improve Disclosures and Require Certifications in Coherent Manner

The exemptions should also be improved by requiring investor certifications and altering disclosures so that, together, the certifications and disclosures provide informative and understandable information to investors. Improving these elements requires changes to both the substance and form of the existing disclosures and certifications.

The SEC found that, “with respect to investment product disclosures, investors favor summary documents containing key information about the investment product,”²⁴³ which makes sense, as this provides investors the opportunity to easily read important material, then seek additional information for those aspects that are not understood or seem more important. By requiring both certifications and disclosures, states can force companies to provide information in this investor-friendly manner: the certifications can contain key information in a summary format (since the signature requirement makes them more likely to be read), with the full disclosures including the necessary detail.

As the summary information and material more likely to be read, it is important that certifications contain the information that is most critical and least likely to be known by an investor. In addition to stating that the securities are not registered, certifications should require investors to acknowledge that they are investing in a high risk offering, that they may lose their investment, and can afford to do so—language frequently included in the existing disclosures. The resale restrictions should also be included, but in a more meaningful way than currently done. The exemptions generally state that the securities are not registered and cannot be resold unless they become registered or fit under another exemption.²⁴⁴ While helpful, this language neglects to inform investors that, even if the securities become registered or remain exempt, selling them may not be an option. Language such as that in the Wisconsin statute, emphasizing that

242. See *supra* notes 96–101 and accompanying text.

243. U.S. SEC. & EXCH. COMM'N, *supra* note 110, at iv.

244. See, e.g., ALA. CODE § 8-6-11(a)(14)(j) (Supp. 2015).

an investor “may be required to hold this investment indefinitely” is instructive.²⁴⁵ This information can easily be incorporated into a certification that is still concise and easy to understand, such as:

I acknowledge that these securities are subject to the restrictions on transferability and resale. I understand that even if these securities are no longer subject to these restrictions, there may be no ready market for the securities and I may still be unable to sell or transfer them. Therefore, I may have to bear the financial risks of this investment for an indefinite period of time.

A certification may also be used to signal investors to other information contained in the disclosures, serving its function as a summary of the full disclosure. For example, when financial statements are required within the disclosure materials, a certification could simply state, “I have reviewed and understand the attached financial statements.”

By separating the certifications and disclosures, there is an added emphasis on investor certifications, making it even more important to ensure that investors read them. At the extreme end, states could require investors to write or type the certifications, rather than simply sign a page on which they are already typed. A middle approach would be to require individual signatures for each statement or section of a certification, which would ideally encourage investors to read each section. At a minimum, states should also clarify that investors must be required to at least type his or her name, effectively banning one-click acceptances of certifications.

This increased emphasis on certifications also makes it tempting to be over-inclusive in the disclosure requirements, since investors will essentially be given a guide of the most important information to help them through the disclosures. However, overwhelmingly large disclosures will reduce both the certifications’ and disclosures’ utility. Instead, the disclosures should maintain a focus on the most important information, building off that included in existing exemptions’ disclosures. The SEC found that retail investors find information about fees and expenses, investment performance, principal risks, and investment objectives useful and relevant prior to purchasing an investment product.²⁴⁶ While many companies utilizing the crowdfunding exemption may not have investment performance information to provide, the other pieces of information could and should be included in disclosures. Further, the disclosures should include information tailored to a crowdfunding issue, rather than just language common to all registration-exempt securities.

245. WIS. STAT. § 551.202(26)(i) (2013–2014).

246. U.S. SEC. & EXCH. COMM’N, *supra* note 110, at iv.

Maine's required disclosure largely achieves this, requiring information such as the issuer's business plan and intended use of the offering proceeds, a description of the financial condition of the issuer, the target offering amount and deadline to reach it, and a description of the ownership and capital structure of the issuer.²⁴⁷ Maine's disclosure also requires information about the risks of minority ownership and "risks associated with corporate actions," both of which seem relevant to crowdfunding issuers that may be startups or other companies that may eventually be acquired by other companies.²⁴⁸ In addition to this information, the disclosure could provide information about the fees charged by any brokers or online funding portals being used. This Article suggests adopting disclosure requirements including these elements, with the required financial disclosures depending on those mandated by the annual maximum capital raise provisions.

