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Inside Equity-Based Crowdfunding: Online Financing Alternatives for Small Businesses

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INSIDE EQUITY-BASED CROWDFUNDING: ONLINE FINANCING
ALTERNATIVES FOR SMALL BUSINESSES

MICHAEL VIGNONE

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INTRODUCTION

The investment guru Benjamin Graham once wrote “[t]he underlying principles of sound investment should not alter from decade to decade, but the application of these principles must be adapted to significant changes in the financial mechanisms and climate.”¹ Equity-based crowdfunding combines virtual technologies with traditional investing principles. Crowdfunding is “[t]he practice of funding a project or venture by raising many small amounts of money from a large number of people, typically via the Internet.”² Equity-based crowdfunding is a financing method for startups and small businesses to raise small amounts of capital from a “crowd” of investors.³ Small businesses can raise capital, advertise a service or product, and receive feedback from crowds of investors in exchange for ownership equity in their business.⁴ Unfortunately, crowdfunding activity in the United States has remained limited. This reluctance is attributed to delays in regulations, unclear guidance, and underdeveloped studies on crowdfunding.

Recently adopted crowdfunding regulations have generated controversies about the potential of crowdfunding and the risks caused by the deregulation of investor protections.⁵ Proponents are confident that this new form of investing will promote growth in small businesses, create jobs, and alleviate risk in business expansion by raising capital outside of friends and family.⁶ Conversely, opponents urging for

1. BENJAMIN GRAHAM, *THE INTELLIGENT INVESTOR* 4 (Jason Zweig ed., 4th ed. HarperCollins 2003) (1949).

2. *Crowdfunding*, OXFORDDICTIONARIES.COM, http://www.oxforddictionaries.com/us/definition/american_english/crowdfunding (last visited Feb. 08, 2015).

3. See John S. Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 585 (2013).

4. *Id.* at 587–90; Roger J. Magnuson, *Another Capital Raising Technique: Crowdfunding*, in *SHAREHOLDER LITIGATION* § 7:6 (vol. 2 2015).

5. Jumpstart Our Business Startups (“JOBS”) Act, Pub. L. No. 112-106, 126 Stat. 306, § 302 (2012) (codified at 15 U.S.C. § 77(d) (adding section 4(a)(6) of the Securities Act of 1933); Rules for Crowdfunding Regulation, Securities Act Release No. 9974, 80 Fed. Reg. 71,387 (Oct. 30, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240 and 249) (adopting rules to implement Title III of the JOBS Act); see Hon. Janice D. Schakowsky, Ill. Rep., In Opposition of H.R. 3606—The Jumpstart Our Business Startups Act (Mar. 21, 2012), in 158 CONG. REC. E407-02 (daily ed. Mar. 21, 2013) (opposing the JOBS Act stating its goal of increasing access to capital is admirable but loosens necessary protections to investors by leaving unsophisticated investors vulnerable to mass solicitations without providing sound financial information); *but see generally* Jonathan Medved, *An SEC Rule Change Opens a New Era for Crowdfunding*, WALL ST. J. (Oct. 9, 2013, 7:55 PM), <http://www.wsj.com/articles/SB10001424052702303722604579111852526014742> (discussing the great opportunities the JOBS Act will provide to entrepreneurs).

6. See *generally* Jumpstart Our Business Startups Act §§ 301–305; Magnuson, *supra* note 4.

strict regulations argue that crowdfunding's deregulation of securities laws will lead to fraud and may influence vulnerable uninformed investors to purchase dangerous investments.⁷

Crowdfunding is still a fairly new concept in the securities industry and its legal use was extremely limited until recently.⁸ Since equity-based crowdfunding involves the offering of stock or ownership in a company, the securities laws are triggered.⁹ Generally, any offer or sale of a security must be registered with the United States Securities and Exchange Commission ("SEC"), unless the security is exempted from registration ("unregistered" or "non-public" security).¹⁰ The four crowdfunding-related securities exemptions are: 1) intrastate crowdfunding,¹¹ 2) accredited crowdfunding,¹² 3) Regulation A+,¹³ and 4) Regulation CF.¹⁴ Prior to September 2013, small businesses could not solicit to strangers or investors without any preexisting relationships except for certain offerings exclusively made within a state.¹⁵ The 2013 repeal of the ban on general solicitation removed a provision which previously barred issuers from soliciting investors nationwide for the purchase of non-public securities but only legalized such solicitation to "accredited investors" or investors with a threshold net worth or annual income.¹⁶

7. John Tozzi, *Crowdfunding's on Hold. So Is Crowdfunding Fraud*. BLOOMBERG BUS. (Apr. 4, 2013), <http://www.businessweek.com/articles/2013-04-04/crowdfundings-on-hold-dot-so-is-crowdfunding-fraud>.

8. Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493, 501 (2014).

9. Securities Act of 1933, 15 U.S.C. § 77(e) (1933); see 15 U.S.C. § 77(b)(a)(1) (definition of a "security").

10. See 15 U.S.C. § 77(e).

11. See 15 U.S.C. § 77(c)(a)(11) (exempting "[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory."). For intrastate crowdfunding legislation see e.g., ALA. CODE § 8-6-11 (2014), COLO. REV. STAT. ANN. § 11-51-304 (West 2014), and GA. COMP. R. & REGS. 590-4-2-.08 (2011).

12. See 15 U.S.C. § 77(d)(b); Exemption for Limited Offers and Sales Without Regard to Dollar Amount of Offering, 17 C.F.R. § 230.506(c) (2013); Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771-01 (adopted July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239, and 242).

13. 15 U.S.C. § 77(c)(b); 17 C.F.R. § 230.251; Amendments for Small and Additional Issues Exemption Under the Securities Act (Regulation A+), 80 Fed. Reg. 21,806 (Apr. 20, 2015) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 240, 249, and 260).

14. 15 U.S.C. § 77(d)(a)(6); Crowdfunding (Regulation CF), 80 Fed. Reg. 71,388, 71,389 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, et al.).

15. See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771-01 (July 24, 2013) (amending 17 C.F.R. § 506(c) to permit general solicitation under 506(c) offering); 15 U.S.C. § 77(c)(a)(11).

16. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. at 44,771-01. Rule 501(a) of Regulation D provides

Equity-based crowdfunding will not replace traditional financing methods, but allows entrepreneurs and small businesses the opportunity to access capital markets traditionally reserved for the proven companies or the “well connected.”¹⁷ The \$482.5 million raised under accredited crowdfunding since September 2013¹⁸ is miniscule in comparison to the \$898 billion raised under Regulation D offerings (the most commonly used private securities offering exemption) in 2012.¹⁹ Before 2015, equity-based crowdfunding was reserved to a fractional amount of investors or offerings kept within a state.²⁰ In 2014, only thirty-five percent of executives at smaller middle-market companies reported being familiar with the Jumpstart Our Business Startups Act (“JOBS Act”), a statute intended to improve small business access to capital markets.²¹ Three and one-half years after enacting the JOBS Act, small businesses may finally raise capital from both unaccredited and accredited investors through online solicitation.²²

This Note examines the applicability and limitations of intrastate crowdfunding, accredited crowdfunding, and the recently adopted un-

several categories of accredited investors: individuals with a net worth or joint net worth with spouse more than \$1 million excluding primary residence, any natural person with over \$200,000 annual income for the last two years and reasonably believes he will have in the next year, or joint annual income with spouse of \$300,000 for the last two years and reasonably expects to make in the next year, institutional investors (U.S. banks, registered broker-dealers, registered investment companies, insurance companies, etc.), business development companies, small business investment companies, private business development companies, etc. 17 C.F.R. § 230.501(a).

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

18. *Crowdnetic's Quarterly Private Companies Publicly Raising Data Analysis*, CROWDNETIC (2015), https://www.crowdwatch.co/hosted/www/download-report?report_month=jan_2015 (capturing data of 5,122 crowdfunded offerings from September 2013 to December 2014).

19. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. at 44,788; see VLADIMIR IVANOV & SCOTT BAUGUCESS, U.S. SEC. & EXCH. COMM'N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009-2012, 11 (2013) [hereinafter IVANOV & BAUGUCESS 2013 STUDY].

20. The recent adoption of Regulation CF and Regulation A+, both in 2015, permits unaccredited investors to crowdfund nationwide. See Amendments for Small and Additional Issues Exemption Under the Securities Act (Regulation A), 80 Fed. Reg. 21,806 (Apr. 20, 2015) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 240, 249, and 260) (Regulation A+); Crowdfunding, 80 Fed. Reg. 71,388, 71,387 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232 et al.) (Regulation CF).

21. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012); COHN REZNICK, MIDDLE MARKET PULSE: LIQUIDITY AND CAPITAL FORMATION SURVEY 1, 8 (2014), http://www.cohnreznick.com/sites/default/files/images/emails/content/news/MM_SurveyRPT_Final.pdf.

22. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 201, 302, 401, 126 Stat. 306 (codified as amended in 15 U.S.C. § 77 (2012)); 15 U.S.C. § 77(d)(a)(6) (adopted in Rules for Regulation Crowdfunding, Securities Act Release No. 9974, 80 Fed. Reg. at 71,389); 15 U.S.C. § 77(c)(b); 17 C.F.R. § 230.251 (adopted in Amendments for Small and Additional Issues Exemption Under the Securities Act, 80 Fed. Reg. at 21,806).

accredited crowdfunding under Regulation A+ and Regulation CF. Part I discusses the traditional financing options and gaps in the capital markets for startups and small businesses. Part II discusses the current state of crowdfunding regulations including their legality and applicability, and provides a cost-benefit analysis for each regulation. Part III explores crowdfunding's vulnerability to securities fraud, the growth of the crowdfunding industry, and a forecast based on the various factors visited in Part I through Part II.

I. CROWDFUNDING OVERVIEW: TRADITIONAL BARRIERS TO CAPITAL FOR SMALL BUSINESSES

Crowdfunding is intended to provide small businesses with better access to capital than what is available using traditional financing methods. Access to capital is a vital component to a small business's success. Small businesses primarily seek financing to start a business, purchase inventory, expand, or strengthen current operations.²³ In 2012, fifty-seven percent of surveyed small business owners were unable to find a lender in the previous four years, which prevented more than half of these businesses from expanding their operations.²⁴ Instead of resorting to debt financing, the most common financing method for small businesses, a company may raise capital by selling its shares to investors who in return receive an ownership stake in the company.²⁵

Out of the 5.7 million U.S. firms in 2010, 99.6 percent were privately held.²⁶ These private companies provided over fifty percent of the U.S. gross domestic product ("GDP") and sixty-five percent of new U.S. job creation in 2014.²⁷ Several factors influence a small privately held business's struggle to raise capital: investor hesitation caused by the lack of publicly available information on the business, the high risk of business failure, and regulatory burdens of going public.²⁸ Raising capital through an initial public offering ("IPO") or by publicly listing a

23. See SBA OFFICE OF ADVOCACY, SMALL BUSINESS FINANCE: FREQUENTLY ASKED QUESTIONS (2014), https://www.sba.gov/sites/default/files/2014_Finance_FAQ.pdf.

24. See NAT'L SMALL BUS. ASS'N, SMALL BUSINESS ACCESS TO CAPITAL SURVEY (2012), <http://www.nsba.biz/wp-content/uploads/2012/07/Access-to-Capital-Survey.pdf>.

