Access to Capital: Rethinking Local Crowdfunding

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ABSTRACT

As a response to recent and possibly premature state action in passing local crowdfunding legislation, this Comment examines why states should exercise care in their choice of language and legislation when amending state securities laws to enable crowdfunding.

In order to understand the landscape of crowdfunding as a form of capital formation, it is imperative to understand generally how and why the states have turned to the enactment of legislation in order to aid small businesses in raising capital. Borrowed from the rewards-based model1 of crowdfunding, made most popular by Kickstarter and Indiegogo, investment crowdfunding2 is viewed as an innovative measure for raising capital that no longer relies upon the conventional3 institutions to provide funding for small businesses. These small companies may never elicit the attention necessary to induce investment from institutions most able to provide them with the capital they need, and so investment crowdfunding was born from this need to reach a broad audience, while also encouraging and facilitating investment from anyone and all who were financially capable of doing so.

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1. Rewards-based crowdfunding is based on the exchange of monetary contributions for current or future goods or services. “Individuals or companies who launch campaigns may compensate contributors with something like a t-shirt, a copy of whatever they are building, or even just a thank you.” The Ultimate Crowdfunding Guide, CROWDFUND INSIDER, http://www.crowdfundinsider.com/the-ultimate-crowdfunding-guide/ [http://perma.cc/5WLT-Y6AC] (last visited May 18, 2016).

2. Investment crowdfunding is based on the exchange of a monetary “investment” for company equity, or ownership through issuance of shares to the person who made the monetary contribution, with an expectation of some future return on that investment. See generally id.

3. Before the concept of crowdfunding took hold, businesses raised money by pursuing investment from venture capital firms, taking on loans from banks or raising the money through friends and family. See, e.g., Adam Heitzman, 5 Best Ways for Funding a Startup, INC. (Nov. 25, 2014), http://www.inc.com/adam-heitzman/5-best-ways-for-funding-a-startup.html [https://perma.cc/H4JS-A3VM].
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INTRODUCTION

The idea that investment crowdfunding could become a viable option for small businesses and startups in raising capital started with a promise from the Jumpstart Our Business Startups (JOBS) Act, which announced that every American would be able to help their fellow countryman raise funds to promote small business growth and job creation. The JOBS Act would provide a way for every person to invest in these businesses. From an even wider angle, it was about economic growth and development of new forms of grassroots efforts to raise cash for those who could no longer go out and get a business loan as a result of the Great Recession and the tightened restrictions on lending. Even at record-low interest rates (which have been held steady by the Federal Reserve Bank), small businesses, and especially start-up companies, suffered from conservative attitudes of financial institutions and typically risk-averse venture capital firms making investments in only the most chic and “slam-dunk” opportunities.

5. See generally id. § 301 (calling the crowdfunding provisions contained in Title III of the JOBS Act the “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012” or the “CROWDFUND Act”).
In order to manage the discourse, in Part I, this Comment establishes a background of securities law as it once stood. Part II examines the emergence of crowdfunding and the questions that arise given the body of law as it stands today. Part III then examines Blue Sky Laws and their effectiveness in creating registration exemptions for crowdfunding through either intrastate exemptions or Rule 504 of Regulation D. Finally, Part IV offers suggestions for how securities laws should evolve in the future in order to facilitate access to capital through crowdfunding. It is the hope of the author that upon reflection on this Comment, the importance of considering the securities law component of state-level investment crowdfunding legislation will reveal itself as the keystone for promotion of investment in small businesses.

I. BACKGROUND OF FEDERAL SECURITIES LAWS

There are numerous statutes and regulations that apply to the offer and sale of securities in the United States.6 On the federal level, the two primary regulatory schemes are established by the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act). Along with the Investment Company Act of 1940 (Investment Company Act), as amended, and the Investment Adviser Act of 1940 (Investment Adviser Act),7 as amended, these statutes create the “core federal law on securities regulation.”8

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7. According to the SEC Legal Overview: (1) the Investment Company Act “regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public” and (2) the Investment Advisers Act “requires that firms or sole practitioners compensated for advising others about securities investments must register with the SEC and conform to regulations designed to protect investors.” See id.

A. The Securities Exchange Act of 1934

The Exchange Act established the United States Securities and Exchange Commission (SEC or the Commission) as the agency primarily responsible for the enforcement of the United States federal securities laws.\(^9\) The Exchange Act is the principal source of reporting obligations for public companies and regulates the secondary trading of securities in the United States.\(^10\) It also establishes the federal regulatory framework applicable to national securities exchanges and various persons involved in the securities industry, such as broker-dealers, securities analysts and credit rating agencies.\(^11\)

The Exchange Act also includes broad anti-fraud provisions which generally apply to all securities offerings, irrespective of whether they are registered or exempt. Section 10(b) of the Exchange Act makes it illegal “[t]o use or employ, in connection with the purchase or sale of any security...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”\(^12\)

Rule 10b-5, promulgated by the SEC under section 10(b) of the Exchange Act, prohibits making an untrue statement of a material fact or omitting a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading.\(^13\)

B. The Securities Act of 1933

Enacted in reaction to the stock market crash of 1929,\(^14\) the Securities Act was designed to ensure investors have access to financial and other significant information about securities being offered and sold by a company to investors.\(^15\) The Securities Act makes it illegal to offer and sell


\(^10\) See id.

\(^11\) Id.

\(^12\) Id.


\(^14\) See Ad Hoc Subcomm. on Merit Regulation of the State Regulation of Sec. Comm., Report on State Merit Regulation of Securities Offerings, 41 Bus. Law. 785, 793 (1986) [hereinafter Report on State Merit Regulation] (discussing the historical context in which federal securities laws were enacted in the 1930s).

\(^15\) The Securities Act also prohibits fraud in connection with the offer and sale of securities and creates recovery rights if investors who purchase securities suffer losses and can prove that disclosures made in connection with the offer and sale of securities by the company issuing such securities were incomplete or inaccurate. SEC Legal Overview, supra note 6.
securities without first registering them with the SEC unless the offering is exempted from registration requirements. Section 5(a) of the Securities Act states:

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

The Securities Act contemplates that some types of offerings would not need to be registered. Sections 3 and 4 of the Securities Act identify the circumstances where the section 5 registration requirements (and, in certain circumstances, other provisions of the Securities Act) do not apply to a particular offer and sale of securities. In many instances, the availability of a particular exemption turns, in large part, upon the nature of the investor (i.e., whether or not they satisfy certain residency, sophistication, or wealth standards), the amount of money an issuer hopes to raise, and the manner by which the offering is conducted (i.e., many exemptions prohibit the use of general solicitation and general advertising to market the securities).

Beyond the protections to investors inherent in the registration requirement, the Securities Act is premised on a disclosure-based model, rather than one based on the merit of the offering. The law requires persons offering and selling securities to prepare specific disclosures based on forms adopted by the SEC that apply depending on the structure and other conditions of the offer. These forms, often including a prospectus, generally include narrative disclosures regarding the company issuing the securities (referred to as the “issuer”), the terms of the offering, and financial disclosures. The goal is for the issuer to fully disclose all material information that a reasonable investor would require in order to

18. See Louis Loss & Joel Seligman, Securities Regulation (3d ed. 1989). The “battle of the philosophies” that arose during the original adoption of the Securities Act of 1933 is thoroughly elaborated upon by the authors, but the outcome is frankly explained by the authors: “President Roosevelt chose the disclosure philosophy.” Id. at 178.
20. Id.
make a decision about whether or not to purchase its securities. The requirement to file a registration statement (and subject it to review by the SEC) is designed to ensure adequacy and completeness of the disclosures as required by the corresponding rules and regulations—not to guarantee of the accuracy of such information, or the fairness, soundness of or relative risk associated with the particular investment.21

II. ACCESS TO CAPITAL THROUGH THE CROWD

With the emergence of new trends in investing came the need for new federal legislation. Signed into law by President Obama in April 2012, the Jumpstart Our Business Startups (JOBS) Act was intended to encourage the funding of small businesses by easing various securities regulations. Among other things, Title II of the JOBS Act allows private companies to openly advertise offerings and solicit certain “accredited” investors, on the internet and elsewhere, through a private placement exemption under Rule 506(c) of Regulation D.22 Secondly, Title III of the JOBS Act paves the way for unaccredited investors23 to take part in these offerings through crowdfunding, subject to various limitations.

Unfortunately, many of the changes proposed by Title III of the JOBS Act are not yet available as of the writing of this Comment, even after finalization of the rules on October 30, 2015.24 Those rules finalized on October 30, 2015 will become effective 180 days after publication in the Federal Register, or May 16, 2016.25 For years since the adoption of the JOBS Act, and even to this day, companies can only accept money in an investment crowdfunding campaign from those investors who are

21. See id. “In declaring a registration statement effective under the Securities Act, the Commission does not consider the merits of the offering, but whether all material information is disclosed.” Id.


23. Individuals who do not meet the requirements of the “accredited investor” definition are those who are not professional investors, do not have more than $1 million in assets, and do not make more than $200,000 a year as an individual, or $300,000 as a household. See 17 C.F.R. § 230.501 (2015).


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"accredited investors" unless local initiatives like the ones discussed within this Comment are available.

Even after the SEC rules become effective, there are many aspects of crowdfunding at the federal level that will likely deter small businesses from utilizing this particular crowdfunding mechanism. Under JOBS Act "Regulation Crowdfunding," companies will be limited to raising $1 million in any twelve-month period. In addition, companies cannot crowdfund on their own; they will be required to engage an intermediary in order to conduct an offering. These intermediaries will be in the form of a funding portal, and will be subject to a number of requirements, including Financial Industry Regulatory Authority (FINRA) membership and SEC registration. All investors, even those that qualify as accredited, will be limited in the amount they can invest by way of crowdfunding in any twelve-month period under the following metrics: (1) if their annual income or net worth is less than $100,000, investors may invest the greater of $2,000 or 5% of annual income or net worth, or (2) if their annual income or net worth is more than $100,000, investors may invest 10% of annual income or net worth up to a maximum of $100,000.

Title III of the JOBS Act added the new section 4(a)(6) to the Securities Act, codifying Regulation Crowdfunding. Section 4(a)(6) requires the SEC to adopt the aforementioned new rules to permit issuers to raise capital through the use of crowdfunding. As considered by the JOBS Act, crowdfunding involves funding a project or venture by raising monetary contributions from a large number of people, typically through the internet. Crowdfunding campaigns designed to let a venture accept monetary "donations" or "contributions" in exchange for some kind of incentive, recognition, or promotional gift have become popular in recent years on platforms such as Kickstarter or Indiegogo. Crowdfunding campaigns of this nature are possible because in exchange for a contribution of money to a venture, it offers "rewards" rather than securities. As illustrated by the discussion above, most of the exemptions that are available on the federal level place limitations on the nature of who can invest in an exempt offering (i.e., either they must be an accredited investor or...
ACCESS TO CAPITAL

Investor or only a limited number of sophisticated or non-accredited investors may participate) and/or prohibit the use general solicitation and advertising—which are in direct opposition to the concept of crowdfunding. Section 4(a)(6) creates an exemption from federal registration requirements and preempts state regulation of such offerings. Companies could raise up to $1 million in any twelve-month period, provided that they meet the requirements imposed by the rules and regulations adopted by the SEC.

The SEC proposed rules implementing section 4(a)(6) on October 23, 2013, years after the deadline imposed by the JOBS Act, and it took another two full years to see finalization of those proposed rules. The crowdfunding provisions of the JOBS Act were designed to help provide startups and small businesses with capital by making relatively low dollar offerings of securities less costly. They also permit the internet-based platforms to facilitate the offer and sale of securities without having to register with the SEC as brokers.

In late October 2013, the SEC proposed a regulatory framework—including rules and forms—that began what will finally be the implementation of crowdfunding provisions of the JOBS Act. The proposed crowdfunding rules and forms include a new regulation, Regulation Crowdfunding, which would govern offerings made in reliance on the section 4(a)(6) exemption from Securities Act registration. FINRA also issued a regulatory notice soliciting comments on proposed rules and forms that would govern SEC-registered funding portals. Under the JOBS Act and the proposal, funding portals must be a member of a national securities association, and FINRA is the only currently existing association of that kind.