As more substance is added to disclosures, states also need to impose requirements to ensure that this additional information is presented in a form that investors readily understand. Disclosures should be made compatible with the certifications, providing the information referenced in the certifications in a logical order. In sum, states should redesign required disclosures to create a coherent system whereby certifications and disclosures function together to make an understandable information system that requires investor signatures.

D. Other Recommended Changes

While many of the above changes are designed to help protect investors in crowdfunding, even the most informed investors can be victims of securities fraud. States need to either implement new anti-fraud provisions or tailor existing ones to better protect investors online. Beyond reading the disclosures and performing adequate research prior to an investment, it is not clear if there is much else that states can expect of investors to protect themselves from fraud. Thus, additional anti-fraud measures may be the responsibility of regulators. One alternative is to mandate that regulators provide more detailed screenings of companies before an offering begins. To avoid such screening becoming a new form of registration, it could be limited to the information and disclosures provided to investors. Exemptions could require that prior to an offering beginning, all information to be provided to investors be submitted to state regulators, taking the place of the existing notice requirement. Such information would need to be submitted early enough for the securities

247. ME. REV. STAT. ANN. tit. 32, § 16304.6-A.E (2015).

248. *Id.* § 16304.6-A.E(9)(e).

commission to review the materials, with the exact period of time depending on that state's regulators and resources. Regulators are in a better position to identify potential issues in a company or its owners and also have the ability to request more information from them if necessary.

Alternatively or additionally, regulators can pass some of this responsibility for screening onto the crowdfunding platforms. A number of crowdfunding platforms currently require companies to apply to be listed.²⁴⁹ Platforms have an incentive to select legitimate, more promising companies so that the platform can earn money off the campaign. This incentive would help to remove questionable companies or owners from the crowdfunding market. Obviously, placing such reliance on the platforms requires that they too be adequately regulated and do not become vehicles for fraud.

When these measures are not enough, effective enforcement of securities laws will be necessary. Again, states do not want to subject companies to extensive ongoing reporting requirements, effectively making exemption-status meaningless. However, through appropriate regulation of platforms, states can obtain reliable information to help facilitate ongoing monitoring. Platforms can be required to regularly examine their listed campaigns and companies and report either all or suspicious activity to regulators. If applicable, platforms can also be required to ensure that a company does not access investor funds until the target offering amount is reached. Investors who contributed to companies with unsuccessful campaigns will then be guaranteed to have their entire investment returned to them. Likewise, withholding funds until the campaign is complete provides investors, platforms, and regulators with more time to receive information about companies before investor funds are spent. States should also require platforms to communicate with investors, either through a post-investment review process or survey. This way, investors will be in a better position to report questionable or fraudulent activity, even if they decline to take legal action.

States could also impose financial liability on crowdfunding platforms that, whether knowingly or not, allow fraud to occur through their listings. However, because states do not want to discourage the creation of funding platforms or encourage a platform to cover fraud it discovers, such penalties would need to be low—perhaps the fees collected off that fraudulent campaign.

249. See, e.g., *Frequently Asked Questions from Entrepreneurs: How Do I List My Company on CircleUp?*, CIRCLEUP, <https://circleup.com/entrepreneur-education/faq/#faq117> [<https://perma.cc/K943-3AJ9>] (last visited May 17, 2016) (explaining the application process).

CONCLUSION

The enactment of numerous crowdfunding exemptions in a relatively short time shows the enthusiasm that lawmakers have for crowdfunding; however, these quick enactments have also limited the opportunities for lawmakers to compare exemptions and learn what types of requirements make crowdfunding most successful for companies and investors. The above examination of these exemptions demonstrates that many of them can be improved by adopting effective provisions seen in others. These suggestions are intended to improve existing crowdfunding exemptions in a way that helps to achieve the goals that led to their enactment: investor protection and small businesses growth.