25. *Id.*

26. John Asker et al., *Corporate Investment and Stock Market Listing: A Puzzle?*, REV. FIN. STUD. 56 (2014).

27. SAGEWORKS, THE PRIVATE COMPANY REPORT (2014), https://www.sageworks.com/pdf/_12302014.pdf.

28. Fisch, *supra* note 17, at 79.

company's securities on a national stock exchange typically provides substantial capital, public relations, liquidity, and other various benefits. However, this option is typically off limits for small businesses and startups. Even larger private companies refuse to "go public" to avoid high costs, disclosure burdens, and vulnerability to various liabilities.²⁹ Furthermore, stock exchanges are selective with their membership and smaller companies typically do not qualify.³⁰ Crowdfunding allows small businesses to avoid these hurdles while still publicly soliciting investors.

Aside from going public, small businesses may sell their unregistered securities in private markets if the securities qualify for an exemption; however, exemptions for unregistered securities come with significant restrictions.³¹ Until recently, issuers could not solicit or advertise exempt securities to investors without a preexisting relationship.³² Smaller sized private offerings are less appealing to broker-dealers and investment bankers who are given meager commissions, which creates another obstacle for raising capital through private placement offerings.³³ Thus, online crowdfunding allows small businesses to access a larger crowd of investors to raise the capital they

29. See 15 U.S.C. § 77(f) (1993) (security registration requirements and costs); IPO TASK FORCE, REBUILDING THE IPO ON-RAMP: PUTTING EMERGING COMPANIES AND THE JOB MARKET BACK ON THE ROAD TO GROWTH 9 (2011), http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf (reporting the average cost of initial IPO regulatory compliance was \$2.5 million and ongoing compliance costing \$1.5 million per year).

30. See Rule 5405(a), *Equity Rules, NASDAQ Stock Market*, NASDAQ (adopted Mar. 12, 2009, as amended Apr. 27, 2009), http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?searched=1&selectednode=chp_1_1_4_3_6_2&CiRestriction=rule+5405&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F (initial listing requirements on NASDAQ Stock Exchange include a minimum bid price of at least \$4 per share, at least 1,100,000 publicly held shares, and additional requirements).

31. The most common Regulation D private placement exemptions have different restrictions. Exemption for Limited Offering and Sales of Securities Not Exceeding \$1,000,000, 17 C.F.R. § 230.504 (2015) (capping offerings at \$1 million for any twelve-month period); Exemption for Limited Offering and Sales of Securities Not Exceeding \$5,000,000, 17 C.F.R. § 230.505 (1982) (capping offerings to \$5 million during any twelve-month period); Exemptions for Limited Offers and Sales Without Regard to Dollar Amount of Offering, 17 C.F.R. § 230.506(b) (2013) (offerings do not have a cap on amount raised but cannot have more than thirty-five unaccredited investors in a twelve-month period); see Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J. L. & Bus. 1, 11 (2007).

32. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201, 126 Stat. 306 (2012) (codified as amended at 15 U.S.C. § 77(d) (2012)) (amending section 4 of the Securities Act of 1933); Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771-01 (July 24, 2013) (adopting rules to implement Title II of the JOBS Act).

33. Cohn & Yadley, *supra* note 31, at 6-11.

need, without the headache of obtaining a loan or the costs of going public.

Crowdfunding commonly refers to the use of a funding portal (“portal”) or website that serves as an online intermediary to connect businesses selling their securities with prospective investors.³⁴ Depending on the crowdfunding exemption employed, an issuer may be prohibited from using a portal unless the portal is registered or associated with a registered broker-dealer.³⁵ A broker is broadly defined as “any person engaged in the business of effecting transactions in securities for the account of others.”³⁶ Similarly, a dealer engages in the business of securities transactions except for their own account in regular business by using a broker or otherwise.³⁷ Thus, both a broker and a dealer must satisfy a two-prong test: (1) engaging in the business of (2) “effecting securities transactions” but differentiate based on whose interest they are acting on behalf of in the transaction.³⁸ Broker-dealers and funding portals must register with the SEC and the Financial Industry Regulatory Authority (“FINRA”), a self-regulatory organization.³⁹

II. CURRENT CROWDFUNDING REGULATIONS

Before deciding which exemption is most appropriate, a business must understand that crowdfunding is more than money. Besides reducing costs for obtaining capital, a business simultaneously receives expansive opportunities to market their product to a new audience

34. See 15 U.S.C. § 78c(80) (defining “funding portal”); Jumpstart Our Business Startups Act § 302(b) (“Nothing in this section or section 4(6) shall be construed as preventing an issuer from raising capital through methods not described under section 4(6).”); see also STARTUPVALLEY, <http://www.startupvalley.com/> (last visited Dec. 30, 2015) (an example of a crowdfunding portal).

35. Intermediaries in 506(c) accredited crowdfunding offerings should consult section 4(b)(1) to determine if they need to register as a broker-dealer. 15 U.S.C. § 77(d)(b)(1). Intrastate portals should check their applicable state securities laws regarding portals.

36. 15 U.S.C. § 78(c)(a)(4)(A).

37. A dealer is defined in section 3(a)(5)(A) of the 1934 Exchange Act as “any person engaged in the business of buying and selling securities” for his own account. 15 U.S.C. § 78(c)(a)(5)(A).

38. See DAVID A. LIPTON, BROKER DEALER REGULATION § 1.5, at 1 (vol. 15 2015). These broad prongs are not determinative but based on several factors such as holding oneself out as a broker, operating mechanisms to execute trades, finding investors for venture capital or angel financing, etc. See *Guide to Broker-Dealer Registration*, U.S. SEC. & EXCH. COMM’N (Apr. 2008), <http://www.sec.gov/divisions/marketreg/bdguide.htm> [hereinafter BD Guide].

39. 15 U.S.C. § 77(d)-1(a). Section 22(a)(1) of the 1934 Act generally makes it unlawful for a broker or dealer to “effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security.” 15 U.S.C. § 78(o)(a)(1).

(the “crowd”).⁴⁰ The collective intelligence from the crowd (“crowd wisdom”) offers relevant industry knowledge and consumer insights that enable businesses to gauge their industry, refine their product, and improve their strategy.⁴¹ Additionally, crowdfunding creates a new industry of portals and an additional revenue stream for broker-dealers and investment advisors. Moreover, investors may seek new business opportunities, create strong professional networks, participate in the ownership of a business, or make a return on their investment.⁴² However, businesses must assess their current needs, budget, and management sophistication before considering crowdfunding. Currently, businesses may crowdfund under the intrastate exemption,⁴³ accredited crowdfunding exemption (General Solicitation),⁴⁴ Regulation A+ exemption,⁴⁵ and Regulation Crowdfunding (“Regulation CF”) exemption.⁴⁶

A. State Level: Intrastate Crowdfunding

Intrastate crowdfunding is the first and oldest type of equity-based crowdfunding with limited state adoption until recently.⁴⁷ Local businesses seeking a cheaper alternative to raising capital may solicit investors online if those investors are state residents and the website restricts access to those residents.⁴⁸ The SEC’s delay in adopting federal rules for Regulation CF prompted several states to adopt intrastate crowdfunding.⁴⁹ While state securities laws must comply with federal

40. Crowdfunding, 80 Fed. Reg. 71,388, 71,388 (Nov. 16, 2015) (effective May 16, 2016) (to be codified at C.F.R. pts. 200, 227, 232 et al.) (“An entity or individual raising funds through crowdfunding typically seeks small individual contributions from a large number of people. Individuals interested in the crowdfunding campaign—members of the ‘crowd’—may share information about the project, cause, idea or business with each other and use the information to decide whether to fund the campaign based on the collective ‘wisdom of the crowd.’”); *see also* Wroldsen, *supra* note 3, at 589–93.

41. Dorff, *supra* note 8, at 495; *see also* Matteo Rossi, *The New Ways to Raise Capital: An Exploratory Study of Crowdfunding*, 5 INT. J. FIN. RES. 2, 10 (2014).

42. *Id.*

43. 15 U.S.C. § 77(c)(a)(11); 17 C.F.R. § 230.147 (2015).

44. 15 U.S.C. § 77(d)(a)(2); 17 C.F.R. § 230.506(c).

45. 15 U.S.C. § 77(c)(b); 17 C.F.R. § 230.251.

46. 15 U.S.C. § 77(d)(a)(6).

47. 15 U.S.C. § 77(c)(a)(11). Securities Act Rule 147 is the available safe harbor for intrastate securities offerings and does not prohibit general solicitation if such advertising is directed only to residents. *See* 17 C.F.R. § 230.147. States such as Kansas and Georgia adopted intrastate crowdfunding prior to the JOBS enactment. *See infra* note 49.

48. *See infra* note 64.

49. Dan Primack, *SEC Chair: No ‘Drop-dead Date’ for Equity Crowdfunding Rules*, FORTUNE (Dec. 11, 2014, 10:17 AM), <http://fortune.com/2014/12/11/sec-chair-no-drop-dead-date-for-equity-crowdfunding-rules/>. Adopted intrastate crowdfunding states include Alabama (ALA. CODE

securities laws, section 3(a)(11) of the Securities Act of 1933 exempts intrastate securities transactions and permits states to adopt securities laws for such securities sold within the state.⁵⁰ Thus, a security sold within Wisconsin by a Wisconsin incorporated business may freely sell their securities to other Wisconsin residents.⁵¹ However, if the intrastate security is sold to an Illinois resident, the security is no longer an intrastate security and no longer qualifies for the exemption.⁵² All intrastate crowdfunding laws must comply with the federal securities exemption but vary in regards to investment limitations and portal restrictions.⁵³

1. Intrastate Crowdfunding Compliance

An issuer must first determine whether it is 1) incorporated in a state with intrastate crowdfunding, 2) the amount of capital permitted under the state exemption, and 3) if all the investors are state residents. Eligible issuers must be organized and doing business in the state of the intended offering.⁵⁴ The maximum capital an issuer may raise varies among states with a ceiling as low as \$100,000 in Maryland⁵⁵ to as high as \$2 million in Minnesota.⁵⁶ As of January 2016, issuers in Illinois may raise up to \$5 million with independently audited

§ 8-6-11 (2014)), Colorado (COLO. REV. STAT. ANN. § 11-51-304 (2015)), Georgia (GA. COMP. R. & REGS. 590-4-2-.08 (2011)), Idaho (Order Pursuant to Idaho Code §30-14-203, In the matter of Treasure Valley Angel Fund, LLC, No. 2012-7-02 (2012), <http://www.finance.idaho.gov/securities/Actions/Administrative/2012/2012-7-02.pdf>), Indiana (IND. CODE ANN. § 23-19-2-2(26) (West 2014)), Kansas (KAN. ADMIN. REGS. § 81-5-21 (2011)), Maine (ME. REV. STAT. tit. 32, § 16304 (2014)), Maryland (MD. CODE ANN., CORPS. & ASS'NS § 11-601 (West 2014)), Michigan (MICH. COMP. LAWS ANN. § 451.2202a (West 2013)), Tennessee (TENN. CODE ANN. § 48-1-103 (West 2013)), Texas (7 TEX. ADMIN. CODE § 139.25 (2014)), Washington (WASH. REV. CODE ANN. § 21.20.880 (West 2014)), and Wisconsin (WIS. STAT. ANN. § 551.202 (West 2014)).

50. 15 U.S.C. § 77(c)(a)(11).

51. WIS. STAT. ANN. § 551.202(26) (requiring issuer to (a) be organized under Wisconsin and authorized to do business in state, (b) transaction meets requirements of federal exemption for intrastate offerings, section 3 of the Securities Act of 1933, 15 U.S.C. § 77(c)(a)(11) and Rule 147, 17 C.F.R. § 230.147, and (c) offering does not exceed certain amount).

52. WIS. STAT. ANN. § 551.202(26)(b) (citing section 3 of Securities Act of 1933, 15 U.S.C. § 77(c)(a)(11)) (requiring resident issuer securities be sold only to persons residents within single State of issuer).