Crowdfunding involves real-time commentary and feedback by potential investors on the value of an investment or the business of a company. Investors are expected to dialogue directly with the issuer and among themselves regarding the terms and value of the offering while it is ongoing. To enable issuers to respond to this type of commentary, the proposed rules also would allow an issuer to communicate with investors and potential investors about the terms of the offering through

32. Id. at 71388.
33. Id. at 71388–89.
communication channels provided by the intermediary on the intermediary’s platform, so long as the issuer identifies itself as such in all communications. 37 Beyond this, the issuer is extremely limited in how it can otherwise advertise the offering. If an issuer compensates a person to promote the offering through the crowdfunding intermediary’s communication channels, the issuer must take reasonable steps to ensure the compensated promoter identifies itself as such. 38

The SEC has only recently finalized the rules that govern how companies can use JOBS Act crowdfunding to raise money from investors, and this Comment will consider whether the implementation of other crowdfunding legislation has become potentially more practical for investors and small businesses alike. These SEC rules are generally much more intricate than any state-level legislation, and include what must be disclosed to prospective investors before they decide to participate, as well as requirements for how intermediaries will operate. For instance, crowdfunding intermediaries are almost certainly going to be in the form of funding portals or registered broker-dealers; thus much of the rulemaking is centered around how to promote and then regulate intermediaries wishing to utilize Regulation Crowdfunding. Initial guidance on crowdfunding intermediaries is available on the SEC website under “Market Regulation” 39 and can be viewed within the final rules as well. 40 Moreover, and all too important when considering different methods for raising capital, companies cannot use JOBS Act crowdfunding until the rules become effective May 16, 2016. In the meantime, businesses must look to other mechanisms in order to fund their next venture.

JOBS Act legislation promised to revolutionize crowdfunding in the national market by greatly increasing the pool of potential investors who could fund small businesses, but despite a deadline to issue rules set forward in the JOBS Act, crowdfunding under the CROWDFUND Act 41 of Title III did not appear to be made a priority. 42 The first hint at possible

38. Id. at 71426.
42. The JOBS Act provided the SEC 270 days from enactment of the legislation to issue rules, placing the long-past deadline at December 31, 2012. Id. § 302, 126 Stat. at 320.
rules came about with the release of Proposed Rules in October 2013, but after the ninety-day comment period, final implementation has only recently seen promise, more than two years later. With years passing, and no legal method of crowdfunding, states turned to the enactment of local statutory provisions, taking the form of legislation enabling state-level crowdfunding, reliant on exemptions from registration of non-qualifying securities offerings.  

III. BLUE SKY LAWS: A LOCAL SOLUTION?

Since the enactment of the JOBS Act, and in particular, since the publication of the initial Regulation Crowdfunding proposed rules in late 2013, many states began to study, propose, and pass new statutory provisions that enable local companies to commence offerings without registering those transactions with the SEC. These efforts generally mirror the fundamental design of section 4(a)(6), permitting crowdfunding of small dollar amounts through the internet in a controlled environment. The resulting provisions tracked two federal exemptions, section 3(a)(11) of the Securities Act (intrastate offering exemption)—often accompanied by the safe harbor of Rule 147—or alternatively, an exemption derived from section 3(b) in the form of Rule 504 of Regulation D. Instead of federal registration, by using Rule 504, an issuer could register securities offerings with the corresponding state securities division, taking advantage of reductions in complexity and cost associated with the local offering and local registration. In regard to the section 3(a)(11) state registration requirement, the aforementioned statutory provisions that developed


44. The term “local” is used generally in this Comment to identify the region in which an issuer is located, with the statutory provisions dictating whether that issuer be required to comply with provisions of section 3(a)(11), the safe harbor provided by Rule 147, or alternatively, constraints incorporated into a state exemption based on the federal exemption in Rule 504 of Regulation D. 17 C.F.R. § 230.147 (2015).

45. Id. A special variety of SEC interpretative rules are the so-called safe harbor rules. A safe harbor rule sets forth conditions under which the SEC will take the position that the law has been complied with. A person’s compliance with a safe harbor rule will thus ensure that he or she is safe from SEC prosecution with regard to the transaction in question. The SEC safe harbor rules are designed to help provide certainty in planning transactions in order to comply with the applicable securities laws.

46. 15 U.S.C. § 77c(b)(1) (2012) (permitting the SEC to adopt rules and regulations exempting a class of security if it finds that the enforcement of registration “is not necessary in the public interest and for the protection of investors” either due to the limited character or by reason of the small amount involved in the offering (not to exceed $5 million)).

47. 17 C.F.R. § 230.504.
recently are a response by which states are providing an easier, and more clear direction for compliance with notification and disclosure requirements.

Inherent in state regulation is a dramatic reduction in the associated cost of an offering,48 as well as statutory provisions that better suit a state-by-state policy regarding capital formation and investor protection. These state exemptions are purposefully designed to limit the need for attorneys or accountants in the preparation of the requisite disclosures and forms. Most limit the need for audited or reviewed financial statements unless the issuer seeks to raise its offering amounts, which in many cases is double that which can be raised under Regulation Crowdfunding.49 However, with the reduced cost of an offering regulated by the states come other challenges. The lack of uniformity among the states adds to the troubles an issuer may face in avoiding federal regulation, while the diminished disclosure requirements are a net positive for many issuers who simply cannot afford the costs of federal compliance and SEC governance.

A. The Gray Areas

i. Lack of Uniformity

Recognizing the need for uniformity among the states, the Uniform Law Commission (ULC)50 proposed the Uniform Sales of Securities Act of 1930. However, no uniform law is effective until a state legislature adopts it, and few states had done so at that time.51 Congress left existing Blue Sky Laws in place in 1933 when it adopted the Securities Act.52 This, combined with unsuccessful attempts at establishing uniformity among the

51. See Securities Act of 1933, §18 (amended 1996) (providing “[n]othing in this subchapter shall affect the jurisdiction of the securities commission . . . of any State . . . over any security or person”).
52. See NSMIA Report, supra note 19.
states,\textsuperscript{53} gave rise to the existing series of overlapping, sometimes contradictory, laws governing securities offerings today.\textsuperscript{54} The lack of uniformity presents significant hurdles for companies attempting to conduct an offering in multiple states.\textsuperscript{55} In particular, a report from the American Bar Association in 1986 highlighted problematic inconsistencies between exemptions provided under the Securities Act, which were not uniformly covered by Blue Sky Laws:

Not all federally exempt offerings . . . are exempted at the state level . . . . In the absence of coordinated state exemptions, a substantial number of offerings exempt from federal registration remained subject to state registration and hence merit review . . . . An offering exempt from federal 1933 Act registration . . . will face an array of options, ranging from registration in every state in which it is offered, to exemption in every such state, to registration in some and exemptions in others.\textsuperscript{56}

Additional substantive or procedural requirements may be imposed on an offering through the application of one or more statements of policy or model rules promulgated by the North American Securities Administrators Association (NASAA).\textsuperscript{57} NASAA’s statement of policy and model rules are designed to offer uniform guidelines for the review of offerings within various states. These guidelines, however, are not uniformly adopted by local jurisdictions, and thus add another layer of complexity to Blue Sky compliance.

\textsuperscript{53} Additional attempts at uniformity among the states continued. The Uniform Securities Act of 1956, which replaced the 1930 Act, was enacted in 37 jurisdictions, but the 1985 revision, as amended in 1988, was enacted in only six states. \textit{Securities Act Summary}, \textit{supra} note 8. The Uniform Law Commission identifies the role of merit review at the state level as a primary reason for many states’ “reluctance” to adopt the 1985 version of the Uniform Securities Act. \textit{Id.} Most recently, the ULC has proposed the 2002 Uniform Securities Act, designed to replace both the 1956 and 1985 Acts. \textit{Id.}

\textsuperscript{54} “Thus, the state-federal system of securities regulation is not a precisely coordinated allocation of regulatory responsibilities but a relatively uncoordinated combination of state and federal agencies with overlapping, and sometimes conflicting, regulatory philosophies and priorities.” \textit{Report on State Merit Regulation, supra} note 14, at 822.

\textsuperscript{55} \textit{See NSMIA Report, supra} note 19.

\textsuperscript{56} \textit{Report on State Merit Regulation, supra} note 14, at 822.

\textsuperscript{57} A voluntary association of local securities administrators, NASAA, is “the voice of state securities agencies responsible for efficient capital formation and grass-roots investor protection” with a fundamental mission of “protecting consumers who purchase securities or investment advice.” \textit{About Us}, NASAA, \url{http://www.nasaa.org/about-us/} [\url{http://perma.cc/8YXL-QR5Y}] (last visited May 19, 2016).
ii. Disclosure Requirements

The disclosure requirements placed on issuers and intermediaries represent an area of significant divergence between federal and state crowdfunding laws. The states do not impose upon issuers the same level of disclosure requirements put into place at the federal level. The SEC's final rules highlight that issuers under the federal rules are subject to complex financial disclosures which potentially require substantial spending on legal fees, accountants, and auditors. These rules also cite estimates that an issuer seeking to raise $1,000,000 could incur as much as $168,500 in costs, while a $99,000 offering could cost the issuer as much as $24,500. These estimates show that raising capital at the federal level is expensive—so much so that issuers look to reduce costs by possibly avoiding the federal crowdfunding exemption altogether. Even though the state exemptions have yet to give issuers a similar estimate to apply, the state legislation provided as an example later in this Comment requires filing much more minimal disclosures. These state exemptions are purposely enacted to limit the need for attorneys or accountants in preparation of the requisite forms, and most altogether refrain from mandating that reviewed or audited financial statements be provided, unless the highest of amounts is to be raised. These costs represent some of the highest single expenses associated with compliance; the proposed rules estimated the cost for audited financial statements to be $28,700 for a raise of $500,000 or more and the final rules reflect a range from $2,500 to $30,000, depending on complexity of the business industry of the issuer.

State law represents the genesis of securities regulation in the United States, with the first state securities regulation preceding the Securities Act of 1933 by twenty-two years. Much like its recent history, Kansas was first to enact legislation regulating the sale and distribution of securities. It is often claimed, even, that the origin of the term "Blue Sky Laws" can
be traced to the Kansas legislature, having been fearful of "fast-talking
eastern industrialists selling everything, including the blue sky."65

Unlike federal securities regulations, many states' securities laws
focus less on full disclosure, generally requiring a merit analysis of the
investment.66 The merit approach precludes the offer for sale of securities
within the state's borders without substantive scrutiny, often implementing
fairness standards that make qualification for state exemptions stricter than
those at the federal level.67 Although seemingly logical to conclude that
regulation at a local level would be more conducive to investor protections,
Congress did not come to the same conclusion. The regulation of securities
would become divided by their local or national nature.

iii. Merit Review

The manner of review on the state level can also vary significantly
from federal regulation. Although registration and/or qualification with the
states involve much of the same process as on the federal level, many states
also apply a merit review approach to registered securities offerings.68
While there is no uniform definition of what "merit regulation" means, an
ad hoc subcommittee of the State Regulation of Securities Committee of
the ABA Section of Corporation, Banking and Business Law (ABA Ad
Hoc Subcommittee)69 suggested it could be defined as:

[A] regulatory system that authorizes state administrators to deny
registration to a securities offering unless the substantive terms of the
offering and the associated transactions (i) ensure a fair relation between
promoters and public investors, and (ii) provide public investors with a
reasonable relation of risk to return.70

In merit review states, the administrator will review a registration statement
to assess the fairness of the offering to investors.71 If an offering is deemed
to be unfair, the administrator will issue comments with respect to the

65. Id.
66. Id.
67. Id. Merit review involves analysis of the substance of the offering, not just whether
every procedural hurdle is met. Id.
68. As of 2015, most jurisdictions apply merit review to securities offerings. See
Report on State Merit Regulation, supra note 14, at 821.
69. The ABA Ad Hoc Subcommittee was establish in response to the then current
"public controversy over state merit regulation of securities offerings" and undertook "to
study the impact of state merit regulation on investor protection and capital formation." Id.
at 787.
70. Id. at 829.
71. Id. at 805.
substance of the offering. If the issues raised by the merit review cannot be resolved satisfactorily, the administrator can (among other things) prohibit the offering from being conducted within its jurisdiction.

iv. Workability of Available Exemptions

The first exemption from federal registration on which this Comment focuses is found in section 3(a)(11) of the Securities Act in the form of the intrastate offering exemption, and the second in Rule 504 of Regulation D, as issued by the SEC under section 3(b) of the Securities Act. Both have certain advantages and disadvantages that will be further examined in later parts, however each offering method has been incorporated into state crowdfunding rules as options to raise capital at the local and regional level.

Only very recently did the SEC propose amendments to Rules 147 and 504, now released for comment, that further consider how both can be utilized. Under these new rules, if finalized, much of the foregoing analysis may change. Proposals made at the end of this Comment reflect, and sometimes mirror, the proposed amendments to the rules that have the potential to increase the viability of the two exemptions, despite the implementation of Regulation Crowdfunding at the federal level.

B. The Intrastate Offering Exemption

State legislation in reliance on the intrastate exemption has been most common thus far, with twenty-seven states enacting legislation in reliance on section 3(a)(11). Some states further enforce compliance with the safe harbor provision of Rule 147, as opposed to providing for qualification for the exemption without compliance with the 80-80-80 test provisions of

72. NSMIA Report, supra note 19, at 8.
73. Id.
78. 17 C.F.R. § 230.147 (2015) (requiring that, for the issuer to be deemed a resident of and doing business within the state in question, it must: (1) be incorporated in that state; (2) have its principal place of business in the state, as evidenced by the fact that at least 80% of
Rule 147 as an addition to the more general “doing business” requirements of the intrastate exemption within section 3(a)(11). In practice, these statutory provisions allow for an exemption from registration requirements when the offering is wholly located within one state. Compliance with Rule 147 is viewed as furthering the already stringent requirements of section 3(a)(11), and dependent on certain circumstances, multiple offerings may be “integrated” and regulated as one offering for the purpose of qualification for the exemption. Under the rules governing the integration of offerings, an offering will not qualify for the Rule 147 safe harbor if it is determined that the offering will be deemed...
to be integrated with any offering that does not also qualify for the safe harbor provision.82 Furthermore, "[a] corporation, partnership, trust or other form of business organization which is organized for the specific purpose of acquiring part of an issue offered pursuant to this rule shall be deemed not to be a resident of a state or territory unless all of the beneficial owners of such organization are residents of such state or territory."83

This is the most common exemption for which states have enacted statutes to facilitate state-level crowdfunding. Due to the nature of the limitations, it would be safe to presume that issuers oftentimes would be companies that are limited in geographic scope by licensing or mobility. Businesses with a higher likelihood of success in qualifying for an exemption, therefore, would include craft breweries, brick-and-mortar retail, and real estate, all of which are typically homegrown. Key in any business wishing to comply with the exemption are considerations of partnerships with non-resident entities, proximity to state borders and out-of-state populations, and forms of communication that are made and distributed by the business.

With new proposed amendments to Rule 147 now released for comment, it is apparent that the SEC sees a need for changes. At this time, however, the current rule prevails, and an analysis of the current state of affairs will act to promote the proposals recently made in response to the many issues arising from the use of the intrastate exemption.84

In order to elaborate further on the practical considerations of the intrastate offering exemption in its different enacted forms, it is necessary to examine current and pending state legislation in order to provide an understanding as to how minute differences will affect operation of the exemption within the states.

i. Early Adopters

Not every state requires issuers to comply with the Rule 147 safe harbor to reliably conduct a section 3(a)(11) intrastate offering made in their state. The first state, Kansas, did not do so in passing the Invest Kansas Exemption.85 Georgia, another early adopter of state legislation

82. Id.
83. 17 C.F.R. § 230.147(d)(3) (emphasis added).
enabling crowdfunding under the intrastate offering exemption, similarly chose only to require compliance with section 3(a)(11) in the Invest Georgia Exemption.\(^{86}\) While these two states still limit their exemption to companies “doing business” in the state—and as such, incorporated under their respective state laws—the financial burden is lower on companies in these states. Companies still must take care to only make solicitations to those offerees and purchasers that reside in their home state, but compliance with the 80-80-80 test is not a per se requirement (although the Rule 147 safe harbor remains available). Georgia even became a state that businesses left North Carolina for, in order to take advantage of adequate and enacted legislation.\(^{87}\)

**ii. North Carolina PACES Act**

North Carolina recently considered the passage of legislation mirroring other state enactments that allow for an intrastate offering exemption utilizing section 3(a)(11), but also included adherence to Rule 147.\(^{88}\) Because this Comment originates from the Old North State, the use of the PACES Act, as currently drafted, will serve as the particular case study for which the intrastate exemption legislation shall be dissected. The bill is representative of legislation across the country, and carries with it the language that will later be fodder for the ultimate discourse and conclusions drawn in this Comment.

Senate Bill 481, entitled “An Act to Enact the North Carolina Providing Access to Capital for Entrepreneurs and Small Business Act” (NC PACES Act), is not the first version of legislation purporting to enable use of the intrastate exemption, and it may well not be the last.\(^{89}\) This current bill modifies section 78A of the North Carolina General Statutes to create the “Invest NC Exemption.”\(^{90}\) As the bill stands, the issuer must be a North Carolina entity, organized and registered in the state, and it must structure its offering in compliance with section 3(a)(11) and Rule 147.\(^{91}\) The offering can raise $1,000,000 in a twelve-month period, or may raise

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89. See S. 481, 2015 Gen. Assemb., Reg. Sess. (N.C. 2015). As of the end of the 2015 legislative session, the NC PACES Act had not been passed, and prior to this current bill, the NC JOBS Act was proposed, later modified, and replaced with this version.
90. Id.
91. Id.
$2,000,000 with audited or reviewed financial statements, and may do so by way of investments of up to $5,000 from any North Carolinian, or an un-capped amount from any accredited investor. Likewise comparable to other legislation, the NC PACES Act contains provisions requiring filing of certain disclosure materials prior to first use as well as ongoing reporting even after completion of the offering. Offering materials must also include a conspicuous, all bold, statement regarding the high risks of the offering, but serves as an important reminder that the offering is still an investment in a small business or start-up company, and consequently should be carefully considered like any other investment—a return is never guaranteed, and losing all of one’s money is possible.

As has been highlighted above in the general concerns with Rule 147, North Carolina has received criticism for its inclusion of Rule 147 compliance. In pertinent part, the language within the proposed section 78A-17.1(a)(2) reads, “The transaction meets the requirements of the federal exemption for intrastate offerings in section 3(a)(11) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(11), and SEC rule 147, 17 C.F.R. § 230.147.” The key word here is “and,” as the use of “or” would operatively change the legislation to effect a less stringent qualification for the exemption. Meeting the “doing business” requirement of section 3(a)(11) is practically easier for small businesses and startups that may find it difficult to meet the burdens imposed by proving qualification for an exemption requiring Rule 147 compliance.

iii. Problems with the Intrastate Exemption as a Local Solution

As may be readily apparent, qualification for an exemption under state crowdfunding statutes created in reliance on the intrastate exemption within section 3(a)(11) will likely be challenging for any offering that is not limited to a determinably local nature. The incorporation of required compliance with the safe harbor provision of Rule 147 severely narrows an issuer’s ability to maintain the sanctity of offerings without running afoul of the many intricacies of the two provisions.

These restricting factors are best summarized in the review of requirements for offers, purchasers, issuers, integration, and intermediaries in an offering relying upon the intrastate exemption from registration. In addition, the practical application of the exemption also raises problems, as will become apparent from the discussion that follows. The expectations of

92. Id.
93. Id.
94. Id.
95. Id. (emphasis added).
each of these components of the offering processes will illustrate how and why the carrying out of an exempt offering can, and likely will, be challenging and demanding. Many uncertainties litter the landscape for offerings hoping to qualify for these newly minted state exemptions, and only time and practice will answer many questions posed. Here, just a few hurdles are suggested for cautionary measure, with future pragmatic implications looming beyond the horizon as the proposed amendments to Rule 147 garner attention and comment.

a. Offers and Offerees

"Offer" is defined in the Securities Act as including "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."96 Therefore, the scope of the offer is of concern to an issuer wishing to rely on the intrastate exemption. The intrastate offering requires that every offeree (and purchaser) be a resident in the state in which the offering will utilize that state's exemption.97 Under Rule 147, an individual resides in the state if their principal place of residence is within the state.98 Therefore, any offering that reaches out-of-state investors—even by mistake or lack of oversight—will be unqualified for reliance on the exemption.99 That is to say, whether or not the offeree actually invests, the intrastate offering exemption does not apply if the offer extends to even one investor whose residence is outside the state in which the offering is made.100 In the future, if the proposed amendments to Rule 147 are finalized as released, this restriction appears to be absolved, only requiring sales to be made to in-state residents, while allowing offers to reach out-of-state.101

The staff at the SEC has provided an interpretation that may be viewed as facilitative to intrastate crowdfunding, detailing particular

97. See supra note 81 and accompanying text. An offeree is anyone to whom an offer to purchase a security has been made, not just actual purchasers of the security. Id.
99. But see Busch v. Carpenter, 598 F. Supp. 519, 520 (D. Utah 1984), aff'd in part, rev'd in part, 827 F.2d 653 (10th Cir. 1987) (holding that, although the exemption is dependent upon the premise that all securities that form a part of the offering will "come to rest" in the possession of local residents, an out-of-state resale that occurs months after the initial offering to residents may not entirely nullify qualification for the intrastate exemption of the original offering).
100. 15 U.S.C. § 77e(a)(11) (2012); but see Busch, 598 F. Supp. at 520.
noteworthy provisions, suggesting that use of a third-party internet platform or funding portal that complies with state regulation would be permissible for an intrastate offering. However, compliance with this staff interpretation seems daunting, leaving questions as to whether an offering made on the internet via a website acting as an intermediary or portal could actually rely on the exemption with sufficient confidence. Inherent in these types of portals is the ability to reach all who have access to the internet. Restrictions that delineate compliance through geographic metrics would be difficult to rectify without similar measures that track a potential viewer’s location(s). Even then, an internet user’s point of access is likely never to be limited to their residency. The limitations on who may have access to an offer would make implementation of sufficient safeguards by the portal nearly unfeasible without raising privacy concerns or placing the burden on all viewers who access the portal. Additionally, 

102. See supra note 35 and accompanying text. “Funding portal” is a term of art, where the defined term encompasses the SEC-registered version; the term “funding portals” in this Comment is also used colloquially to represent platforms at the local level that operate on the internet, in very similar capacity to the Funding Portals considered within the JOBS Act.


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

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

Id.

104. See id. Presumably sufficient safeguards could be implemented either by the viewer’s IP address, a location question directed to the viewer, or both. As noted in the text, a viewer’s IP address only identifies the location of the device on which access to the
how would a portal determine if an offering made on the website complies with other Rule 147 requirements that would not be fulfilled by affirmation of an individual viewer?\textsuperscript{105} It is quite possible that the SEC’s proposed amendments to Rule 147 will address all of these concerns, however we cannot predict when or if the new rules will actually be finalized as proposed.

\textit{b. Purchasers and Shareholders}

Naturally, along the same logic, every purchaser must be a resident of the issuer’s state for the offering to qualify for the intrastate exemption.\textsuperscript{106} This stipulation shares the challenges posed in regard to the offer, and once again, the waters have become murky. The difficulty here, however, emerges from a lack of determinable standards for verification of a purchaser’s qualifications. As an illustration, conventional exempt sales under Regulation D mandated only that the issuer have a reasonable belief that a purchaser was an accredited investor, and therefore eligible to participate.\textsuperscript{107} Once advertising or general solicitation entered the fold, however, the SEC sharpened its gaze at verification requirements for offerings involving solicitation and advertising wishing to utilize the exemptions found in Regulation D.\textsuperscript{108}

Using congruent logic, where Rule 147 is unaccompanied by an SEC rule directly on point that provides for verification of a purchaser’s residency, the comparable proviso within Regulation D for Rule 506 offerings using general solicitation could be analogously applied to these offerings to compel disclosures of information that many investors might rather avoid assembling for public dissemination.\textsuperscript{109} As will be discussed later in this Comment, these verification methods could at least provide some reliability for issuers, even if formal guidance on verification is not provided. As cogent as it may be for rules of an intrastate offering to mirror those for Regulation D offerings in terms of verification, it is foreseeable that many investors would shy away from involvement where

\begin{itemize}
\item \textsuperscript{105} Note that if the offeree is an entity, then if it is organized for the specific purpose of investing in the issue, all beneficial owners must be residents of the state to qualify it as a resident for purposes of Rule 147. See 17 C.F.R. § 230.147(d)(3) (2015).
\item \textsuperscript{106} 17 C.F.R. § 230.147(d).
\item \textsuperscript{107} 17 C.F.R. § 230.506(c)(2)(ii) (2015).
\item \textsuperscript{108} Id.
\item \textsuperscript{109} See 17 C.F.R. § 230.506(c)(2)(ii)(A)–(D) (requiring accredited investor to disclose information contained in IRS forms, bank, brokerage, and securities statements, tax assessments, appraisals, credit reports, etc.).
\end{itemize}
such requirements have been implemented. Additionally, this potentially inhibitory requisite would only become more concerning if the investor is an entity, instead of an individual investor. For example, a corporation organized for the purpose of investment in the issue, pursuant to Rule 147(d)(3), could only participate in purchasing if all beneficial owners qualify as residents of the state in which the offering and purchase is made.110

Furthermore, even with reasonable certainty by the issuer of compliance with the verification steps, the issuer does not yet know what the implications are of an actual failure to make the correct verifications. The issuer may not be willing to impose such risks upon the company, and the intermediary or portal could choose to avoid these offerings altogether, further limiting any real utilization of the exemptions in fear of crippling repercussions. Practically speaking, many states are simply too small in geographic size and population to facilitate a company wishing to make an offering within the confines of their resident state. If a methodology for verification of residency or accredited status is not made clear, the inability to qualify enough purchasers within an issuer’s own state may seal the fate of a small company in need of capital.