53. The Supremacy Clause in the U.S. Constitution declares federal laws the "supreme Law of the Land" and all state laws cannot conflict with federal laws. U.S. CONST. art. VI, cl. 2. Compare WIS. STAT. ANN. § 551.202(26) (permitting issuer to raise up to \$2 million with audited financials), with TENN. CODE ANN. § 48-1-103(13)(A) (permitting issuer to raise no more than \$1 million).

54. Securities Act of 1933 § 3, 15 U.S.C. § 77(c)(a)(11); 17 C.F.R. § 230.147. *E.g.*, WIS. STAT. ANN. § 551.202(26).

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

56. MINN. STAT. ANN. § 80A.461 (West 2015).

financials or up to \$2 million without audited financials.⁵⁷ Luckily for the issuer, most states do not require audited financials unless issuers intend on raising more than \$1 million.⁵⁸ Investor limitations vary from \$5,000 to \$10,000 caps per investor unless the investor is accredited.⁵⁹

Many states are silent as to whether individuals may use non-broker portals to conduct intrastate offerings.⁶⁰ Some states, such as Michigan, expressly state that offerings may use a non-broker portal if the portal qualifies for the broker-dealer exemption.⁶¹ Moreover, Indiana and Wisconsin both require that the intrastate crowdfunding offering be conducted only through a registered portal.⁶² These portals need to be either registered as a broker-dealer, or qualify for the broker-dealer exemption.⁶³

In response to the rise of intrastate crowdfunding adoptions, the SEC released a disclosure to clarify state compliance with federal securities regulations.⁶⁴ While use of crowdfunding portals is not prohibited under Rule 147 (a safe harbor intended to guide issuers with intrastate offerings), the portals must maintain “adequate measures” to ensure the offering is made only to state residents.⁶⁵ Moreover, issuers are advised not to use social media given the high likelihood of exposing the offering to outside residents.⁶⁶ In addition, issuers may use their own websites to advertise or solicit securities to other in-state residents but should take precautionary measures to limit those communications to only state residents.⁶⁷ This includes monitoring the lo-

57. *See* Intrastate Offerings Exemption, H.B. 3429, 99th Gen. Assemb., Reg. Sess. (Ill. 2015) (enacted).

58. WIS. STAT. ANN. § 551.202(26) (permitting issuer to raise up to \$2 million with audited financials); H.B. 3429 (permitting issuers to raise up to \$1 million without audited financials or \$4 million if issuer provided audited financials).

59. WIS. STAT. ANN. § 551.202(26) (permitting Wisconsin resident investors to invest up to \$10,000 unless accredited); MINN. STAT. ANN. § 80A.461 (permitting Minnesota residents to invest up to \$10,000 unless accredited); ALA. CODE § 8-6-11 (2014) (permitting Alabama residents to invest up to \$5,000 unless accredited).

60. *See* Kansas (KAN. ADMIN. REGS. 81-5-21 (2011)), Maine (ME. REV. STAT. tit. 32, § 16304 (2014)), Maryland (MD. CODE ANN., CORPS. & ASS'NS § 11-601).

61. MICH. COMP. LAWS ANN. § 451.2202a (West 2013).

62. *See* IND. CODE ANN. § 23-19-2-2(26) (West 2014); WIS. STAT. ANN. § 551.202.

63. *See id.*

64. *Securities Act Rules: Questions and Answers of General Applicability*, U.S. SEC. EXCH. COMM'N (last updated Aug. 6, 2015), <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm#141-03> (Answer to Questions 141.03, 141.04, and 141.05).

65. *Id.*

66. *Id.*

67. *Id.*

cation of users' IP addresses and including disclaimers or restrictive legends.⁶⁸

Michigan went a step further by permitting its residents to cash out on their crowdfunding investments in secondary markets through a local stock exchange.⁶⁹ The Michigan Investment Markets Act⁷⁰ provides a broker-dealer exemption and also created a local market for intrastate securities. The transactional requirements remain the same as intrastate exemption requirements, which permits transactions only of Michigan securities to Michigan residents.⁷¹ The Act enhances the intrastate securities' liquidity by connecting and facilitating transactions between buyers and sellers to "cash out" their investments.⁷² Michigan's innovative approach shows potential for intrastate crowdfunding with the hope that more residents will recognize the value of intrastate crowdfunding. Fortunately, some Michigan businesses have begun taking advantage of the intrastate crowdfunding such as Tecumseh Brewing Company, which raised \$175,000 from Michigan residents.⁷³ The somewhat flexible nature of intrastate crowdfunding presents both strengths and weaknesses for small businesses and investors.

a. Strengths of Intrastate Crowdfunding

Intrastate crowdfunding offers a cheap form of financing and less burdensome compliance, and encourages entrepreneurship and community ties. First and most importantly, businesses in crowdfunding states have easier access to capital, thus stimulating business and overall economic growth. Given the minimal complexity of intrastate regulations, intrastate offerings are estimated to cost less than \$5,000 for accountants, lawyers, and filing fees.⁷⁴ Likewise, businesses avoid unfavorable interest rates from debt financing and increase their

68. *Securities Act Rules*, *supra* note 64 (Answer to Question 141.05).

69. MICH. COMP. LAWS ANN. § 451.2202a (West 2013); Amy Cortese, *A Way for Local Businesses to Grow*, N.Y. TIMES (Oct. 24 2014), <http://www.nytimes.com/2014/10/25/opinion/a-way-for-local-businesses-to-grow.html?r=0>.

70. See Michigan Investment Markets Act, H.B. 5273, 97th Leg. Reg. Sess. (Mich. 2014) (codified at MICH. COMP. LAWS § 451.2451 (2014)).

71. *Cf. id.*; 15 U.S.C. § 77(c)(a)(11).

72. MICH. COMP. LAWS § 451.2451.

73. *Michigan's First Investment Crowdfunding Campaign, Tecumseh Brewing Co., a Success*, LENAWEE ECON. DEV. CORP. (May 2, 2014), <http://www.lenaweenow.org/michigan-investment-crowdfunding-campaign-tecumseh-brewing-success/> (using the crowdfunding website localstake.com to manage fundraising campaign).

74. Marcia Kaplan, *Intrastate Crowdfunding: Financing Option for Small Businesses*, PRACTICALECOMMERCE.COM (June 11, 2014), <http://www.practicalecommerce.com/articles/69251-Intrastate-Crowdfunding-Financing-Option-for-Small-Businesses>.

chances of funding by soliciting to a larger audience than a few angel or venture capital investors.⁷⁵ Thus, intrastate crowdfunding is the cheapest type of equity-based crowdfunding.

While all state crowdfunding must comply with federal securities laws, intrastate crowdfunding rules are easy to understand, incorporate portals, and promote innovation.⁷⁶ Less complicated laws reduce compliance costs and encourage participation, and should reduce unintentional securities violations. Moreover, less restrictive laws allow states to develop innovative programs such as Michigan's local crowdfunding stock exchange.⁷⁷

Issuers also receive great marketing opportunities. Companies may advertise on state-restricted websites, receive assistance from portals, and connect with investors across the state. Intrastate crowdfunding will mostly benefit main street businesses looking for limited growth instead of rapid growth or "hockey stick" start-ups.⁷⁸ A company looking for regional expansion can obtain cheap advertising within the community, expand their customer base, and expand investor networks.⁷⁹ Additionally, programs intended to stimulate business growth and investing benefit the state with the potential to increase tax revenue, encourage businesses to expand, and educate residents on business financing and personal investing.

b. Weaknesses of Intrastate Crowdfunding

Intrastate crowdfunding presents two significant barriers: (1) eligibility is limited to the state and (2) the threat of losing the exemp-

75. Angel investors commonly refer to wealthy individuals who invest their own money in earlier stage companies, and are less interested in obtaining control in the company while venture capitalists are often managing pools of funds or funds with several investors and/or institutions usually targeting more developed companies, and are interested in obtaining control in the company.

76. Kansas (KAN. ADMIN. REGS. 81-5-21 (2011)), Maine (ME. REV. STAT. tit. 32, § 16304 (2014)), Maryland (MD. CODE ANN., CORPS. & ASS'NS § 11-601 (2014)), Michigan (MICH. COMP. LAWS ANN. § 451.2202a (West 2013)), Tennessee (TENN. CODE ANN. § 48-1-103 (West 2013)), Texas (7 TEX. ADMIN. CODE § 139.25 (2014)), Washington (WASH. REV. CODE ANN. § 21.20.880 (West 2014)), and Wisconsin (WIS. STAT. ANN. § 551.202 (West 2014)).

77. MICH. COMP. LAWS § 451.2451.

78. A hockey stick startup refers to a startup's growth where the revenue starts at a normal linear pace followed by an inflection point where growth takes off exponentially. The graphed growth resembles the shape of a hockey stick.

79. Kaplan, *supra* note 74; see Anthony Zeoli, *Illinois Crowdfunding Bill Gets Approval in Both House & Senate*, CROWDFUNDINSIDER.COM (May 22, 2015), <http://www.crowdfundinsider.com/2015/05/68210-illinois-crowdfunding-bill-gets-approval-in-both-house-senate/> (discussing the benefits of intrastate crowdfunding for Illinois businesses and resident investors).

tion. Intrastate offerings and resales of those securities are permanently restricted to the state's geographical location and state populace.⁸⁰ Depending on the state's size, this restriction may be more or less of a barrier. Thus, the exemption's applicability is restricted to regional businesses interested in marginal expansion. Reliance on the exemption may stall business growth due to fears of expanding into other states and disqualifying intrastate eligibility.

Intrastate crowdfunding is also less appealing due to the likelihood of violating the exemption and the lack of clarity on how to legally conduct an intrastate offering online.⁸¹ Locating interested residents without soliciting non-residents is difficult and risky. The SEC recommended banning the use of social media for offerings to prevent the possibility of soliciting to non-residents thus eliminating a valuable marketing tool.⁸² Portals must exclude non-residents from portal websites and monitor these safeguards to avoid violations.⁸³ While social media offers an additional platform to check for credible businesses or offerings, fraudsters may also promote false companies through social media pages. Thus, the geographical restrictions inherent to intrastate crowdfunding limit the participant pool and strength of the crowd, but may simultaneously reduce investor fraud.

B. The Federal Level: Accredited Crowdfunding

The second type of equity-based crowdfunding exemption is "accredited crowdfunding," a product of the Title II provision in the JOBS Act⁸⁴ enacted on April 5, 2012 to "increase American job creation and economic growth" by providing emerging growth companies with greater access to U.S. capital markets.⁸⁵ Accredited crowdfunding per-

80. Securities Act of 1933 § 3, 15 U.S.C. § 77(c)(a)(11) (2012) (requiring resident issuer securities be sold only to persons residents within single State of issuer).

81. See Cohn & Yadley, *supra* note 31, at 19 n. 39 (discussing the lack of defense for out of state violations to the intrastate exemption for accidental or good faith mistakes); Dorff, *supra* note 8, at 502-03 (stating the lack of utility for intrastate crowdfunding due to prohibition of broad solicitation over Internet); Anthony Zeoli, *SEC Advisory Committee Recommends Modernizing Rule 147 to Support Intrastate Crowdfunding*, CROWDFUND INSIDER (June 17, 2015, 10:42 AM), <http://www.crowdfundinsider.com/2015/06/69665-sec-advisory-committee-recommends-modernizing-rule-147-to-support-intrastate-crowdfunding/>.

82. *Securities Act Rules*, *supra* note 64 (Answer to Question 141.05).

83. *Id.*

84. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306 (2012) (codified as amended at 15 U.S.C. § 77(d)) (amending section 4 of the Securities Act of 1933).

85. Jumpstart Our Business Startups Act, § 201; Press Release, White House Office of the Press Secretary, Statement on H.R. 3606 (Apr. 5, 2012), 2012 WL 1133728, at *1 ("The President has signed into law H.R. 3606, the 'Jumpstart Our Business Startups Act,' which provides for Fed-

mits businesses to raise capital online from accredited investors nationwide. This “Access To Capital For Job Creators”⁸⁶ provision amended a securities exemption to free up capital in the private markets by permitting businesses to publicly solicit accredited investors without filing a registered offering and undergoing burdensome disclosure.⁸⁷ Thus, issuers may publicly solicit accredited investors by their own efforts or through an intermediary.⁸⁸ Small businesses and investors must consider the compliance requirements before participating in accredited crowdfunding.

1. Accredited Crowdfunding Compliance

Issuers interested in raising capital under the accredited crowdfunding exemption must take “reasonable steps to verify” that their purchasers are accredited investors.⁸⁹ This requirement significantly expands the traditional rule of making investors complete a questionnaire and shifts liability onto the issuer. Since issuers must verify and solicit only accredited investors, they have no limit on the amount of money they can raise.⁹⁰ Furthermore, the issuer must file a Form D at least fifteen days prior to any general solicitation and may voluntarily submit the solicitation materials to the SEC.⁹¹ The SEC estimates this filing burden to cost \$1,200 per filing, which reflects an estimated four hours to become familiar with the rules, prepare documents, and file a Form D.⁹²

eral securities law exemptions intended to ease access to capital and investments for emerging growth companies and through crowdfunding.”).

86. Jumpstart Our Business Startups Act § 201.

87. See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771 (July 24, 2013) (adopting rules to implement Title II of the Jumpstart Our Business Startups Act).

88. See 15 U.S.C. § 77(d)(b) (2012); 17 C.F.R. § 230.506(c) (2015).

89. 17 C.F.R. § 230.506(c)(2)(ii). The SEC has provided a non-exhaustive list of ways an issuer can verify an accredited investor including review of annual tax forms, bank documents, etc. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. at 44,778-44,780 (referring to the independent requirements that purchasers must be accredited investors and issuer must take reasonable steps to verify that purchasers are accredited investors).

90. See generally 17 C.F.R. § 230.506(c).

91. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. at 44,787; 17 C.F.R. § 230.503(a). An issuer relying on a Regulation D securities exemption must file the standard Form D with the SEC. For an example of a Form D, see U.S. SEC. & EXCH. COMM’N, Notice of Exempt Offering of Securities (Form D), <http://www.sec.gov/about/forms/formd.pdf>.

92. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. at 44,787 (assuming twenty-five percent of prepara-

Issuers may use portals or broker-dealers to conduct the accredited verification and due diligence. Except issuers must acknowledge that portals not associated with a registered broker-dealer may only provide limited services.⁹³ Broker-dealer registration is not required for the following activities: 1) maintaining a portal or website to allow offers, sales, general solicitation, purchases, or other similar activities, 2) co-investing in the securities offered on the portal, or 3) providing ancillary services related to those securities such as due diligence and providing documentation.⁹⁴ An intermediary relying on the broker-dealer exemption cannot possess any customer funds during the transaction process, must have good standing with the SEC, and may not receive *any* compensation directly or indirectly related to the purchase or sale of the offered securities.⁹⁵ Before adopting Regulation CF, many portals already offered their services to accredited investors by sidestepping federal securities laws.⁹⁶

Accredited crowdfunding portals typically follow two business models: 1) the Broker-Dealer Model and 2) the Investment Fund Model. The Broker-Dealer Model requires broker-dealer registration or an affiliation with a broker-dealer.⁹⁷ These portals' broker-dealer affiliations permit the portal to charge transaction fees, membership fees, and service fees for soliciting offerings on the portal's website. In contrast, the Investment Fund Model does not require broker-dealer regis-

tion is completed by issuer and seventy-five percent is completed by outside professionals at an average cost of \$400 per hour).

93. See 15 U.S.C. § 77(d)(b)(1). For broker and dealer requirements, see 15 U.S.C. § 78(o)(a)(1) ("It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.").

94. 15 U.S.C. § 77(d)(b)(1)-(2); PRACTICAL LAW CORPORATE & SECURITIES, JOBS ACT: REGULATION D AND RULE 144A GENERAL SOLICITATION SUMMARY 1 (last updated July 3, 2014).

95. 15 U.S.C. § 77(d)(b)(2); *JOBS Act Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act, Question 5*, U.S. SEC. & EXCH. COMM'N (Feb. 5, 2013), http://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm#P34_4730.

96. See Letter from David W. Blass, Chief Counsel, U.S. Sec. & Exch. Comm'n, to Robert H. Rosenblum (Mar. 28, 2013), 2013 WL 1279194.

97. Some funding platforms with broker-dealer partnerships include Crowdfunder.com (partnered with Point Capital partners), ConfidentCrowd.com (aggregation of BDs), and CircleUp.com (partnered with WR Hambrecht & Co.).

tration but is limited to investment advisors.⁹⁸ This type of portal indirectly invests in startups by pooling investors' money into a separate investment fund that then invests in those startups.⁹⁹ The portal receives non-transactional compensation derived from the termination of the managed investment fund known as "carried interest."¹⁰⁰ The strictly limited rules for portal compensation under the Investment Fund Model demonstrates the limited availability of the broker-dealer exemption for intermediaries such as investment advisors.¹⁰¹ Thus, accredited crowdfunding diminishes the value of a non-broker-dealer portal, essentially eliminating the cost savings of using a portal instead of a broker-dealer or investment advisor. The respective strengths and weaknesses of accredited crowdfunding are discussed below.

a. Strengths of Accredited Crowdfunding

Accredited crowdfunding offers a variety of benefits to issuers including a cheaper alternative to unlimited capital and access to a broader investor audience than traditional financing methods in private offerings. Issuers may now use the Internet to advertise their companies' unregistered securities to accredited investors across the country without having any prior relationship with the investors.¹⁰² Although the issuer will likely pay at least \$1,200 for preparing a Form D and five to fifteen percent of raised funds if using a broker-dealer, these are still low costs without waiting periods. Thus, a small business may reach a larger crowd of accredited investors over the Internet for less time and money. Aside from the blatant benefit of avoiding substantial costs for registration, investor presentations, or time spent es-

98. For an example of an investment model portal see Letter from W. Hardy Callcott to David W. Blass, Chief Counsel, U.S. Sec. & Exch. Comm'n (Mar. 22, 2013) (on file with author) (granting relief to FundersClub, an investment advisor operating a portal website that solicited investment funds for startups to accredited investors, where the funds were managed by FundersClub's subsidiary. FundersClub and its subsidiary relied on the broker-dealer exemption since it only provided traditional fund management services. No violation occurred since the accredited crowdfunding portal received "carried interest" from terminating an investment fund in addition to other traditional advisory services. The SEC stated that it would not recommend an enforcement action since FundersClub and its subsidiary would not receive any transaction-based compensation in connection to the investment funds); *see also* Letter from David W. Blass to Robert H. Rosenblum, *supra* note 96.

99. Letter from David W. Blass to Robert H. Rosenblum, *supra* note 96, at 5.

100. *Id.* at 8-9.

101. 15 U.S.C. § 77(d)(b)(2); *see* Letter from W. Hardy Callcott to David W. Blass, *supra* note 98.

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

tablishing relationships with investors, issuers may raise an unlimited amount of capital.¹⁰³

Although issuers will still incur some compliance costs creating offering documents, filing a Form D, and verifying accredited investors, the time and cost reduction for young businesses is crucial for short-term success because it allows businesses with limited resources to expend those resources elsewhere.¹⁰⁴ A business in its beginning stages is especially vulnerable to failure for a variety of reasons deriving from a lack of capital. The average cost of a public offering is \$2.5 million, with ongoing compliance costs of \$1.5 million per year.¹⁰⁵ These costs are catastrophic for small businesses and should be avoided for capital needs less than \$20 million.¹⁰⁶ Thus, accredited crowdfunding can extend the life of many young businesses that are impractical to take public and lack the relationships to raise substantial capital through other private offerings.

b. Weaknesses of Accredited Crowdfunding

The accredited crowdfunding exemption also presents several considerable disadvantages such as requiring the crowd to be accredited investors, requiring more disclosures by investors, squeezing out non-broker portal services, and continuing to preserve the private markets to the wealthy. First, the potential of crowdfunding is restricted when the crowd itself is restricted. The SEC estimated that 7.4 percent of all U.S. households in 2010 were qualified accredited investors based on their net worth above \$1 million.¹⁰⁷ Limiting crowdfunding to accredited investors contradicts the very essence of crowdfunding. From the issuers' perspective, limiting the crowd impacts their likelihood of receiving enough small investments to reach their investment goals. Issuers are more likely to reach their investment goals with larger pools of investors. As a result, limiting the crowd reduces capital, investor feedback on companies, and restricts valuable advertising.

Aside from limiting the crowd to accredited investors, the pool is reduced by requiring the issuer to reasonably verify that investors are

103. See 17 C.F.R. § 230.506(c) (2015).

104. Jeremy Derman, *Does the SEC Rule the Job Creation Roost? Squaring SEC Rulemaking with the Jobs Act's Relaxation of the Prohibition Against General Solicitation and Advertising*, 47 SUFFOLK U. L. REV. 139, 159 (2014).

105. See Crowdfunding, 78 Fed. Reg. at 66,508.

106. Cohn & Yadley, *supra* note 31, at 7–8.

107. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,793 (July 24, 2013).

accredited. This new requirement, not found in other private offering exemptions, not only shifts liability to the issuer but also discourages accredited investors.¹⁰⁸ Many accredited investors are uncomfortable providing tax documents with written representations of future income, bank statements, or credit reports.¹⁰⁹ Consequently, these individuals will pay additional costs for attorney fees, third-party fees, and other ancillary service fees. If the issuer uses a broker to facilitate the offering, he will sacrifice a portion of the proceeds to broker fees. Or the issuer could use the cheaper alternative of using a non-broker portal but still needs to pay another third-party for services non-broker portals cannot provide.¹¹⁰ A portal not associated with a broker or investment advisor carries the additional risk of violating the broker-dealer exemption.¹¹¹ Accordingly, the limited functions of a non-broker portal strip away the benefits an issuer would receive from the accredited crowdfunding exemption by shifting costs, limiting funding portal services, and essentially requiring a broker-dealer.

The accredited crowdfunding exemption also restricts the growth and value of the portal industry. Since 2009, Rule 506 offerings made up ninety-nine percent of Regulation D offerings but only thirteen percent of those offerings used a financial intermediary.¹¹² In addition, portals operating without a broker-dealer or investment advisor face several obstacles. Aside from the effects on the issuer's potential offering, non-broker portals have limited means for generating revenue. To make matters worse, these constrained portals carry the same responsibility as a broker-dealer without the transactional benefits.¹¹³ Thus, becoming an accredited funding portal is recommended only if the portal intends on partnering with a broker-dealer or certain investment advisors. Non-broker portals advertising interstate securities should wait for unaccredited crowdfunding or recalibrate their business models to comply with intrastate crowdfunding.¹¹⁴

The accreditation requirement is intended to prevent investments from individuals unable to suffer an investment loss and assumes in-

108. *Deal Marketing on the Internet the Outlook for 2014: Raising Capital Using Rule 506(c) and General Solicitation*, DEALFLOW.COM (Jan. 2014), https://dealflow.com/whitepapers/Dealflow_White_Paper_Q4_2013.

109. 17 C.F.R. § 230.506(c) (2013).

110. *See supra* Part I(3)(i).

111. 15 U.S.C. § 77(d)(b)(2) (2012).

112. *See* IVANOV & BAUGUESS 2013 STUDY, *supra* note 19, at 2.