If the issuer has enough confidence to carry on with the offering, its challenges have not yet ceased, however.111 Each investor can contribute only a relatively small amount in each offering, and thus intrastate crowdfunding is inherently likely to produce a relatively large number of shareholders.112 It follows then, that due to the requirement that all offerees and purchasers must reside in the state of the offering, the issuer may find it difficult to attract investors that are willing and able to invest the maximum contribution, and therefore may be forced to take on investments from many more people in order to raise their desired amount. With an increased number of shareholders comes more of a headache for a startup that cannot or may not be desirable for administrative purposes, as well as for future investors.113

As a final caution, there is yet another level of concern that may come into play in connection with issuing equity under these exemptions. Rule

110. 17 C.F.R. § 230.147(d)(3).
111. Presuming that whatever verification method for offerees and purchasers is sufficiently reliable for the company to make a business judgment, the risk of enforcement action is low enough to continue with the offering.
147\textsuperscript{114} and section 3(a)(11) provide no exemption from section 12(g) of the Exchange Act.\textsuperscript{115} Any issuer with more than 499 non-accredited shareholders and more than $10,000,000 in assets must comply with federal reporting requirements of section 12(g)(1)(A)(ii).\textsuperscript{116} If the number of purchasers and eventual shareholders reaches 499 non-accredited investors, the Exchange Act reporting requirements may be implicated. The issuer would be treated more like a public company that had conducted an IPO, but without actually having one, and yet still implicating the great financial burden imposed.\textsuperscript{117}

c. Issuers

As stated previously, to qualify under section 3(a)(11), an issuer must be a resident of and doing business in the state in which the offering is to be made.\textsuperscript{118} Rule 147 provides a safe harbor for an issuer but does so only if it is determined that an issuer is a resident in the state (1) of issuer’s incorporation,\textsuperscript{119} (2) of the location of 80% of its revenues, (3) of the location of 80% of its assets, and (4) of where 80% of the proceeds of the investment will be used.\textsuperscript{120} Each requirement alone is hard to measure for many companies, but for a startup, these may be particularly challenging to comply with. Although the proposed amendments released on October 30, 2015 have addressed the complexity of the issuer requirements of the

\textsuperscript{114} 17 C.F.R. § 230.147 (Preliminary Notes).
\textsuperscript{116} Reporting requirements will be triggered when the total number of shareholders of any class of security reaches 2000, regardless of whether they are accredited shareholders. \textit{Id.} § 78l(g)(1)(A)(i).
\textsuperscript{117} The SEC itself identified “the average cost of achieving initial regulatory compliance for an initial public offering is $2.5 million, followed by an ongoing compliance cost, once public, of $1.5 million per year . . . Hence, for an issuer seeking to raise less than $1 million, a registered offering is not economically feasible . . . .” Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70741, 78 Fed. Reg. 66428, 66509 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 240, 249).
\textsuperscript{119} 17 C.F.R. § 230.147(c)(1).
\textsuperscript{120} 17 C.F.R. § 230.147(c)(2).
current rule, as the rule stands today, each and every issuer must be
diligent when attempting to rely on the intrastate exemption. For instance,
in an age where online sales and worldwide distribution and exposure are
desirable for a growing startup, how can they be asked to then only
generate 20% of revenues outside of their resident state?

The requirements of the 80-80-80 test will thus be problematic, or
even unachievable, for many companies. While local companies may be
more certain in satisfying these requirements, the most appealing and
lucrative emerging growth companies, and those likely to provide
employment long-term, are those with explosive growth potential.
Markets for these types of companies are national or global, so to limit that
market share to 20% of company revenues is nonsensical. Furthermore,
assuming that the other 80% of any such market would be in one state,
regardless of geographic size or population, necessarily impedes growth.
Apart from application to early-stage pre-revenue company offerings, this
is oxymoronic where the purpose of this exemption is to facilitate access to
capital in order to promote progress and success of small business. This
is exceptionally true of internet, mobile applications, and other
technology-focused startups, but it is also true of most industries.

Regardless of where companies may have their principal places of
business, Delaware is a common state of incorporation for start-up
corporations. Many businesses located in other states choose Delaware
in which to incorporate, over their home state. Delaware is perceived as
being an easy state in which to incorporate for the following reasons:
Delaware corporate law is driven by advantageous precedent and therefore

121. See Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities

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

123. As an example of crowdfunding legislation aspirations, look no further than the
long title of the JOBS Act for the purpose behind exemptions: "To increase American job
creation and economic growth by improving access to the public capital markets for

124. See generally LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE
(2007).

125. See id. at 1.
is unambiguous;\textsuperscript{126} some venture capital funds will still only invest in Delaware corporations;\textsuperscript{127} and some states have legislation that inhibit the start-up process by way of antiquity or policy.\textsuperscript{128} A monumental concern, consequently, is that intrastate crowdfunding would be unavailable to any company incorporated in Delaware but residing in another state.\textsuperscript{129} Whether or not this would be insurmountable, as it could be argued that the availability of financing might be enough to persuade some startups to incorporate in their home state, is possibly open to debate. Regardless of the number of companies that do choose to incorporate in the state in which they reside, there surely will be many more that feel Delaware incorporation is a better business decision.

\textit{d. Integration}

Rule 147 contains strict rules on integration of offerings.\textsuperscript{130} Under these rules, an offering cannot qualify for the Rule 147 safe harbor if it is deemed integrated with any non-qualifying offer.\textsuperscript{131} This is a factual question which considers various factors, such as whether both of the “offerings” are part of the same “plan of financing,” occur at the same general time, and occur “for the same general purpose.”\textsuperscript{132} Generally, integration rules required a six month “cooling off” period between two separate offerings.

Following the trend, possibility of integration is yet one more consideration to be made. Most likely, sales of the same kind of security to an out-of-state purchaser will preclude crowdfunding under the intrastate

\textsuperscript{126} See id.


\textsuperscript{128} See, e.g., \textit{N.Y. Bus. Corp. L.} \S 630 (McKinney 2015) (imposing liability under certain circumstances for employee wages on the ten largest shareholders of a corporation); \textit{see also} Depperman \textit{v. Chenango Valley Pet Foods, Inc.}, 201 A.D.2d 936, 936 (N.Y. App. Div. 1994) (holding that a company president could not sue investors because a president is not a "laborer, servant or employee" as defined in New York's business incorporation law); \textit{see also} \textit{THERESE H. MAYNARD} \& \textit{DANA M. WARREN, BUSINESS PLANNING: FINANCING THE START-UP BUSINESS AND VENTURE CAPITAL FINANCING} (2d ed. 2014).

\textsuperscript{129} See \textit{Busch v. Carpenter}, 827 F.2d 653, 657–58 (10th Cir. 1987); \textit{see also} \textit{SEC v. Truckee Showboat, Inc.}, 157 F. Supp. 824, 825 (S.D. Cal. 1957) (holding that the section 3(a)(11) exemption was not available, despite the residency and geographic doing-business conditions being satisfied, because the proceeds of the offering were to be used to acquire and operate a business in another state).

\textsuperscript{130} \textit{See} 17 C.F.R. \S 230.147 (2015) (Preliminary Note 3).

\textsuperscript{131} \textit{Id.}

\textsuperscript{132} \textit{Id.}
exemption for the next six months. An offering made in order to raise capital for operational expenses will likely be integrated with any other offering made for working capital; these two plans are likely deemed to be "for the same general purpose," and if they are not, an issuer may be able to raise outside the bounds of the intrastate exemption requirements. Would the issuer be safe to assume that risk? If not, the issuer must wait six months until making an offering under, for example, Rule 504, "for the same general purpose" in order to maintain the qualification for their intrastate exemption of the previous offering. The rules for integration seem clear enough, but in following the letter of the law, integration severely limits the ability to raise capital in quick succession when experiencing rapid growth. A company that makes an offering in reliance on the intrastate exemption has effectively removed all access to capital from individual investors outside of their home state for the next six months.

e. Intermediaries and the Website Portal

In the SEC's view, registered intermediaries are necessary to bring the issuer and potential investors together and to provide safeguards to those investors. Crowdfunding offerings are required to be conducted through a registered broker or funding portal that complies with the Securities Act in Title III. The finalized rules provide two new requirements: (1) issuers are only allowed to use one intermediary for their crowdfunding offering; and (2) intermediaries must be online.

The federal crowdfunding regulation therefore requires the use of a portal. The JOBS Act created the "funding portal" as a new entity under the securities laws. Funding portals are internet-based platforms or intermediaries that may facilitate crowdfunding offerings without having to register as brokers. The SEC proposes to establish a streamlined registration process under which a funding portal would register with the SEC by filing information consistent with, but less extensive than, the

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134. Id. at 71395-96.


136. Id.
information required for broker-dealers. Section 3(a)(80)\textsuperscript{137} of the 1934 Act now defines a funding portal to be:

any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to Section 4(6) of the [1933 Act] ..., that does not--

(A) offer investment advice or recommendations;

(B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;

(C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;

(D) hold, manage, possess, or otherwise handle investor funds or securities; or

(E) engage in such other activities as the Commission, by rule, determines appropriate.\textsuperscript{138}

The states do not all require the use of a portal, and not all have the same expectations of the portal if the use of one is mandated.\textsuperscript{139} "While the federal rule preemptively addresses the status of such an intermediary as a broker-dealer, the state rule cannot do so, since the status of an intermediary will remain governed by federal law."\textsuperscript{140} Therefore, the pertinent question to be asked is whether the use of an intermediary or a third party website to conduct an intrastate offering will trigger the registration requirements imposed on intermediaries at both the federal and state level.\textsuperscript{141} Before release of the final rules, the proposed SEC


\textsuperscript{138} Id. at 71395–96.


\textsuperscript{141} Only registered broker-dealers may effect a securities transaction. See 15 U.S.C § 78c(a)(4) (2012). According to SEC application of the rule, nearly anything beyond providing contact information could be considered as "effecting" a securities transaction. For example, any of these activities are considered to require an intermediary to register: recommending a company or the purchase of its securities; negotiating the terms of a transaction or involvement in such negotiations; attending meetings where the merits are discussed; providing valuations or estimates of value; or performing or accommodating due diligence efforts. See, e.g., Report and Recommendations of the Task Force on Private Placement Broker-Dealers, 60 BUS. LAW. 959, 974 (2005) (stating that the SEC describes
crowdfunding regulations implied that the activities portals would likely be subject themselves to registration as a broker-dealer under existing rules. Following this line of logic, states requiring equivalent activity would almost unquestionably subject the portal to SEC registration. Consequently, whether or not state law mandated parallel operational requirements, any such activity falling within the broker-dealer definition under federal law would potentially be subject to SEC registration.

Even though the SEC recognizes an intrastate exemption for broker-dealers, it interprets the exception very narrowly, and at any rate, the portal may still be required to register under state rules as an intermediary conducting broker-dealer activities. More problematic is that state rules comparable to those under the JOBS Act would more likely subject those portals to full broker-dealer registration, without the benefit of the "tailoring" that the SEC had proposed for crowdfunding portals. As such, it would be wise for states to consider treading lightly when

142. "Because a funding portal would be engaged in the business of effecting securities transactions for the accounts of others through crowdfunding, it would meet the Exchange Act definition of broker." Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70741, 78 Fed. Reg. 66428, 66458 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 240, 249) (footnote omitted). Nonetheless, the proposed regulations impose requirements on a portal that the SEC has characterized as "tailored to the limited brokerage activities in which funding portals may engage." Id. at 66458 n.309.


144. Id.


A broker-dealer that conducts all of its business in one state does not have to register with the SEC. (State registration is another matter. . .) The exception provided for intrastate broker-dealer activity is very narrow. To qualify, all aspects of all transactions must be done within the borders of one state. This means that, without SEC registration, a broker-dealer cannot participate in any transaction executed on a national securities exchange or Nasdaq. Also, information posted on the Internet that is accessible by persons in another state would be considered an interstate offer of securities or investment services that would require Federal broker-dealer registration.

Id. (emphasis added).

146. "Because a funding portal would be engaged in the business of effecting securities transactions for the accounts of others through crowdfunding, it would meet the Exchange Act definition of broker." Crowdfunding, Securities Act Release No. 9470, 78 Fed. Reg. at 66458. Nonetheless, the proposed regulations impose requirements on a portal that the SEC has characterized as "tailored to the limited brokerage activities in which funding portals may engage." Id. at 66458 n.309.
requiring the use of portals and mandating certain operational requirements of those portals. The portal is a valuable tool for dissemination of information and as a platform for issuers to properly advertise and solicit investors.\(^{147}\) The activities of these portals at the state level, however, is more than likely going to be restricted by the aforementioned difficulties of complying with the intrastate exemption and Rule 147 requirements, as they currently stand. Before enforcement action, however, regulators should consider the newness of their implementation when a portal makes the inevitable misstep. As a practitioner advising a portal, it would be most wise to consider both federal and state broker-dealer definitions and treatment, as the uncertainty of governance of funding portals could lend itself to risks that may not be worth the reward.