113. *See supra* text accompanying notes 79–80.

114. *See* Letter from W. Hardy Callcott to David W. Blass, *supra* note 98.

vestors below the threshold are most likely financially unsophisticated. Presumably, accredited investors are more experienced in securities trading and develop networks from that experience to pursue alternative investments outside of online crowdfunding. However, several critics have identified the common misconception that the wealthier accredited investors are more sophisticated or smarter in their investment decisions.¹¹⁵ The accredited investor requirement supports the contention that private markets are only for the wealthy.¹¹⁶ Accredited investors already may invest in venture capital funds, hedge funds, and other private equity funds, which are unavailable to the unaccredited investor.¹¹⁷ Likewise, broker-dealer and investment advisor fees are more affordable to affluent accredited investors; unaccredited investors are more suitable for the smaller crowdfunded offerings.

C. Federal Level: Regulation A+

Regulation A+ is the third type of equity-based crowdfunding exemption. It was adopted to implement the Title IV Small Company Capital Formation provision of the JOBS Act.¹¹⁸ On March 25th, 2015, the SEC adopted Regulation A+ permitting smaller privately held businesses to raise capital through the public solicitation of both accredited and unaccredited investors under a two-tiered exemption (“Tier 1” and “Tier 2”).¹¹⁹

1. Regulation A+ Compliance

The recently amended and adopted Regulation A+ enables issuers to raise up to \$20 million under Tier 1 or \$50 million under Tier 2 within a 12-month period through the public solicitation of accredited and unaccredited investors.¹²⁰ The Tier 1 and Tier 2 offerings are

115. 17 C.F.R. § 230.501(a) (2013); see Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3422–25 (2013) (discussing common criticisms regarding the accredited investor requirement).

116. Rodrigues, *supra* note 115, at 3413.

117. *Id.* at 3399–3400.

118. Jumpstart Our Business Startups Act, Pub. L. No. 112–106, § 401, 126 Stat 306 (2012); Amendments for Small and Additional Issues Exemptions Under the Securities Act (“Regulation A+”), 80 Fed. Reg. 21,806 (Apr. 20, 2015).

119. Amendments for Small and Additional Issues Exemptions Under the Securities Act (“Regulation A+”), 80 Fed. Reg., at 21,807.

120. 17 C.F.R. § 230.251. For the first few Regulation A+ filings, see *Latest Filings Received and Processed at the SEC*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/cgi-bin/browse-edgar?company=&CIK=&type=1-A&owner=include&count=40&action=getcurrent> (last visited Dec. 31, 2015).

“mini-public offerings” because the offerings are exempt from registration, but share common characteristics of registered offerings.¹²¹ For example, Regulation A+ offerings require the issuer to submit a Form 1-A offering statement, which is similar to a registration statement and subject to an SEC-review period.¹²²

The two tiers of Regulation A+ offerings differ considerably. First, Tier 1 offerings have no minimum capital requirements but cannot exceed \$20 million.¹²³ Tier 1 offerings require reviewed financials, yet do not require ongoing reporting, and are not preempted from state review, which means issuers must receive state approval from every state where the offering is made.¹²⁴ Conversely, Tier 2 offerings require compliance with Regulation S-X,¹²⁵ audited financials and ongoing reporting, and are preempted from state review, thus avoiding state approvals of such offering. Also, Tier 2 offerings may “test the waters” where issuers may approach investors to gauge interest without such communications constituting an offer of securities, while Tier 1 offerings may not test the waters depending on state law.¹²⁶ Tier 2 offerings also do not have minimum capital requirements but cannot exceed \$50 million.¹²⁷ Under Tier 2, unaccredited investors cannot invest more than the greater of ten percent net worth or annual income while Tier 1 offerings have no investment limits.¹²⁸ The two tiers of Regulation A+ produce a new set of strengths and weaknesses for interested crowdfunders.

a. Strengths of Regulation A+

Regulation A+ creates two tiers for issuers to raise up to either \$20 million under Tier 1 or \$50 million under Tier 2, from both accred-

121. 17 C.F.R. § 230.251; Cohn & Yadley, *supra* note 31, at 7-10 (describing regulatory requirements of public offering).

122. *Id.*

123. 17 C.F.R. § 230.251(a).

124. 17 C.F.R. § 230.251; Daniel M. Gallagher, Comm’nr, U.S. Sec. & Exch. Comm’n, Grading the Commission’s Record on Capital Formation: A+, D, or Incomplete?, Address at Vanderbilt Law School’s 17th Annual Law and Business Conference (Mar. 27, 2015), http://www.sec.gov/news/speech/032715-spch-cdmg.html#_edn17.

125. 17 C.F.R. §§ 210.1-01 to 210.12-29 (1988).

126. Gallagher, *supra* note 124 (discussing issues with Regulation A+, SEC Commissioner Gallagher explains how Tier 2 issuers are preempted from state review and enjoy the ability to test the waters of the offering nationwide but Tier 1 issuers, not preempted by state review, must look to each state’s securities laws where the offering is being made to determine if they may test the offering before proceeding).

127. 17 C.F.R. § 230.251(b).

128. 17 C.F.R. § 230.251.

ited and non-accredited investors, thus opening up capital markets to unaccredited investors and raising capital limits for issuers.¹²⁹ Under Tier 1, issuers are not required to provide audited financials but only require reviewed financials, which saves thousands of dollars that would be spent for audited financials.¹³⁰ Under Tier 2, issuers may test their offerings with investors before spending large sums of money on accountants and lawyers and can ultimately determine if the costs are worth the benefits.¹³¹ Thus, issuers may gauge investor interest through public solicitation for up to twenty-one days without the communications constituting an “offer” of securities; issuers may also withdraw the intended offering without registering the securities.¹³² Tier 2 offerings are also preempted from state review, thus issuers avoid additional filing costs and the potential denials by states to permit offerings to its residents.¹³³ Lastly, the securities sold in both Regulation A+ offerings are unrestricted, and may be sold freely to other interested investors except for shares owned by affiliates.¹³⁴

b. Weaknesses of Regulation A+

Ultimately, Tier 1 offerings should be limited because issuers cannot test their offerings to gauge investor interest and the offering must be reviewed by each state’s securities division where the offering is made.¹³⁵ As a result, issuers may be required to file offering documents with several states, and perhaps even be denied by stricter, merit-based jurisdictions.¹³⁶ Tier 1 offerings will likely be an extension of intrastate crowdfunding for offerings among a few states.¹³⁷ Issuers with a majority of their investors in a certain state may want to avoid a Tier 1 offering in case the state denies the offering.¹³⁸ Without testing the offering, issuers may end up raising a small amount of capital while paying substantial compliance costs.

129. *Id.*

130. *Id.*

131. *Id.*

132. Amendments for Small and Additional Issues Exemptions Under the Securities Act (“Regulation A+”), 80 Fed. Reg. 21,806, 21,823 (Apr. 20, 2015).

133. *Id.* at 21,841, 21,886.

134. *Id.* at 21866.

135. *Id.* at 21,882; Gallagher, *supra* note 124.

136. Amendments for Small and Additional Issues Exemptions Under the Securities Act (“Regulation A+”), 80 Fed. Reg. at 21,861–21,862.

137. *See id.*

138. *See id.* (discussing merit-based jurisdictions).

Tier 2 offerings also face significant obstacles such as obtaining independently audited financials, complying with Regulation S-X, and ongoing reporting disclosures.¹³⁹ Audited financials can range from \$5,000 to \$75,000 for small businesses and nearly double the cost for reviewed financials.¹⁴⁰ Regulation S-X provides extensive rules and procedures for disclosing financials that many hope to avoid.¹⁴¹ The initial qualification and reporting costs for a Tier 2 offering is an estimated \$400,000 in the first year and \$200,000 annually.¹⁴² Indirect costs include seller liability¹⁴³ and revealing proprietary information to competitors.¹⁴⁴ Thus, Regulation A+ requires far more disclosure requirements and costs than intrastate or accredited crowdfunding.

Regulation A+ serves as a great step towards improving access to capital markets for mid-size and emerging growth companies interested in being listed on an exchange or where an IPO is still not a viable option. However, the regulation does not resolve the capital barriers for most startups and smaller companies before the pre-IPO stage. This regulation is more suitable for well-established companies with organized financial statements, a management team with some degree of sophistication, and cash flows for compliance costs.

D. Federal Level: Regulation CF

Regulation CF¹⁴⁵ is the fourth type of equity-based crowdfunding exemption, which the SEC finalized on October 30th, 2015 to implement the Title III Crowdfunding provision of the JOBS Act.¹⁴⁶ Regula-

139. 17 C.F.R. § 230.251 (2013); Regulation S-X, 17 C.F.R. §§ 210.1-01 to 210.12-29 (1988).

140. Amendments for Small and Additional Issues Exemptions Under the Securities Act ("Regulation A+"), 80 Fed. Reg. at 21,881 (SEC stating it could not provide a quantitative estimate but cited an estimate that registered IPOs below \$50 million in 2014 incurred about 1.65% gross in accounting fees); Angus Loten, *Audits Add Shine to Firms*, WALL ST. J. (Jan 13, 2011, 12:01 AM), <http://www.wsj.com/articles/SB10001424052748703791904576076474014311438>.

141. 17 C.F.R. § 210.3-01-16 (detailing the requirements for preparing financial statements).

142. Amendments for Small and Additional Issues Exemptions Under the Securities Act ("Regulation A+"), 80 Fed. Reg. at 21,883.

143. 15 U.S.C. § 77(c)(b)(2)(D) (providing seller liability under section 12(a)(2) of the 1933 Act, 15 U.S.C. § 77(l)(a)(2) for anyone offering and selling Regulation A securities).

144. Amendments for Small and Additional Issues Exemptions Under the Securities Act ("Regulation A+"), 80 Fed. Reg. at 21,871.

145. Crowdfunding, 80 Fed. Reg. 71,388, 71,387 (Nov. 16, 2015) (effective May 16, 2016) (to be codified at C.F.R. pts. 200, 227, 232 et al.).

146. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306, § 302 (2012) (adding section 4(a)(6) of Securities Act of 1933, 15 U.S.C. § 77(d)(a)(6)); Crowdfunding, 80 Fed. Reg. 71,388 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232 et al.); see *SEC Adopts Rules to Permit Crowdfunding*, U.S. SEC. & EXCH. COMM'N (last modified Nov. 3, 2015), <http://www.sec.gov/news/pressrelease/2015-249.html>.

tion CF permits both accredited and most importantly unaccredited investors, to participate in crowdfunding nationwide.¹⁴⁷ The Regulation CF exemption requires crowdfunding offerings to be conducted through a funding portal or broker-dealer and also establishes rules governing those funding portals.¹⁴⁸

1. Regulation CF Compliance

Under Regulation CF, issuers may raise up to \$1 million in a twelve-month period.¹⁴⁹ The required information and cost of disclosure increases with the size of the offering.¹⁵⁰ For offerings less than \$100,000, the issuer must provide financial statements certified by a principal executive officer.¹⁵¹ For offerings between \$100,000 and \$500,000, the issuer must provide financial statements reviewed by an independent public accountant.¹⁵² However, the final rules do not require an issuer to provide audited financials for offerings of more than \$500,000 if its the issuer's first crowdfunded offering.¹⁵³

Regardless of the amount, all issuers must disclose the offering price, target amount, deadline to reach the target and intended use of the proceeds, discuss the company's financial condition, and provide information on directors, executives, and twenty percent or more shareholders.¹⁵⁴ Investors with either an annual income or net worth less than \$100,000 may invest the greater of \$2,000 or five percent of the lesser of their annual income or net worth.¹⁵⁵ For example, an investor with \$85,000 annual income may invest up to \$4,250 (five percent of \$85,000) in all crowdfunding offerings in a twelve-month period.¹⁵⁶ Investors with both their annual income and net worth equal to or more than \$100,000 may invest ten percent of the lesser of their annual income or net worth.¹⁵⁷ For example, an investor with an \$185,000 annual income and \$500,000 net worth may invest up to \$18,500 (ten percent of \$185,000) in all crowdfunding offerings in a

147. See Crowdfunding, 80 Fed. Reg. at 71,390.

148. *Id.* at 71,388.

149. *Id.* at 71,387.

150. See generally *id.* at 71,412.

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.* at 71,402-71,403.

155. *Id.* at 71,390.

156. *Id.*

157. *Id.*

twelve-month period.¹⁵⁸ No investor may invest more than \$100,000 in crowd-funded offerings within a twelve-month period.¹⁵⁹

Regulation CF allows issuers to use registered funding portals or broker-dealers to conduct the offerings.¹⁶⁰ These intermediaries must be registered with the SEC and FINRA. At least twenty-one days before selling any securities in an offering, portals must make all issuer-required information publicly available.¹⁶¹ The portal must provide a communication channel on its platform, adequate educational materials that inform potential investors about the risks of crowdfunding, and have a reasonable basis for believing that its investors comply with investment limits.¹⁶² Moreover, funding portals are prohibited from offering investment advice, making recommendations, compensating promoters or other individuals regarding offering solicitations, and holding or possessing any investor funds or securities.¹⁶³ An important modification to the proposed rules is that portals may now hold a financial interest in offerings only if the financial interest represents compensation for services,¹⁶⁴ whereas the proposed rules prohibited portals from all financial interests in offerings.¹⁶⁵

a. Strengths of Regulation CF

Regulation CF is theoretically the most suitable exemption for providing small businesses and startups access to capital markets. While businesses can raise capital through the previously discussed intrastate, accredited, and Regulation A+ crowdfunding exemptions,¹⁶⁶ Regulation CF allows small businesses to solicit both accredited and unaccredited investors without geographical restrictions¹⁶⁷ or excessive costs.¹⁶⁸ In addition, Regulation CF connects the capital markets gap because the offerings are tailored to startups and small businesses well before the pre-IPO stage, enabling these businesses to reach Regu-

158. *Id.*

159. *Id.*

160. *Id.* at 71,388.

161. *Id.* at 71,405.

162. *Id.* at 71,388.

163. *Id.* at 71,387–71,388.

164. *Id.* at 71,431.

165. Crowdfunding, 78 Fed. Reg. 66,428 (Nov. 5, 2013) (Proposed Rules).

166. *See supra* Part II.

167. Intrastate crowdfunding only permits crowdfunding to residents within a state. 15 U.S.C. § 77(c)(a)(11) (2012) (requiring securities to be sold only to state residents).

168. *See supra* text accompanying notes 138–143 (describing costs of Regulation A+ offerings).

lation A+ levels.¹⁶⁹ Thus, businesses seeking both accredited and unaccredited investors in more than one state, without the regulatory hurdles of a mini-IPO, may now raise capital under Regulation CF.

Unaccredited investors represent an enormous portion of the crowd. Removing accreditation limits allows issuers to solicit more pools of investors leading to more funding.¹⁷⁰ Young businesses without a track record have better funding prospects by appealing to this larger audience with differing investment criteria and experience. Using portal sites, businesses can develop campaigns to effectively present their business concept, connect with new or prior customers, and provide easy accessibility for interested investors. Investors may also become interested in a business after viewing its customer fan base or prior investor contributions. Nevertheless, Regulation CF provides younger and less stable companies with a cheaper opportunity to pitch their concept and improve on their weaknesses.¹⁷¹ The JOBS Act was introduced to promote small business growth and job creation, not to limit investing opportunities to the wealthy and established companies.¹⁷²

Regulation CF does raise reasonable concerns regarding regulations, its overall success, and vulnerability to fraud. Investing in small businesses is inherently risky, but gathering pools of small investments diversifies the risk to all individuals' small investments. Additionally, investors are protected from investing beyond their means with maximum investment amounts.¹⁷³ Although crowdfunding is not a "get rich quick" strategy, new investors can learn a great deal about investing through participation and accessing portal education centers. Unsurprisingly, several studies reported a strong correlation between financial knowledge and household wealth.¹⁷⁴

169. *Id.*

170. *See supra* text accompanying note 107 (stating the limited amount of households that are accredited investors based on net worth).

171. Crowdfunding, 78 Fed. Reg. 66,428 n. 918 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249) (estimating total compensation of unaccredited offering ranging between five–fifteen percent of total offering amount for compensation to intermediary, filing a Form C, filing and updating Form C-U updates, etc.).

172. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified at 15 U.S.C. § 77(d)).

173. *See supra* text accompanying note 154–158 (describing the investment limitations of Regulation CF).

174. *See* Annamaria Lusardi et al., *Optimal Financial Knowledge and Wealth Inequality* 1 (Ctr. for Research on Pensions and Welfare Policies, Working Paper No. 133/13, 2013), http://filesserver.carloalberto.org/cerp/WP_133.pdf.

Regulation CF places substantial responsibilities on intermediaries, such as requiring communication channels, continual disclosures, and backgrounds checks for the benefit and protection of investors.¹⁷⁵ Fortunately, the final rules removed a big portal burden of issuer liability unless red flags are apparent.¹⁷⁶ Moreover, the portal may own a financial stake in an offering but only if the financial stake represents compensation for services. These two changes certainly make operating a portal more ideal. Individuals new to investing are entitled to receive a substantial amount of information regarding the issuer's company, which would not be provided in other private markets. Funding portals must still educate investors, closely monitor issuers, and maintain public communications through the portal website. Without these requirements, unaccredited investors may fall prey to fraud, deceit, or other investment misfortunes. Moreover, portals may assist new or unsophisticated business owners throughout the offering process. While raising \$1 million most likely will not fulfill all future capital needs, it is a solid step towards unlocking capital markets.

b. Weaknesses of Regulation CF

The final rules for Regulation CF put a damper on the future of equity-based crowdfunding by limiting the offerings to a \$1 million cap, restricting investments for all investors instead of only unaccredited investors, and limiting portal value. First, issuers should be able to raise more than \$1 million under Regulation CF in order to make the exemption more attractive and worthwhile. The costs of offerings rise significantly in relation to the marginal increase in an offering's size. For offerings of \$100,000 or less, the SEC estimates that an issuer will spend \$2,500 to \$7,500 to compensate the intermediary, and roughly \$4,200 for filing and compliance costs.¹⁷⁷ For offerings more than \$100,000 but less than \$500,000, the SEC estimates that the issuer will spend \$15,000 to \$30,000 to compensate the intermediary, \$1,500 to \$18,000 on accounting (reviewed or audited financial statements), and roughly \$3,600 to \$8,300 for filings and related compliance.¹⁷⁸ For offerings more than \$500,000, the SEC estimates that the issuer will

175. See *supra* text accompanying note 159–162 (describing the requirements of funding portals).

176. Crowdfunding, 80 Fed. Reg. 71,388, 71,436 (Nov. 16, 2015) (effective May 16, 2016) (to be codified at C.F.R. pts. 200, 227, 232 et al.).

177. *Id.* at 71,499–71,500.

178. *Id.*

spend \$37,500 to \$56,250 to compensate the intermediary, \$1,500 to \$18,000 on accounting (or \$2,500 to \$30,000 for second-time issuers) and up to roughly \$33,000 for filings and related compliance.¹⁷⁹ Under the current regime, an issuer may spend about three to eleven percent of a \$1 million offering just on accounting and filing expenses.¹⁸⁰ While these rules promote growth in startups, most companies will need to be established before spending thousands to hundreds of thousands of dollars on setting up the offering.

Critics believe the SEC's prior reluctance to finalize Regulation CF saved the future of crowdfunding.¹⁸¹ While permitting unaccredited investors to crowdfund has ample opportunities for many investors and businesses, the exemption must do more to encourage the use of portals. Regulation CF requires portals to establish important educational centers, disclosures, and transparent communications but favors broker-dealers with portal restrictions. Both intermediaries and brokers are subject to registration,¹⁸² compliance measures, and liability; however, broker-dealers have the better deal. Broker-dealers usually are already licensed brokers and can rely on services outside of crowdfunding.

The rules compel effective portal responsibilities but preclude portals from providing investors with other critical information and protections.¹⁸³ Registered portals cannot offer investment advice, recommendations, solicit offers or sales of the securities displayed on the website, or handle investor securities, but are required to register with the SEC and FINRA.¹⁸⁴ This prohibition prevents industry professionals whom solely conduct crowdfunding offerings and are exposed to the industry daily from providing insightful advice. Uninformed and unrealistic investor expectations exacerbate investment risk in small businesses or startups. Portal recommendations or ratings, similar to ana-

179. *Id.*

180. *Id.*; Gallagher, *supra* note 124 (Commissioner Gallagher recognizing the potential of crowdfunding but believes Regulation CF requires overly burdensome disclosure and needs to increase its million dollar cap).

181. Steven D. Solomon, *SEC's Delay on Crowdfunding May Just Save It*, N.Y. TIMES (Nov. 18, 2014), <http://dealbook.nytimes.com/2014/11/18/s-e-c-s-delay-on-crowdfunding-may-just-save-it-2/>.

182. "We estimated the costs for a funding portal to act as an intermediary in transactions pursuant to Section 4(a)(6) to be approximately \$417,000 in the first year, and approximately \$90,000 each year thereafter." Crowdfunding, 78 Fed. Reg. 66,428, 66,539 (Nov. 5, 2013) (Proposed Rules).

183. Crowdfunding, 80 Fed. Reg. at 71,390.

184. *Id.*

lyst reports, would assist investors in making a well-informed investment decision. Thus, Regulation CF should provide more favorable treatment to portals and encourage portal recommendations without eliminating neutrality.

Finally, Regulation CF should not place investment restrictions on accredited investors. These restrictions contradict the long-standing belief that accredited investors can “fend for themselves” and is inconsistent with other private offering exemptions. Accredited investors can raise an unlimited amount of capital under Regulation A+ and the accredited crowdfunding exemption; consequently Regulation CF should adhere to this consistency.

III. SECURITIES FRAUD AND CROWDFUNDING VULNERABILITIES

The varying degrees of compliance, investment restrictions, and disclosure requirements under the crowdfunding exemptions may partly be explained by fraud concerns and the enhanced risk associated with offering securities over the Internet. Crowdfunding has been criticized for its susceptibility to securities violations and Internet fraud.¹⁸⁵ According to the North American Securities Administrators Association, Internet fraud and crowdfunding ranked third in most enforcement actions by state securities regulators.¹⁸⁶ The Internet is a fundamental crowdfunding tool with unlimited amounts of information. While crowdfunding’s dependence on the Internet generates numerous benefits, unfortunately, it also bears costs, particularly to investors. The Internet’s easy accessibility to an infinite audience allows fraudsters to trick and deceive investors with rapid efficiency. Moreover, investors trading online may develop a false sense of security from the abundance of attainable investment information at their fingertips without the aggressive trader in the room pressuring the sale. Even the most cautious surfers may fall victim to the professional and legitimate appearance of fraudulent websites.