C. Alternative Path: Rule 504 of Regulation D\(^{148}\)

Much less common among state legislation enabling local crowdfunding, statutes allowing for an exemption from federal registration requirements have been enacted that track Rule 504 as an alternative to the intrastate exemption provided for by most state legislation. Rule 504 of Regulation D is an SEC rule enacted as required by section 3(b) of the Securities Act, by which the Act created exemptions from registration that were not self-executing.\(^{149}\) The nature of these exemptions was determined only from the one statutory limitation on their creation: that the SEC must find “that the enforcement of [the Act] with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of public offering . . . .”\(^{150}\)

Dissimilar to the intrastate exemption from registration altogether, these statutes only facilitate an exemption from federal registration, and accordingly require some form of registration at the state securities division.\(^{151}\) Resulting from NSMIA, the state securities regulation effectively supersedes federal enforcement due to the localized nature of the offering. This alternative to the intrastate offering allows for access to

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147. For an example of an operational portal in North Carolina, although conducting offerings using Rule 506(c) of Regulation D, see MALARTU, https://malartufunds.us [https://perma.cc/9LXG-3FMB] (last visited May 19, 2016).
149. Section 3(b) of the Securities Act was not self-executing, and therefore, SEC Rule 504 was promulgated.
investors in more than one state, and therefore affords offerings a much less limited exemption. In order for this alternative exemption to be fully utilized, however, compliance with applicable laws of each state in which the offer reaches is vital. Leading the way, Maine has taken the route of providing not only enacted legislation containing the Rule 504 exemption, but creating a short-form registration that simplifies the compliance process for the issuer. Most notably, the cost associated with the short-form registration is significantly reduced so that companies can use the capital they intend to raise on their business growth and not on compliance and professional fees.

As covered in earlier sections of this Comment, Rule 504 of Regulation D, oftentimes referred to as the “Seed Capital Exemption,” is afforded to offerings of up to $1,000,000 in any twelve-month window, with no restriction on the qualification of the offeree. Issuers, however, are restricted in that they cannot be (1) subject to the reporting requirements of the Exchange Act sections 13 or 15(d); (2) investment companies; or (3) development stage companies that have either no specific business plan or purpose or have indicated that their business plans include engaging in a merger or acquisition with unidentified entities.

Rule 504 is historically underutilized, as the manner by which these offerings are regulated varies significantly on the state level. Most states require some form of notice and disclosure document, with some imposing substantive limitations on the manner and size of the offering. Thus the analysis of what may be required in each state where the offering takes place can be cost prohibitive for many companies, particularly in comparison to efforts required to conduct a Rule 506 offering. Most recently, and likely as a response to this concern, the SEC proposed amendments to Rule 504 (alongside the Rule 147 proposals) that would increase the offering amount to $5,000,000, but the comment period must occur before these amendments may be finalized.

To qualify for the exemption, offers and sales: (1) must satisfy certain conditions under Rules 501 and 502(a), (c) and (d); and (2) cannot exceed

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152. 17 C.F.R. § 230.502(c) (2015) (stating that exemptions exist for Rule 502’s prohibition against general solicitation or general advertising).
154. The short-form registration statement is no misnomer and is designed to allow a layperson to complete it without legal assistance.
156. 17 C.F.R. § 230.504(a).
the $1,000,000 aggregate offering price limit. What makes Rule 504 interesting from a crowdfunding standpoint, however, is found within Rule 504(b)(1). This provision permits an issuer to conduct an exempt "public offering" of securities under certain circumstances, which turn, primarily, on regulation of the offering by the state(s) in which the offering is being made. In focusing on state registration, review, and disclosure requirements, 504(b)(1) permits legitimate small companies access to the capital markets without having to sell restricted securities. An issuer or portal may use general solicitation and general advertising to market the Rule 504 offering if any of the following circumstances is met: (1) the offering is made "[e]xclusively in one or more states that provide for the registration of the securities, and require the filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those state provisions;" (2) a company registers, offers, and sells in a state that requires registration and disclosure delivery and also offers and sells in a state without those requirements, so long as the issuer or portal delivers the disclosure documents required by the state where the company registered the offering to all purchasers (including the state that does not require such); or (3) for offerings made "[e]xclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to 'accredited investors' . . . ."

The first two conditions appear to be ideal for crowdfunding. They permit the use of general solicitation and do not limit the type of investor that may participate. General solicitation and general advertising is viewed as fundamental to a successful offering by many issuers. One of the benchmarks of a general solicitation is contacting potential investors with no previous relationship to the issuer, persons, or portal promoting the

159. Id. § 230.504(b)(2).
160. Id. § 230.504(b)(1).
161. Rule 504 is promulgated pursuant to section 3(b)(1) of the Securities Act, unlike section 4(a)(2) of the Securities Act (discussed below), which is not conditioned on whether the offering is public or private in nature.
162. Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7644, 64 Fed. Reg. 11090 (published Mar. 8, 1999) (codified at 17 C.F.R. pt. 230) (requiring resale restrictions unless either (1) the securities are registered under state law that requires the filing and distribution of a substantive disclosure document, or (2) the securities are offered only to accredited investors under a state law exemption from registration that permits general solicitation).
163. 17 C.F.R. § 230.504(b)(1).
164. Id.
165. Id.
offering. Without being able to expand the scope of the offer to investors outside the issuer's network, many startups and small companies could never expect to find a sufficient number of new investors from which they have not already sought out to raise capital.

i. Blue Sky Exemptions Reliant on Rule 504 of Regulation D

So far, it is evident that very few states have chosen to include a method of incorporating the exemption from federal registration found in Rule 504 of Regulation D. These states take advantage of Rule 504 by creating or accepting a short-form, modified, or alternative registration statement at the state level that complies with the requirements of Rule 504. In each occasion, the exemption is facilitated by a registration that is purposefully simpler than the federal registration. Maine, as the pioneer, created a short-form registration statement that complies with Rule 504 requirements and allows for a much more cost-effective capital raise, without the stringent and complex nature of the intrastate exemption; offerings do not have to be confined within the borders of Maine. In fact, that is the entire point of the exemption within Rule 504, and until now, its underutilization has been squarely blamed on the costly nature of conventional registration.

At least two more states have entered the fold as of the writing of this Comment: Washington and Mississippi. Washington chose to accept an alternative form of registration in the form of preexisting disclosure documents amounting to a state-level registration required by Rule 504. Washington did not even pass legislation but allowed their equivalent securities division to adopt a position that allowed use of the Washington Crowdfunding Form and an Application for Registration by Qualification, thereby facilitating the exemption provided by Rule 504. Mississippi, as a somewhat latecomer, followed the lead of Maine and created a simplified registration that would similarly reduce costs and allow for an offering by a resident issuer to cross state lines. Mississippi, however, created exemptions for offerings that may rely on either Rule 147 or Rule 504, evident in their “Simple Registration Rule 2.04” and “Intrastate Exemption

166. HAZEN, supra note 63, at 128–29.
167. See ME. STAT. tit. 32, § 16304(6-A) (2014). Maine first passed legislation providing for an exemption reliant on Rule 504 of Regulation D on March 2, 2014, and was the first state to utilize Rule 504 in doing so.
Rule 7.21." As of enactment in May of 2015, Invest Mississippi Crowdfunding offers both options, with some unique additions to annual investors limits.

In order to best understand the ways in which Rule 504 has been integrated into exemptions from federal registrations by way of state registration of offerings, it is most helpful to highlight the general details of each state’s approach.

ii. Maine: An Act to Increase Funding for Startups

As the premier example, Maine’s short-form registration statement was the first of its kind. As authorized within 6-A of section 16304 of the Maine Revised Statutes, the newly-adopted Rule 523 adopts and clarifies “requirements of crowdfunding in Maine and also provides the template documents for use in the process.” To take advantage of the streamlined method of registration, the offering must be in accord with an offering reliant on Rule 504. The issuer must also have its principal place of business in Maine, but the issuer is not required to be incorporated under Maine law. As a result, an issuer with a choice of forming as a Maine company or under the laws of another state, like Delaware, has the ability to use this exemption for an offering that will not qualify for the intrastate exemption.

Furthermore, a company is not necessarily required to retain escrow agents but can choose instead to use a segregated bank account until the

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170. MISS. CODE ANN. §§ 75-71-203; 401-404; 605(a)(1), (3); 605(b); 608(c); 610(e) (2009); see also Comment and MISS. CODE ANN. §§ 75-71-304-305 (2009), as amended by 1-140 MISS. CODE R. § 2.04 (LexisNexis 2015).

171. See generally MISS. SEC’Y OF STATE, INVEST MISSISSIPPI CROWDFUNDING (2015) (see file with phone conversation with MS securities division). It appears that the MS Rule 2.04 is designed to reflect SEC Rule 504 and provide for a simplified registration form, and MS Rule 7.21 is designed to reflect Rule 147, however the Booklet is organized in such a way that there may be a question as to whether certain rules relating to the 80-80-80 test of Rule 147 apply to both types of offerings. Id.

172. See ME. STAT. tit. 32, § 16304(6-A) (2014).


176. Id. § 16304(6-A)(A).
offering minimum has been reached.\textsuperscript{177} This is yet another cost-saving measure that Maine has implemented.

Some of the requisite documents that Maine has incorporated as part of qualification for the exemption include the Fund-ME Short-Form Seed Capital Registration Filing Checklist and the Form Fund-ME Offering Circular,\textsuperscript{178} which includes a business plan, financial statements,\textsuperscript{179} a capitalization table, biographical information, a subscription agreement, and an impoundment agreement.\textsuperscript{180}

The Maine Office of Securities then reviews the submitted documents and determines whether or not they are sufficient for an offering. The office does not, however, “verify the accuracy or completeness of the information provided in the offering materials.”\textsuperscript{181} The burden on verifying the substance is left to the issuer.\textsuperscript{182} “Thus, in conducting the offering, companies remain subject to the anti-fraud provisions of both federal and state securities laws.”\textsuperscript{183}

\textit{iii. Washington: The Department of Financial Institution’s Guidance}\textsuperscript{184}

“Can my company use the Washington Crowdfunding Form without having to comply with all the intrastate restrictions of federal Rule 147?”\textsuperscript{185} This question is all that was needed for the Washington State Department of Financial Institutions (DFI) to release a position that accepts an offering reliant on the exemption in Rule 504, all by utilizing a preexisting form

\textsuperscript{177.} \textit{Id.} § 16304(6-A)(F). There is no explicit requirement to escrow funds; however, this option still would be allowable by the language of the statute.\textsuperscript{178.} \textit{Fund-ME Short-Form, supra} note 173. This document (with attachments) is the short-form registration statement filed with the Maine Office of Securities. It must include information such as the following: (i) the company’s name, legal status, address and website address; (ii) the names of directors, officers, and other persons performing similar functions; (iii) the name of each person holding more than 20% of the company’s equity; (iv) a description of the company’s business and its anticipated business plan; (v) a description of the company’s financial condition; (vi) a description of the intended use of proceeds raised in the offering; (vii) the offering amount and the deadline; (viii) the price of the securities; and (ix) a description of the company’s ownership and capital structure, including the terms of the securities being offered and risks to investors. \textit{Id.}\textsuperscript{179.} \textit{ME. STAT. tit.} 32, § 16304(6-A)(E)(5) (highlighting that the type of financial statements required vary based on the amount of the offering).\textsuperscript{180.} \textit{See generally id.}\textsuperscript{181.} \textit{Crowdfunding in Maine Effective January 1, 2015, supra} note 174.\textsuperscript{182.} \textit{Id.}\textsuperscript{183.} \textit{Id.}\textsuperscript{184.} \textit{Crowdfunding Frequently Asked Questions, supra} note 168.\textsuperscript{185.} \textit{Id.}
along with adequate disclosure documents. The pertinent response is quoted below:

An issuer may not want to conduct a crowdfunding offering under federal Rule 147 for a number of reasons, including the restrictions that Rule 147 places on internet advertising and the use of proceeds. To accommodate issuers that would like to conduct a crowdfunding offering that is not subject to the restrictions of Rule 147, the Division will allow an issuer to use the Washington Crowdfunding Form as the disclosure document for an offering of up to $1 million that is registered under RCW 21.20.210. As such an offering would be registered at the state level, the offering could qualify for an exemption under federal Rule 504 instead of Rule 147. In an offering that is registered in one or more states, federal Rule 504 does not impose the restrictions on internet advertising that apply in intrastate offerings conducted under Rule 147. In addition, none of the other intrastate restrictions of federal Rule 147 apply in a Rule 504 offering.

An issuer that wishes to use the Washington Crowdfunding Form in order to conduct an offering registered under RCW 21.20.210 will need to submit the completed form, an Application for Registration by Qualification, and the required fee. Please note that with respect to the majority of the required exhibits to the Application for Registration by Qualification, the issuer may simply include a cross reference to the location in the Washington Crowdfunding Form where this information is available. Further, the financial statements specified in the Washington Crowdfunding Form will satisfy the financial statement requirements under RCW 21.20.210 (thus an issuer may disregard the financial statement instructions in the application form). The fee is calculated as $100 for the first $100,000 of securities to be offered in this state plus 0.0005 times the amount of securities to be offered in excess of $100,000. For example, an offering of $1 million would require the submission of a fee in the amount of $550.

It should be noted that if the issuer wishes to make the offering in additional states, the issuer will likely need to register the offering in the other states where the offering will be made. Washington observed what Rule 147 meant for its residents in practical application of that rule and decided that accepting the Washington Crowdfunding Form as the disclosure document necessary for compliance with Rule 504 in Washington would better facilitate capital formation, while maintaining an acceptable level of investor protection. Washington’s DFI understood that this statement of accepting these documents as compliant with utilization of Rule 504 in their state was

186. Id.
187. Id.
sufficient for the exemption to be made available.\textsuperscript{188} This is critical in the analysis of the intrastate versus the Rule 504 exemptions. The ease of accommodating the Rule 504 exemption through a modified and simplified registration method, not at all unlike required disclosures in intrastate offerings, is the single most important concept that other state legislatures need to grasp, as they can forgo the bureaucracy and ask that state securities divisions model their actions after those of Washington's, by way of a registration system analogous to Maine's short-form registration.

\textbf{iv. Mississippi: Rule 2.04 Invest Mississippi Crowdfunding Simplified Registration Statement (IMC Statement)}

A verbatim quote of Rule 2.04 expresses the "boilerplate" simplicity of the addition of the Invest Mississippi Crowdfunding (IMC) Statement:

By authority delegated to the Secretary of State in Section 75-71-307 of the Act, and for the purposes of simplifying the registration statement for smaller offerings, the Division has adopted the Invest Mississippi Crowdfunding Simplified Registration Statement to be used as the registration statement for securities being registered under this Rule and sold in offerings in which the aggregate offering price does not exceed the maximum amount specified herein. This rule offers an alternative method for state registration for issuers that are exempt from federal registration pursuant to Rule 504 of the SEC Regulation D, 17 CFR Section 230.504, promulgated pursuant to the Securities Act of 1933, 15 U.S.C. Section 77a, et seq., and any amendments thereto.\textsuperscript{189}

The IMC Statement provided for by Mississippi appears to reflect an approach similar to Maine's short-form statement.\textsuperscript{190} The purpose here was to facilitate an offering exemption in reliance on Rule 504 by lowering the cost of state registration. This was a creative move on the part of regulators in Mississippi. However, the legislature also passed a more complete "Invest Mississippi Crowdfunding" initiative that includes both a Rule 504 and an intrastate offering alternative. It appears that Mississippi actually had the forethought to identify both methodologies as viable options for their resident companies and issuers.

It was previously suggested that if there is anything unique about the Mississippi Rule 2.04, it would be the delineated investment limits for accredited and non-accredited investors.\textsuperscript{191} Inherent in the rule is a restriction on the aggregate amount sold by multiple issuers, to a single

\textsuperscript{188} Id.
\textsuperscript{189} 1-140 Miss. Code R. § 2.04 (LexisNexis 2015).
\textsuperscript{190} Fund-ME Short-Form, supra note 173.
\textsuperscript{191} 1-140 Miss. Code R. § 2.04(B)(4) (LexisNexis 2015).
investor, possibly requiring one more question in due diligence confirming an investor is still within their limits.

D. Intrastate or Rule 504: Which is Better?

States enacting legislation to allow for crowdfunding are faced with a choice between tracking Rule 504 for an exemption from federal registration or implementing an intrastate exemption statutory scheme. It is important to examine the practical implications and regulatory concerns surrounding both exemptions.

i. Practical Implications and Problems

a. Liability

Failure to comply with the requirements for the federal exemption carries a risk of liability that may deter many from the very start. Section 12(a)(1) of the Securities Act imposes strict liability if or when an offering fails to qualify for exemption from registration. Investors would have rescission remedies under most state laws and federal law. Furthermore, the SEC and state securities divisions have asserted that issuers have the burden of proof where qualification for an exemption is in question.

Compliance measures are heightened by this position alone, forcing small business to anticipate proving their qualification by way of errorless recordkeeping that would include tracking all aspects of the 80-80-80 test for an offering made in reliance on Rule 147, and knowledge of all state laws in which an offering under Rule 504 has been availed.

b. Utilization of a Website Portal: Ensuring Limitation of Accessibility

The website, platform, or portal operator will face the brunt of the burden imposed by the requirements concerning the restriction of access to the offering by investors that are not residents of the issuer's state (intrastate), or a state in which the offering is registered (Rule 504). The internet is practically the greatest problem and the greatest advantage of crowdfunding under the two exemptions. The internet provides access to an unfathomable wealth of information and data, but much of that is not designed to be accessible to the vast majority of users. The funding portal therefore faces a unique challenge, in that its primary function is inhibited

193. See id. § 77(a)(1).
by the mechanism through which it operates. The funding portal may be able to implement satisfactory restrictions by using a two-fold measure, including both a password-protected firewall and a verification procedure.

Operators of these portals should implement a password-protected firewall (firewall) for purposes of limiting liability in the instance of an intrastate offering, for example. If the intrastate offering must be made through a portal, as many states mandate, a firewall is likely to be viewed as a minimum requirement. Although the firewall cannot actively track the individual person accessing the site, the IP address of that person’s computer can passively be filtered. The funding portal will need to implement software within their website that uses both a firewall and an active verification process. The loss of the exemption is still possible here if the firewall isn’t sufficient to limit access, so verification via user input will also be necessary. Currently, no specified approach to verification is prescribed by rule. A principled verification process would be dependent on a series of questions that determine the qualification of the user to access the offering information behind the firewall and landing page. Preexisting procedures may be the most logical way to develop such validations, ergo Rule 506(c) verification methods could be implemented in order to standardize an already-accepted verification process. The “reasonable steps to verify” approach under 506(c)(2)(ii) can be a credible model for verification under any exemption, even as the requirements for investor qualification under each differ, where the procedures are those that the SEC has previously approved.

The same “firewall plus verification” gatekeeping method should therefore be acceptable for the Rule 504 offering, because access can potentially be screened from neighboring state residents by registering the offering with those neighboring states’ securities divisions. The key issue here remains that the registration will be cost prohibitive unless a short-form registration, comparable to the three aforementioned states, is in existence. Even if the funding portal can limit access to those residents of states in which the offering is registered, the limitation on access will only be made affordable if the registration is practical.

Along with the actual website or portal landing page, the offering could potentially be advertised on many different platforms. The

195. See 17 C.F.R. § 230.506(c) (2015); see also Securities Act Rules, supra note 103 (stating that portals use the same verification procedures and in referencing the net worth test of Rule 501(a)(5) and Question 260.35, how an issuer could reasonably conclude that a purchaser is an accredited investor, and thus satisfy the verification requirement under the principles-based verification approach).


197. Id.
immediate thought of an unknowing issuer would be to let the “world” know of their offering by posting on social media. Facebook, Twitter, LinkedIn, Google+, and even Snapchat could potentially be used to target potential investors. This would make for a disastrous and expedient end to an intrastate offering. It is impossible to use any form of social media in an intrastate offering because there is simply no way to limit exposure of the offering to remain within the geographic borders of the issuer’s resident state. Likewise, the Rule 504 offering suffers the same drawback. The current forms of social media are purposefully created to spread information to the mass public.

c. Issuer State of Incorporation (i.e., Delaware Incorporation)

Under an exempt offering in reliance on Rule 504, issuer state of incorporation is a requirement that is set forth at the option of the state regulators. Maine only requires that the issuer’s principal place of business be in Maine, while Mississippi and Washington require formation and incorporation under their state law and that the issuer’s principal place of business be located in those states, respectively.

Issuers hoping to qualify an offering under the intrastate exemption, whether solely based on section 3(a)(11) or incorporating current Rule 147, must always be formed and incorporated in the resident state of the offering. The language is clear and there is no option, as the baseline intrastate exemption of section 3(a)(11) mandates that all aspects of the offering, including a company’s residence and formation, are within the confines of the single state. The recently proposed rules hint at changes to these requirements under Rule 147, but as they are still in the infancy of the process, it could be a while before those requirements change at all.  

198. All various social media platforms that facilitate instant dissemination of information fall into this category.


201. Crowdfunding Frequently Asked Questions, supra note 168. While no statute or rule exists confirming such, this would be the safest assumption to make based on the Washington State Department of Financial Institutions’ website.


203. See Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 33-9973, Exchange Act Release No. 34-76319, 80 Fed. Reg. 69786, 69788 (Nov. 10, 2015) (to be codified at 17 C.F.R. pt. 230) ("Our proposed amendments to the rule, however, would allow an issuer to make offers accessible to out-of-state residents and to be incorporated out-of-state, so long as sales are made only to in-state residents and the issuer's principal place of business is in-state and it satisfies at least one additional requirement that would further demonstrate the in-state nature of the issuer’s business.").
d. Cost of Conducting an Offering

Inherent in any offering is the cost associated with raising the capital. These costs include legal fees, accounting fees relating to initial disclosures and ongoing reporting, recordkeeping, intermediary fees, and numerous other costs and expenses.\textsuperscript{204} The recent proposal by the SEC to amend the rules behind the two exemptions highlights the economic analysis of both intrastate (via Rule 147) and Rule 504 offerings.\textsuperscript{205} The analysis covers alternatives to raising $5,000,000, even including an initial public offering, and explains the various common choices under the current legal regime.\textsuperscript{206} It is apparent from that analysis that the IPO is certainly not suitable for most companies, with compliance fees in the millions of dollars.\textsuperscript{207} The general takeaway is that the size of the offering matters. In conducting an offering under either of the two rules considered in this Comment, the costs start at a baseline and increase based on certain regulatory threshold requirements having been exceeded. However, upon reaching a certain level, for instance the $1,000,000 maximum amount in a current Rule 504 offering, these costs would likely not continue to increase at the same rate as the offering amount increases. The costs associated with a larger offering can be offset by the total amount raised, while baseline costs of any offering will naturally consume a much larger percentage of a smaller offering amount.\textsuperscript{208}

e. Investor Protections

Much concern has been cited in opposition to changing or "loosening" the requirements of Rule 147 and Rule 504. One particular reference is made to Rule 504(b)(1)(iii), where state registration is also exempted and general solicitation is still permitted. This, however, is not the aspect of Rule 504 considered within this Comment. This Comment poses that state registration is capable of streamlining and thus legislation under the operation of Rule 504(b)(1)(i), in particular, will not foster the same

\textsuperscript{204} See Fallon-Houle, supra note 48.
\textsuperscript{206} Id. at 69811.
\textsuperscript{207} Id. at 69809 ("Two surveys concluded that the average initial compliance cost associated with conducting an initial public offering is $2.5 million, followed by an ongoing compliance cost for issuers, once public, of $1.5 million per year.").
\textsuperscript{208} See Crowdfunding, Securities Act Release No. 33-9974, Exchange Act Release No. 34-76324, 80 Fed. Reg. 71387, 71388 (proposed Nov. 16, 2015); see also Bradford, supra note 59, at 217. Although these notes refer to regulation crowdfunding, the costs are reflective of the common services required for compliance with state legislation.
Moreover, Rule 504 has a history of fraudulent activity when general solicitation is permitted, but that activity came during a period from 1992 to 1999, where the SEC removed prohibitions on general solicitation of unrestricted securities. Subsequently, that particular prohibition was reinstated and much of the issues with fraud were resolved. It is worth noting, however, that the general nature of general solicitation can inherently reach individuals who would not otherwise seek information about investment in an offering, and thus the potential for "accidentally" luring an investor incapable of properly assessing risk should be considered. In regard to more general concerns with the regional nature of a Rule 504 offering, incidence of fraud could indeed be higher "due to reduced oversight by state regulators that may rely on reciprocal registration or coordinated review in the alternate state," as identified in the recent proposed amendments to Rule 504. Like in any offering, it is key for each individual issuer to properly disclose and provide all potential investors with sufficient information to make an informed investment decision.