Several factors increase an investor’s vulnerability to fraud including the individual’s willingness to take risks, the underreporting of fraudulent investments, and the general public’s lack of understanding for what constitutes a reasonable return on investment (nearly half of

185. See Tozzi, *supra* note 7.

186. N. AM. SEC. ADM’RS ASSOC., NASAA ENFORCEMENT REPORT: 2014 REPORT ON 2013 DATA 1, 7 (2014), http://www.nasaa.org/wp-content/uploads/2011/08/2014-Enforcement-Report-on-2013-Data_110414.pdf [hereinafter NASAA ENFORCEMENT REPORT].

surveyed respondents reported a daily return of two percent as appealing).¹⁸⁷ Other influences include the high likelihood of receiving investment solicitations by email or on the Internet (sixty-seven percent of individuals surveyed reported receiving an email investment solicitation; three percent admitted to responding to the solicitation), and an individual's education level and income.¹⁸⁸ The likelihood of solicitation and losing money on fraudulent investments is positively correlated with household income and higher education, with white males being the least risk-averse.¹⁸⁹ Although these findings are not determinative, the study contradicts some critics' assertions about unsophisticated investors' vulnerability but reaffirms the higher occurrence of Internet-related fraud.

A. Types of Securities Fraud

The securities industry is no stranger to fraud. Top investor threats include pyramid and Ponzi schemes, and fraudulent Regulation D offerings and microcap sales.¹⁹⁰ Although microcap companies are public, due to their size most do not report to the SEC.¹⁹¹ Just like crowdfunding offerings, microcap offerings are less regulated and transacted over the Internet which makes them highly vulnerable to email spam, paid promoters, and "pump and dump" schemes.¹⁹² Consequently, crowdfunding is vulnerable to both traditional forms of securities fraud and Internet-related fraud.

In crowdfunding, traditional omissions or misrepresentations of material facts may occur in addition to a variety of new opportunities over the Internet.¹⁹³ Material misrepresentations or omissions, the most common securities fraud actions, occur when any person employs a deceptive device or materially false statement, or omits materi-

187. APPLIED RESEARCH & CONSULTING LLC, FINANCIAL FRAUD AND FRAUD SUSCEPTIBILITY IN THE UNITED STATES (2013),

http://www.finrafoundation.org/web/groups/sai/@sai/documents/sai_original_content/p337731.pdf.

188. *Id.*

189. *Id.*

190. Microcap stock refers to the "micro" capitalizations of small public companies, generally less than \$250 million in market capitalization. *Top Investor Threats*, NASAA, <http://www.nasaa.org/3752/top-investor-threats/> (last visited Feb. 20, 2015).

191. *Microcap Stock: A Guide for Investors*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/investor/pubs/microcapstock.htm#How> (last modified Sept. 18, 2013).

192. See generally Kevin C. Bartels, "Click Here to Buy the Next Microsoft": *The Penny Stock Rules, Online Microcap Fraud, and the Unwary Investor*, 75 IND. L.J. 353 (2000).

193. Christopher A. Yeager et al., *Securities Fraud*, 51 AM. CRIM. L. REV. 1661, 1665 (2014).

al information “in connection with the purchase or sale of any security.”¹⁹⁴ The case of *SEC v. Ascenergy LLC* is a prime example in the crowdfunding context. The issuer allegedly used his own website and several crowdfunding websites to post false claims about a 506(c) offering to spur the interest of investors.¹⁹⁵ The claims misrepresented manager contributions and included statements such as “highly liquid” and “investment will be profitable as long as there is oil and gas to sell regardless of price.”¹⁹⁶ By using the Internet as a new weapon for old tricks, fraudsters have come a long way from handing out brochures used to sell fraudulent bridge bonds.¹⁹⁷

Another common securities violation likely to victimize crowdfunding is the selling of fraudulent or illegal securities by wrongfully claiming an exemption.¹⁹⁸ For example, a man in California allegedly used crowdfunding websites to locate business owners and send unsolicited emails offering to help issuers raise money, falsely claiming to be a registered broker-dealer.¹⁹⁹ Requiring registered intermediaries and issuers to ensure valid registration exemption under Regulation CF exemption²⁰⁰ should reduce this type of fraud; however, some intrastate crowdfunding rules are silent on requiring registered portals, which could lead to more fraudulent exemption claims.²⁰¹

Fraudsters may also tout false information through a variety of social media websites, spam emails, or illegitimate websites. An issuer may advertise false information on websites regarding its company's financial health or growth prospects. More commonly, an issuer may provide false reports of its company's performance over the past few years, or material misrepresentations of investors' likelihood of return.

194. Section 10 of Exchange Act of 1934, 15 U.S.C. § 78(j) (2010); 17 C.F.R. § 240.10b-5 (2010); Yeager, *supra* note 193, at 1665.

195. Plaintiff's Complaint, *SEC v. Ascenergy LLC*, No.2:15-cv-01974-GMN-PAL (D. Nev. 2015), 2015 WL 6513864.

196. *Id.*

197. *Baron v. Shields*, 131 F. Supp. 370, 371 (S.D.N.Y. 1954).

198. Plaintiff's Complaint for Violations of the Federal Securities Laws, Sec. & Exch. Comm'n v. Fleet Mutual Wealth Ltd., No. CV14-01409-DMG(JEMx) (C.D. Cal. 2014); Plaintiff's Complaint for Injunctive Relief, *SEC v. Inter Reef, Ltd.*, No. 1:13-Cv-1104 (N.D. Ga. 2013); 15 U.S.C. § 77(e) (2012) (prohibiting offers and sales of unregistered securities unless relying on a security transaction exception under § 77(d) or a class of securities exemption under § 77(c)).

199. *In re Steven J. Muehler*, Exchange Act Release No. 75996, 2015 WL 5692555, at *1 (Sept. 28, 2015) (order instituting administrative and cease-and-desist proceedings pursuant to sections 15(b) and 21C of the Securities Exchange Act of 1934).

200. Crowdfunding, 80 Fed. Reg. 71,387, 71,451 (Nov. 16, 2015) (effective May 16, 2016) (to be codified at C.F.R. pts. 200, 227, 232 et al.).

201. See Kansas (KAN. ADMIN. REGS. § 81-5-21 (2011)), Maine (ME. REV. STAT. tit. 32, § 16304 (2014)), and Maryland (MD. CODE ANN., CORPS. & ASS'NS § 11-601 (West 1993)).

Using the Internet to promote false successes of a company outside a regulated portal could force uninformed investors into purchasing worthless securities. Because the widespread use and availability of information on the Internet allows fraudsters to target specific groups of people, such as the elderly, investors should avoid third-party websites or information from unknown sources.²⁰²

The primary purpose of the Securities Act of 1933 and the Securities Exchange Act of 1934 is to maintain fair markets and eliminate abusive practices in the securities markets.²⁰³ Both Acts regulate the offer and sale of securities; however, section 10(b) of the 1934 Act and Rule 10b-5 are the key securities fraud provisions.²⁰⁴ Luckily, these federal securities anti-fraud provisions (section 10(b) and Rule 10b-5) apply to all securities, registered and unregistered.²⁰⁵ Thus, the offer and sale of all accredited, unaccredited, and intrastate crowdfunding securities are subject to the same federal anti-fraud provisions.²⁰⁶

B. Obstacles to Enforcement

While informing investors of fraud risks is a great step towards fair markets, Internet-based fraud can be difficult to detect. Internet-based misrepresentations on third-party websites present severe obstacles for securities regulators and investors. These obstacles include the increased need for resources to monitor social media sites and track down violators. Fraudsters commonly use social media websites, such as LinkedIn, to sell fictitious securities to users.²⁰⁷ These websites

202. Sec. & Exch. Comm'n v. Imperia Invest IBC, Litigation Release No. 21686, 2010 WL 3938787 (Oct. 7, 2010) (SEC obtains temporary restraining order and asset freeze of Imperia Invest IBC relating to Internet based offering fraud); *In re Michael Migliozi II & Brian William Flattow*, SEC News Digest 2011-110-5, 2011 WL 2249148, at *1 (June 8, 2011).

203. 15 U.S.C. § 77 (2012); 15 U.S.C. § 78; see *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975).

204. See 15 U.S.C. § 78(i)(b) (1934); 17 C.F.R. § 230.10b-5.

205. A violation under section 10(b) includes "[t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78(j) (emphasis added); A violation under Rule 10(b)-5 includes "(a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (emphasis added).

206. See Yeager, *supra* note 193, at 1666.

207. *In re Anthony Fields, CPA*, Securities Act of 1933 Release No. 474, 2012 WL 6042354, at *1, *13 (Dec. 5, 2012).

also provide fraudsters with a platform to connect with other violators for the purpose of posting misleading or false information about companies and offerings. While resale restrictions and holding periods help prevent some forms of affinity fraud such as short selling, fraudsters can still inflate stock through false claims on third-party websites or email spam.

The biggest threat and arguably the best explanation for the SEC's long delay in adopting crowdfunding is the risk of fraud to unaccredited or unsophisticated investors.²⁰⁸ Presumptively, accredited investors (a) can risk an investment loss due to their affluent status or (b) be financially sophisticated to make well-informed investment decisions unlike unaccredited investors.²⁰⁹ Investing always carries some inherent risk but dealing in private securities certainly heightens this risk due to minimal monitoring and disclosure. Even the highly regulated and publicly traded companies on the NASDAQ and the New York Stock Exchange experience substantial acts of fraud and misrepresentation, such as the notorious Bernie Madoff Ponzi scheme.²¹⁰ Thus, adequate regulations will never completely remove fraud but should aim to achieve effective monitoring through disclosure without overly burdensome or confusing compliance.

Under Regulation CF, the issuer's use of third parties to advertise deals outside funding portals should prove difficult to enforce. The SEC's intent to require portals to provide most, if not all, the necessary information on the portal is the safest approach, but unrealistic. While registered crowdfunding sites can provide some information on issuers, investors will likely use external resources to gain more information.²¹¹ This provides an opportunity for criminals to solicit false information on deals.²¹² Therefore, preventing risks of false information on third-party websites will mostly rely on the investors or "the crowd."

208. Steven Solomon, *S.E.C.'s Delay on Crowdfunding May Just Save It*, N.Y. TIMES (Nov. 18, 2014, 2:56 PM), http://dealbook.nytimes.com/2014/11/18/s-e-c-s-delay-on-crowdfunding-may-just-save-it-2/?_r=0.

209. Rodrigues, *supra* note 115, at 3422-23.

210. See Robert Lenzner, *Bernie Madoff's \$50 Billion Ponzi Scheme*, FORBES (Dec. 12, 2008, 6:45 PM), http://www.forbes.com/2008/12/12/madoff-ponzi-hedge-pf-ii-in_rl_1212croesus_inl.html.

211. *Id.*

212. Sec. & Exch. Comm'n v. Agora, Inc., No. MJG 03 CV 1042 (D. Md. 2003) (website claiming to provide independent information but offered inside tips to induce investors to pay Agora for subscriptions or purported insider information that was false).

Funding portals must include measures to prevent fraud and provide investor education centers to encourage informed decisions by investors.²¹³ Education centers, in addition to communication channels, should help investors detect crowdfunding fraud. Moreover, imposing site restrictions and monitoring should reduce third-party exposure but will not eliminate exposure to misleading information. The threat of exposing investors to misleading information on the Internet presents a need to balance investors' ability to access information by maintaining "the crowd" but weeding out illegitimate websites. Portals must monitor and implement policies intended to block ineligible individuals from crowdfunding. Equity-based crowdfunding presents fraud risk with the wide use of the Internet and less regulated capital markets, however, the industry is producing products and services to combat fraud.²¹⁴

C. The Crowdfunding Industry

The crowdfunding industry has rapidly expanded with professionals looking to ease the compliance confusion and assist participants with fraud concerns. The emergence of crowdfunding has kept traditional securities regulators like the SEC and FINRA busy developing suitable rules, interpretations, and proposals for both federal and state crowdfunding. Fortunately, new crowdfunding associations and advocates are stepping in to assist securities regulators in developing rules including the Crowdfund Intermediary Regulatory Advocates and the National Crowdfunding Association.²¹⁵ Advocates and various websites are devoted to educating investors and promoting the best crowdfunding practices.²¹⁶ Investors, intermediaries, and issuers can obtain a vast amount of information from sites such as crowdsourcing.org and thecrowdcafe.com. Services such as Crowdfunding Accreditation for Platform Standards ("CAPS") provide accreditation for fund-

213. See Dorff, *supra* note 8, at 504.

214. *Infra* text accompanying notes 224–228.

215. CROWDFUND INTERMEDIARY REGULATORY ADVOCATES, <http://www.cfira.org/> (last visited Feb. 8, 2016); NAT'L CROWDFUNDING ASSOC., <http://www.nlcfa.org/> (last visited Feb. 8, 2016).

216. [Crowdfundinsider.com](http://crowdfundinsider.com) is an excellent resource for crowdfunding news, research, and guidance on the emerging industry. Moreover, websites such as accreditedinvestormarkets.com provide unlimited research, advice, and educational resources.

ing platforms,²¹⁷ and other companies provide accreditation services for investors to ensure compliance with accredited crowdfunding laws.

In the last few years, crowdfunding portals' virtual presence has grown rapidly in response to an increased demand for their dynamic services. A portal's process starts with the issuer or business creating an account on the portal's website.²¹⁸ The issuer provides a substantial amount of information regarding the company, investment goals, employees, financial information, and proposal documents.²¹⁹ Some websites require more information and emphasize the need to submit credible documents while others demand less. Once the application is submitted, the portal's staff reviews the application and may request more information during review. If accepted, the offering is publicly displayed on the website for member investors to review and start making investments. This initial review is a great mechanism for screening out ineligible investors, and fraudulent issuers.

The companies listed on portals can vary in terms of industry, offering size, and growth stages. For example, SeedInvest.com focuses on the early growth stage companies while AcePortal.com seeks later stage companies.²²⁰ However, portals generally follow one of the two approaches in regards to issuers' investment goals: 1) the "all or nothing" approach or 2) the "keep what you raise" approach.²²¹ The "all or nothing" approach is a safer method against fraud because issuers must reach investment targets before receiving funds. This gives portals, regulators, and investors more time to research the offering. However, some portals operate under the "keep what you raise" approach where the issuer receives the investments regardless of the amount raised.

The growing adoption of intrastate crowdfunding in numerous states has generated a variety of local portals. Residents can use the North American Securities Administrator's Association's ("NASAA") Intrastate Crowdfunding Directory in addition to their state securities

217. CROWDSOURCING.ORG, <http://www.crowdsourcing.org/caps> (last visited Feb. 28, 2015) (basing accreditation on the following factors: (1) operational transparency, (2) security of information and payments, (3) platform functionality, and (4) operational procedures).

218. For an example of the application process see SEEDINVEST.COM, https://www.seedinvest.com/apply?ref_page=landing&ref_loc=banner_link (last visited Dec. 31, 2015).

219. *Id.*

220. *Id.*; ACEPORTAL, <https://aceportal.com/> (last visited Dec. 31, 2015).

221. See C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 16 (2012).

website to search for portals in their state. For example, Wisconsin's website publishes filings made by portals in their state including information on the type of companies portals seek to provide their services.²²² Intrastate crowdfunding portals may offer services to one individual state or services to several states, such as LocalStake.com. But these multi-state portals must restrict investors to local offerings within their resident state. One website even provides state bill tracking for individuals to monitor their state's progress in adopting crowdfunding laws.²²³

This innovative crowdfunding industry has produced a wide range of services beyond portals. Entrepreneurs offer marketing, crowd design, and other ancillary services intended to attract investors and ease crowdfunding operations. Individuals can obtain a wide range of services tailored to their needs including due diligence and disclosure reports for compliance,²²⁴ regulatory research,²²⁵ crowdfunding software for portals,²²⁶ and advertising and consulting services.²²⁷ NextGen Crowdfunding and Crowdfundingroadmap, Inc. recently formed a partnership to help connect crowdfunding investors, issuers, and service providers offering a range of services including: broker-dealers, accountants, securities attorneys, and other industry experts.²²⁸ Several law firms initiated new crowdfunding practice groups including large firms such as Seyfarth Shaw LLP and Goodwin Procter LLP.²²⁹

222. For State of Wisconsin, see *Crowdfunding in Wisconsin*, STATE OF WIS. DEPT. FIN. INST., <https://www.wdfi.org/fi/securities/crowdfunding/default.htm> (last visited Dec. 31, 2015).

223. BILL TRACK 50, <http://billtrack50.com/About> (last visited Feb. 28, 2015).

224. CROWDCHECK, <http://www.crowdcheck.com/> (last visited Feb. 5, 2015).

225. ZACKS CF RESEARCH, <http://research.zackscrowd.com/> (last visited Feb. 15, 2015).

226. CROWDENGINE, <http://www.crowdengine.com/> (last visited Feb. 15, 2015).

227. ZACHS DIRECT, <http://www.zacksdirect.com/> (last visited Feb. 28, 2015) (accredited investor advertising services); PREFUNDIA, <http://prefundia.com/> (last visited Feb. 28, 2015) (pre-crowdfunding activities consulting); *Company Overview of Deliver the Crowd LLC*, BLOOMBERG BUS., <http://investing.businessweek.com/research/stocks/private/snapshot.asp?privcapId=251761650> (last visited Dec. 31, 2015).

228. Samantha Hurst, *NextGen Crowdfunding Teams Up with Crowdfundingroadmap to Advance Regulation A+*, CROWDFUND INSIDER (Oct. 28, 2015, 11:15 AM), <http://www.crowdfundinsider.com/2015/10/76400-nextgen-crowdfunding-teams-up-with-crowdfundingroadmap-to-advance-regulation-a/>.

229. Kaitlin Ugolik, *Firms Meet Crowdfunding Fervor with New Practice Groups*, LAW360 (Aug. 18, 2014, 7:15 PM), <http://www.law360.com/articles/567742/firms-meet-crowdfunding-fervor-with-new-practice-groups>; *Crowdfunding*, GOODWIN PROCTER, <http://www.goodwinprocter.com/Practices/Specialty-Practices/Crowdfunding.aspx> (last visited Dec. 31, 2015). Additionally, Seyfarth Shaw LLP received recognition for the firm's strong contributions to the crowdfunding industry, including its software "Disclosure Dragon," which is the first online document assembly tool for preparing documentation directed towards the crowd-

D. Future of Crowdfunding

The rising adoption of crowdfunding in the federal and state securities laws demonstrates the desirability of equity-based crowdfunding and need to bridge the gap in accessing capital markets. The current regulations created a crowdfunding market but will require continual adjustments to produce an efficient market. The future of crowdfunding depends on the industry's ability to identify flaws and collaborate with regulators towards developing the best practices. Increasing offering caps, simplifying compliance obligations, and removing state-based review for federal offerings are all recommendations that will make crowdfunding more affordable, efficient, and comprehensible. The value of crowdfunding is derived from its flexibility, accessibility, and creativity, which must not be displaced by overregulation.

Equity-based crowdfunding in the United States should rise dramatically due to the growing public awareness and acceptance by regulators. In 2012, NASAA reported a sharp rise in crowdfunding-related websites in reaction to the JOBS Act.²³⁰ However, the delay in adopting regulation put many of these sites on hold until recently. Since 2013, businesses have raised approximately \$765.15 million through accredited crowdfunding.²³¹ Crowdfunding should increase substantially now that the additional ninety-one percent of Americans may now crowdfund.²³² Notably, the real estate industry has benefitted substantially

funding industry. *SeyfarthLean Consulting Unveils Disclosure Dragon Software to "Jumpstart" Crowdfunding Offerings*, SEYFARTH SHAW (Feb. 25, 2014), <http://www.seyfarth.com/news/2448>; see also Georgia Quinn & Anthony Zeoli, *The Definitive Guide: Proposed Intrastate Crowdfunding Exemptions*, CROWDFUND INSIDER (July 24, 2014, 12:04 PM), <http://www.crowdfundinsider.com/2014/07/45170-definitive-guide-proposed-intrastate-crowdfunding-exemptions>.

230. "An analysis of Internet domain names by state and Canadian securities regulators found nearly 8,800 domains with "crowdfunding" in their name as of November 30, 2012, up from less than 900 at the beginning of the year. Of these websites, about 2,000 contained content, more than 3,700 had no content and more than 3,000 appeared to be 'parked' and serving as placeholders to reserve a domain name for later use or sale. Of the domains with 'crowdfunding' in their name, about 6,800 have appeared since April, 2012 when the JOBS Act was signed into law." Bob Webster, *NASAA Sees Sharp Spike in Crowdfunding Presence on the Internet*, NASAA (Dec. 5, 2012), <http://www.nasaa.org/18951/nasaa-sees-sharp-spike-in-crowdfunding-presence-on-the-internet/>.

231. *Crowdnetic's Q2 Report: The Industry Continues to Grow*, CROWDNECTIC, <http://www.crowdnetic.com/reports/jun-2015-report> (last visited Dec. 3, 2015).

232. Jonathan Shieber, *As SEC Votes on Title III Crowdfunding Regulations, Investment Platforms Are Divided on Impact*, TECHCRUNCH.COM (Oct. 30, 2015), <http://techcrunch.com/2015/10/30/as-sec-votes-on-title-iii-crowdfunding-regulations-investment-platforms-are-divided-on-impact/>.

from equity-based crowdfunding and continues to grow with total capital raised above \$662 million in 2015.²³³

Small businesses should note the low success rates for equity-based crowdfunding. Crowdfunding is not a simple path to capital but a science. Issuers will need to provide a strong campaign, know their investors, make continual updates, and present signs of success. Investors must also make realistic expectations and understand the limited secondary market. A “venture exchange” bill is currently circulating Congress to improve crowdfunding liquidity by developing a secondary market exchange similar to the NASDAQ and NYSE.²³⁴ Moreover, the SEC recently proposed rules to modernize Rule 147 for intrastate crowdfunding, which would allow regional crowdfunding exchanges.²³⁵ The adaptable and entrepreneurial characteristics of crowdfunding should expand capital avenues and produce revolutionary investment vehicles. With help from industry experts, regulators, and financial professionals, the crowdfunding framework will continue to evolve, bridging gaps in capital markets.

CONCLUSION

The growing adoption of equity-based crowdfunding in the United States demonstrates progress in easing access to capital for small businesses and startups. The four currently available crowdfunding-related exemptions offer different costs and benefits, allowing businesses to identify optimal suitability. Crowdfunding is not intended to replace traditional financing methods nor will it be any less vulnerable to fraud; however, crowdfunding provides businesses with a unique opportunity to be creative, and to publicly solicit and interact with a crowd of investors at a relatively low cost. Both businesses and investors can learn more about financing through this revolutionary investment mechanism.

233. Andrew Zaleski, *Equity Crowdfunding Hits \$662 Million in 2015*, CNBC: QUARTERLY INV. GUIDE (Apr. 16, 2015, 10:54 AM), <http://www.cnbc.com/2015/04/16/equity-crowdfunding-hits-662-million-in-2015.html>.

234. Main Street Growth Act, S. 1, 114th Cong. (2015) (proposed by Rep. Scott Garrett); *Venture Exchanges and Small-Cap Companies: Hearing on H.R. 3606 Before the S. Subcomm. on Sec., Ins., and Inv., Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. (Mar. 10, 2015) (testimony of Stephen Luparello, Director, Division of Trading and Markets).

235. Press Release, Sec. Exch. Comm'n, SEC Adopts Rules to Permit Crowdfunding (Oct. 30, 2015) (on file at <http://www.sec.gov/news/pressrelease/2015-249.html>).