Rule 147 may not elicit the same concerns regarding general solicitation and the regional nature of the exempt offering made in reliance on Rule 504, but different trepidations should arise in conducting this type of exempt offering. While concerns regarding interstate offerings may be dealt with, the local nature of the intrastate offering likely relying on the Rule 147 safe harbor is also prone to restraining the ability of the "crowd" to scrutinize the offering for its merits. While of seemingly less concern, one benefit of general solicitation is that a more diverse and sophisticated crowd can view an offering. As a result of a more varied audience, engagement in the offering, even after increased scrutiny, serves as an evaluation by consensus of the risks of investment. With a less diverse
One concern that may arise from changes to Rule 147 in the proposed amendments is that states will, in changing their legislation to comport with a rule change, also be overly permissive in the interest of expanding capital raising opportunities. The SEC Release containing the proposed amendments calls this a "race-to-the-bottom" that may ultimately impair investor protections.\(^{213}\)

While this is not an exhaustive list of all investor protection concerns, it appears that Rule 147 and Rule 504 proposed amendments may move investor protection in different directions, respectively. The Rule 147 amendments, while ostensibly more lenient, appear to contain more features that skeptical regulators would be apt to oppose.\(^{214}\) Rule 504 amendments, on the other hand, appear to accomplish more with less, in that additional issuers may choose the exemption created by an amended Rule 504, allowing $5,000,000 to be raised, thereby giving individual state regulators new opportunities to review offerings for merit that would have otherwise been regulated by the SEC.\(^{215}\)

\section*{ii. Regulatory Concerns for Both Exemptions}

\subsection*{a. Impact of Regulation Crowdfunding Final Rules}

Regulation Crowdfunding and the localized exemptions are governed by separate regulators, allow for different categories of investors, reach distinctive markets, and require many contrasting compliance measures. The scope of this Comment is not set to compare the two at length, though the action taken on October 30, 2015, by the SEC should be some indication that they are not viewed as mutually exclusive methods.\(^{216}\) For a general overview of the comparison between Rule 147 and Regulation Crowdfunding, Table 6 of the proposed amendments to the local exemptions provides an outline of the differences.\(^{217}\) A Rule 504-based offering might be chosen if those proposed amendments increase the offering amount limit to $5,000,000, but for the time being, neither the

\begin{itemize}
\item \(^{213}\) Id. at 69819.
\item \(^{214}\) See, e.g., id. at 69820.
\item \(^{215}\) Assuming that issuers seeking to raise upwards of $5,000,000 would otherwise choose exemptions that involve covered securities, often solely due to the requirement of more capital.
\item \(^{217}\) See Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 33-9973, 80 Fed. Reg. at 69786 (Table 6).
\end{itemize}
federal rule nor the proposed amendments may be utilized, so the potential advantage of state registration is not yet comparable. The differences will have to be weighed by the issuer, as a full analysis of the potential offering, the business needs, and the desired scope of the offering should be considered when choosing state versus federal regulation. As of the time of this Comment, the final rules remain ineffective, so no true experiential comparison can be made among Regulation Crowdfunding and state-level crowdfunding, but the future will be telling as to what factors most influence the selection to be made.

b. Intermediary Regulation

The two likely intermediaries that will affect an offering, whether of the local nature by way of Rules 147 or 504, or via Regulation Crowdfunding at the federal level, are the funding portal and the broker-dealer. While generally outside the scope of this Comment, acting and operating as a registered broker-dealer has the potential to open the door to many other regulatory considerations. As it relates to this Comment, the activity of websites, platforms, or portal operators may elicit regulatory responses as that activity infringes on the broker definition, especially considering that many portals may seek to register with the SEC as a result of the Title III Regulation Crowdfunding rules having been finalized.218

While registered funding portals may generally be exempt, at least in part, from the broker or dealer definition with respect to activities relating to Regulation Crowdfunding, the many business models of portals may lead to each seeking different or unique methods of monetizing their platforms, including the collection of fees that typically would only be assessable by a registered broker-dealer.219 It is unclear at this point, between the release of the Regulation Crowdfunding rules and the proposed amendments to Rule 147 and Rule 504, whether a funding portal that wishes to conduct both offerings would have conflicting regulatory requirements from the state and SEC regulators.220 What is clear, however, is that more guidance on the roles of intermediaries will be necessary for

220. See supra notes 143–47 and accompanying text; see also 15 U.S.C. § 78c(a)(80)(h); Weitz & Halket, supra note 140, at 556–57.
portals wishing to facilitate an offering at the state level without SEC or FINRA registration. So far, many states have chosen not to require the use of funding portals, as they are defined in this Comment. Portal regulation is in flux; many portals, depending on their status as a broker-dealer, investment adviser, or in some other function, will be regulated in different ways and FINRA rules may or may not directly provide guidance.

Under current rules, specifics as to the substance of an offering made in reliance on the Intrastate exemption and Rule 147 that are posted on social media by a portal are likely to entirely disqualify the offering from the exemption. Unfortunately, the use of social media in some cases can inherently be an all-or-nothing scenario. When posting on social media platforms the information is made available to everyone who has access to the account of the user, which frequently is more people than may be readily apparent. While the Compliance and Disclosure Interpretations of the SEC seem to suggest that restriction is possible, they only do so in regard to the individual issuer. Commonly, as has become evident in other areas of law, social media tends to expose and proliferate information much more broadly than anticipated. These concerns apply to both the intrastate offering and the Rule 504 offering, as the exposure to potential purchasers may result in an unintended sale either out of state, or from a state in which the offering is not registered.

c. Advertising and Solicitation

According to a Compliance and Disclosure Interpretation released by the SEC,

Securities Act Rule 147 does not prohibit general advertising or general solicitation. Any such general advertising or solicitation, however, must be conducted in a manner consistent with the requirement that offers made in

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221. See Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 33-9973, 80 Fed. Reg. at 69786. Notice that state legislation varies, but the use of portals is sometimes mandated, but almost never denied. Id.

222. Financial Industry Regulatory Authority (FINRA) is an independent, not-for-profit organization authorized by Congress to protect America’s investors by making sure the securities industry operates fairly and honestly. See About FINRA, FINRA, https://www.finra.org/about [https://perma.cc/U8UF-5XDR] (last visited May 19, 2016).

223. For instance, disability claims have been denied after those persons have posted on Facebook, or the like, of their not-so-physically-limited behavior. See Desiree Baughman, Your Social Media Could Affect Your Insurance Rates, INSURANCE QUOTES, http://www.insurancequotes.org/auto/your-social-media-could-affect-your-insurance-rates/ [https://perma.cc/DDM6-FHHY] (last visited May 19, 2016).
reliance on Section 3(a)(11) and Rule 147 be made only to persons resident within the state or territory of which the issuer is a resident.224 Consequently, advertising and solicitation within the resident state is acceptable, but a portal especially must be careful of reaching a broader geographic audience than intended.225 Another Compliance and Disclosure Interpretation answers whether "an issuer [can] use its own website or social media presence to offer securities in a manner consistent with Rule 147," and while the answer226 is worded with caution, it appears that it is possible.227

The Rule 504(b)(1)(i) requirement that excepts offers and sales of securities under Rule 504 from the prohibition against general solicitation requires registration of the securities in each state that would receive the offering.228 The question remains, however, whether making a Rule 504 offering outside of the resident state can be done without registration if there is no actual solicitation of the offering. The consideration might be a valid one, but clearly it is much safer to register in a state by way of short-form registration or registration by qualification of a regional neighbor, and therefore avoid the worry over solicitation restrictions. The risk of foregoing registration is firmly rooted in whether a preexisting, substantive relationship with someone outside of the resident state of registration is sufficient.229 If not, the offering will probably be considered

224. Securities Act Rules, supra note 103, at Question 141.03.
226. Securities Act Rules, supra note 103, at Question 141.05 ("Issuers generally use their websites and social media presence to advertise their market presence in a broad and open manner so that information is widely disseminated to any member of the general public. Although whether a particular communication is an 'offer' of securities will depend on all of the facts and circumstances, using such established Internet presence to convey information about specific investment opportunities would likely involve offers to residents outside the particular state in which the issuer did business.").
227. Id. ("We believe, however, that issuers could implement technological measures to limit communications that are offers only to those persons whose Internet Protocol, or IP, address originates from a particular state or territory and prevent any offers to be made to persons whose IP address originates in other states or territories. Offers should include disclaimers and restrictive legends making it clear that the offering is limited to residents of the relevant state under applicable law. Issuers must comply with all other conditions of Rule 147, including that sales may only be made to residents of the same state as the issuer.").
228. 17 C.F.R. § 230.504(b)(1)(i) (2015) (requiring that the public filing and delivery to investors of a substantive disclosure document before sale, and that the offer and sale be made in accordance with applicable state provisions).
229. See 17 C.F.R. § 230.502(c) (2015); see also Securities Act Rules, supra note 103, at Questions 256.26, 256.29.
to have reached them through general solicitation, and therefore has run
afoul of the rules and disqualified the offering from exemption.

iii. Specific Concerns About the Rule 504 Offering Exemption

Like in the application of SEC Rule 504, an issuer may use the Rule
504-based state exemption for a public offering of its securities with
general solicitation and advertising when stipulations within Rule 504(b)(1)
are met, as outlined previously in this Comment. The three existing state
methods of utilizing Rule 504 track the federal exemption closely, as the
purpose of the clarifications of state positions was first and foremost aimed
at providing for a simplified and less costly registration. They wished to
comply with all aspects of Rule 504, while facilitating the relatively simple
exemption that was once viewed as cost prohibitive. Unfortunately, as
helpful as these states have been in making the Rule 504 exempt offering
more plausible, other states have not yet followed along.

Due to the basic requirement that a Rule 504 exempt offering must be
registered in each state through which general solicitation and advertising
will extend, the exemption is rarely used. State qualification in all but the
three aforementioned states involves the preparation and review of lengthy
foreclosure documents and review by state regulators (who may impose
merit review on the offering), all of which is time consuming and
expensive. Most state registrations require a full disclosure document
and a registration and comment process, as well as "reviewed" financial
statements, driving up the cost of raising capital, with an inability to
mitigate expenses by seeking greater than $1,000,000. "Death by
Expense" is the phenomenon of the Rule 504 exemption. Legal and
accounting costs therefore take up a significant portion of the amount
raised, as filing registration statements and complying with the remainder
of Rule 504(b)(1) requires a better understanding of the process than an
issuer in the form of a small business is likely to have. A few of the
considerations below highlight the importance of creating new and efficient
methods of compliance.

230. See supra notes 140–41 and accompanying text.

34-76324, 80 Fed. Reg. 71387, 71399 (proposed Nov. 16, 2015); see also Bradford, supra
note 59, at 217. Generally, the costs of services are comparable to costs expected under
regulation crowdfunding, but the cost associated with "reviewed" financial statements is
lower than audited financial statements, by way of the work required of each, respectively.

232. See ME. STAT. tit. 32, § 16304(6-A) (2014); 1-140 MISS. CODE R. § 2.04
(LexisNexis 2015).

233. Fallon-Houle, supra note 48.
a. **Cost of Registration**

It is accepted that Rule 504 offerings are not the predominate choice of issuers seeking to raise capital at this time. The cost prohibitive nature of registration, even at the state level, has led to a steep decline in the utilization of Rule 504, and most issuers point to the relatively small $1,000,000 offering limitation as impacting the issuer’s inability to offset the cost of registration. Even more concerning is that the cost is not a one-time expense but would be necessary in each state in which the offering would extend general solicitation.

The cost of registration itself had not been considered a point of streamlining until the recent legislation appeared from Maine, in which a simplified short-form registration statement could serve as sufficient compliance with Rule 504(b)(1)(i). This legislation has paved the way for a newer concept of reducing the cost of state registration by simplifying the documents through legislative action and state securities division rulemaking. The concern, currently, is that only three states—Maine, Mississippi, and Washington—have provided for a simplified registration process, and they are not considered to share any reasonable configuration of geographic regions. These states have gone so far as to make forms and procedures capable of being adequately completed by the issuer itself, foregoing at least most legal and accounting fees associated with registration is nearly every other state. What Rule 504 needs even more is a way to further reduce registration costs so that issuers are not penalized financially for extending general solicitation to the region in which they reside.

b. **Limit on Offering Amount**

Currently the maximum aggregate amount of securities that may be offered and sold in any twelve-month period is $1,000,000 under Rule 504. The SEC has not raised that amount since 1988, when it increased the limit from $500,000. The main consideration here is whether the $1,000,000 limitation is restrictive on issuers, when an increase in that amount could allow for mitigation of costs associated with each offering. The SEC has the statutory authority to raise the ceiling to $5,000,000, as both the

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235. Me. Stat. tit. 32, § 16304(6-A) (2014); see also Fund-ME Short-Form, supra note 173.
proposed amendments and section 3(b)(1) of the Securities Act demonstrate. Likewise, the proposed amendments offer insight as to why the maximum aggregate should be raised, predominantly citing that the SEC believes an increase would facilitate an issuers’ ability to raise capital and aid the state regulators’ efforts to increase efficiencies associated with the registration of securities offerings in multiple jurisdictions through regional coordinated review programs.

As mentioned above, the costs of registration and compliance can be a significant portion of a $1,000,000 offering relying on the Rule 504 exemption, but where that offering amount rises, the cost of each dollar raised begins to decrease. The current Rule 504 does not adequately allow for an issuer to offset the costs, and thus an offering made in multiple states becomes less attractive, even when it may need to extend that far in order to actually find investors willing to contribute capital. An increase, according to the proposed amendments, will also create a larger federal exemptive framework for state regulators to tailor and coordinate among themselves state-specific requirements for smaller offerings by smaller issuers that are consistent with their respective sovereign interests in facilitating capital formation and the protection of investors in intrastate and regional offerings. As Rule 504 currently is utilized rarely due to the cost prohibitive nature of registration and the inability to mitigate those costs, the $1,000,000 maximum aggregate amount is too low for a well-conceived offering to rely on this exemption from federal registration.

iv. Specific Concerns with the Intrastate Offering Exemption

a. Interpretation

Issuers face a question of interpretation: must they comply with section 3(a)(11) and Rule 147? Or must they choose between the requirements of section 3(a)(11) or Rule 147? “Or” is better for issuers, but many state regulators argue that the addition of Rule 147 ensures investor protections and certainties. As previously stated, the requirements of Rule 147 are difficult to comply with for start-up companies and small businesses. Imposing the Rule 147 requirements on businesses wishing to conduct an intrastate offering is a non-starter for many. As the proposed

239. See id. at 69801.
240. Id.
amendments to Rule 147 explain, many state crowdfunding laws requiring compliance with Rule 147 were found to be very difficult to comply with, and therefore elicited the SEC proposals.\footnote{17 C.F.R. § 230.147 (2015) (Preliminary Notes).} Companies of the type most in need of this exemption have relatively little capital to spend on the professional services required for compliance, without regard to the bookkeeping and operational structure necessary to prove up qualification with an exemption reliant on Rule 147, where the burden of proof is placed on the issuer to show that it meets the standards.\footnote{Id.}

\paragraph{Compliance}

Deviation from the bounds of Rule 147 generally, if not absolutely, disqualifies the offering from the exemption. One particular aspect of the intrastate exemption, and Rule 147 in particular, is the 80-80-80 test, as defined in an earlier section of this Comment.\footnote{See supra notes 78–79 and accompanying text.} The most difficult aspect of the 80-80-80 test is that all requirements must be met, leaving small businesses wishing to rely on the intrastate exemption which requires Rule 147 compliance with challenging, if not unreasonable expectations imposed on management. Relating to the requirements of issuers, offerees, and purchasers all having to be originating within the same state, Rule 147 eliminates many individuals within a state who could otherwise be any of the three, but for some “violation” of the rule. From a realistic approach, businesses that wish to participate in e-commerce are unlikely to qualify for an intrastate offering, as the inability to manage compliance, or the exorbitant cost of actually doing so, would deter them from even attempting such an offering. In general, compliance costs are either too high due to the necessary work involved in meeting requirements, or complying at all is impossible for certain businesses wishing to solicit an offering on the internet, because they are unable to adequately manage exposure of the offering.

Uncertainties of this kind are why Rule 147 is no safe harbor at all but in fact a shallow, rock-riddled inlet, through which passage is perilous and tedious. In the area of securities laws, uncertainty makes both issuers and investors reluctant to rely on a process that might subject them to liability or risk, and uncertainties such as those mentioned certainly qualify.\footnote{Cf. Cole, supra note 127, at 500–01. One of the reasons that venture capital firms prefer to invest in companies organized in Delaware is the “high certainty level surrounding corporate governance” in that state. Id. at 501.}
c. Geographic Limitations

From a pragmatic standpoint, utilization of the intrastate exemption to make an offering in the Northeast United States will likely not be feasible for companies counting their pennies. Pertaining to the Northeast region, the most limiting feature of the exemption is the geographic constriction on the offering. Considering the implications of the 80-80-80 test constraints, startups and small businesses within the region will have to critically monitor the three percentage thresholds. Furthermore, requirements that issuers, offerees, and purchasers all reside in the same state in which the offering originates will be just as challenging. Despite the higher population density, the Northeast is made up of the smallest states in the country, with residents of those states living in one state and working in a neighboring state. The New Jersey or Connecticut businessman who commutes into New York City for work each day may likely access his investments at work, thereby creating interesting problems for issuers. While possible for issuers to implement firewalls that filter IP addresses with geolocation software, this method has no control over the person sitting in front of the computer. Likewise, the verification method, where the person accessing the offering through a portal, or otherwise, is still dependent on the potential investor’s own residency representations. The focus on residency at both the time of the offer and the sale is an impediment in the internet and social media age where an offering should be put publicly on a website for it to be actively promoted. Both the internet and social media are mechanisms that go across state lines, and are thus incongruent with Rule 147 without careful implementation of safeguards.

IV. WHAT CAN BE DONE TO IMPROVE THE LOCAL SOLUTIONS?

The heart of the issue lies in the complexity of securities laws generally, but by bringing together the most practical aspects of offering procedures created for the intrastate exemption and Rule 147, the Rule 504 exemption, and the exemption provided for in Regulation A, a more cohesive offering process can be facilitated. A flexible, efficient, and cost effective exemption will promote start-up and small-business growth, while the inherent vetting of the crowd will continue to filter out those companies that may not bear muster.

In order to solve the myriad problems and address the criticisms, allowing for both a Rule 504 exempt offering and an intrastate offering should be a priority for state securities administrators and state legislatures. Expedient action is not only necessary for the overall local offering scheme, but it is desirable for startups and small businesses to have access to these exemptions in order for access to capital to improve. This concept is embodied in action taken by Mississippi, where two rules mirroring Rule 147 and Rule 504 were simultaneously enacted. With the most recent proposed amendments to those two rules, states and businesses alike will have the opportunity to comment on their concerns and voice suggestions for better rules moving forward.

Rule 504 is a much more flexible approach already, as it allows for the offering to extend to any state where a registration statement is filed, and thus is not confined to the borders of the home state of the issuer. The primary drawback of the Rule 504 exempt offering, however, is the lack of short-form registration or coordinated review methods on a nationwide scale. Both the Rule 504 and section 3(a)(11) offerings could utilize the same short-form registration statement as sufficient disclosures, even when those documents are only for review, and not an actual registration. Either or both of the following can address this: (1) strongly encouraging states to implement the short-form registration statement; or (2) encouraging the development of a coordinated review procedure comparable to Tier I of Regulation A+ by establishing regional coordinated review among the states.

The imposition by the federal regulators on state-regulated securities would likely cause pushback, so the movement needs to originate from NASAA or amongst state securities regulators. The action taken by the SEC in proposing amendments to both Rule 147 and Rule 504 speaks to the type of effort that is needed to facilitate utilization of both exemptions moving forward. In consideration of the internet impacting the offer and sale of securities, both rules will have an effect on the ability of small businesses to raise capital in an efficient manner if amendments can be finalized that will encourage investment and limit costs imposed on the issuer. The following section of this Comment will elaborate further upon suggestions for improvement of the state-regulated securities offering exemptions.

A. Suggested Regulatory Action

State securities regulators have sought to expedite the state securities law registration process by developing coordinated review programs. In general, coordinated review is not a new concept, but only recently has further development been considered in relation to Rule 504. To assist small businesses seeking to undertake registration of a securities offering in several states, some states coordinate their reviews through a NASAA program called “coordinated review.” NASAA maintains a web page that provides information for companies seeking additional information on its coordinated review program. Currently, a regional approach to updating coordinated review has been under development by state regulators, further signifying the opportunity for Rule 504 offerings to become more commonplace. “The state registration of securities offerings under coordinated review programs are examples of efforts undertaken by states to streamline the state registration process for issuers seeking to undertake multi-state registrations.” Additionally, “[t]hese programs establish uniform review standards and are designed to expedite the registration process,” thus drastically reducing the need for an issuer to individually file a registration statement and comply with all other disclosure requirements of each particular state. “Participation in such programs is voluntary and imposes no additional costs on issuers,” but the benefit, especially in light of the current maximum aggregate offering amount remaining at $1,000,000, has cost-savings potential. The states have created coordinated review protocols for equity, small company and franchise offerings; direct participation program securities;” and for Tier I offerings of securities pursuant to Regulation A.

248. For example, in order to address the potential inefficiencies associated with state law review and qualification of Regulation A offering statements, as highlighted by the GAO Report to Congress required under Title IV of the JOBS Act, state securities regulators and NASAA implemented a streamlined coordinated review program for Regulation A offerings that was designed to address many of the perceived concerns of market participants. See U.S. Gov’t Accountability Office, Securities Regulation: Factors That May Affect Trends in Regulation A Offerings GAO-12-839 (2012), http://www.gao.gov/assets/600/592113.pdf [https://perma.cc/ZKK6-ECBG].


251. Id. at 69787 n.11.

252. Id.

253. Id.

254. See id.
Faith Anderson, Chief of Registration and General Counsel for the Department of Financial Institutions in the State of Washington, noted that the CR-SCOR program is currently being taken up for updates and modifications that will enable internet offerings by which Rule 504 may be utilized, as well as increase the participation by the states.\textsuperscript{255} She sees state-level crowdfunding exemptions as inherently different from Regulation Crowdfunding, specifically in that states have the opportunity to reduce costs imposed on issuers through their own legislation.\textsuperscript{256} As one of the pioneering states, Washington allows for simplified registration compliant with Rule 504, echoing Anderson’s suggestion that cost reduction is possible, particularly with an update of the CR-SCOR program for compatibility with offerings being made on the internet. The same sentiment is held within the proposed amendments to Rules 147 and 504, where the SEC suggests that state regulators have begun to examine coordinated review methods and reciprocity in acceptance of registration methods in order to facilitate a reduction in cost of Rule 504-based offerings that wish to utilize general solicitation through a particular region.\textsuperscript{257}

To facilitate small business capital formation, NASAA, in conjunction with the American Bar Association, developed the Coordinated Review-Small Company Offering Registration (CR-SCOR) program.\textsuperscript{258} The current program includes a simplified question-and-answer registration form that companies can use as the disclosure document for investors in connection with a Rule 504 offering.\textsuperscript{259} The CR-SCOR program was primarily designed for state registration of small business securities offerings of up to $1,000,000 annually, mirroring offering requirements conducted under Rule 504.

The CR-SCOR program has potential for future application within the Rule 504 and intrastate exemptions if updates can be made. Most essential is an update that acknowledges the new age of capital formation through the use of the internet and involves more states across the nation. Consideration of securities offers and sales over the internet is paramount to any new CR-SCOR program update because the current program does...
not offer such compatibility. States should expect that issuers would almost always wish to conduct their offerings through the web, now that the efficiencies in marketing, advertising, soliciting, and closing deals with digital documents can be realized.

Thus, it is the contention of this Comment that the establishment of coordinated review by state regulators for streamlining the registration process required by Rule 504 is paramount to the practicality of the rule. The same benefits exist for section 3(a)(11) offerings, where similar disclosures could be standardized with the same short-form statement. The CR-SCOR program update would be a method by which registration could be made more efficient through coordinated review. The coordinated review program should primarily seek to accomplish the goals and positive aspects of reducing registration costs, as those cost reductions are likely necessary for Rule 504 to fully provide an easier way for small business to successfully raise capital.

B. Finalize Proposed Amendments to Rule 147 and Rule 504

In addition to creating or updating CR-SCOR to provide for coordinated review of Rule 504 offering registration statements, it is imperative that some version of the proposed amendments to Rule 147 and 504 be finalized.\textsuperscript{260} Finalization should, however, strive to exclude the operation of Rule 147 as a freestanding exemption. Preservation of Rule 147 as a safe harbor to section 3(a)(11) is imperative to maintain currently functioning state legislation incorporating the current scheme. As highlighted throughout this Comment, the intrastate offering exemption accompanied by Rule 147 makes maintenance of compliance difficult with the many intricacies and requirements of the exemption, but ideally the proposals should be designed to resolve these issues effectively without dissociating the safe harbor from the exemption.

The 80-80-80 test alone is enough to deter an issuer from attempting to conduct an intrastate offering under the current rules. Additionally, the requirement that no offer or sale be made to an out-of-state person is practically impossible to manage with the implementation of websites, platforms, or portals and internet offerings. The proposed amendments address these obstacles.\textsuperscript{261}

The proposed modernization and expansion of Rule 147 is in response to what market participants and state securities regulators have suggested. The changes would be made to modify the rule in order to comport with


\textsuperscript{261} See id.
modern business practices and communications technologies, particularly where recently adopted state crowdfunding provisions have become difficult to comply with.\textsuperscript{262} Additionally, the amendments propose to redefine what it means to be an “intrastate offering,” and ease issuer eligibility requirements, making the rule available to more businesses seeking intrastate financing.\textsuperscript{263} Most notably, perhaps, is the proposed amendment to the requirements of issuers meeting the “doing business” tests. The proposal seeks to only require meeting one of the current 80-80-80 test requirements, alongside requiring that the issuers “principal place of business” be in the state.\textsuperscript{264} This is much easier than complying with all aspects of the current rule, while likely facilitating capital formation and avoiding exclusion of legitimate businesses operating within the state.

Furthermore, the proposed amendment to Rule 147 would not immediately disqualify an offer for reaching beyond state borders, but instead only require that sales not be made to anyone except residents of the issuer’s state and require a disclosure of that condition.\textsuperscript{265} This change promotes maintaining qualification for an offering exemption, even on the occasion of an errant offer. Issuers would no longer face the costly implementation of restrictions on offers and instead would be able to focus on identified investors and their individual qualifications. While lessening the effective penalty on an issuer, investor protection is still upheld through the remaining restriction on sales to those investors who conform to the requirements. Additionally, the prerequisite that an issuer obtain investor representations as to residency status is supplanted by a reasonable belief standard conceptually consistent with similar requirements in Regulation D.\textsuperscript{266} This allows for the issuer to utilize the internet to make broad solicitations, while not worrying about implementation of firewalls and IP detection software that still may not prevent the one investor from viewing the offering that he is not allowed to see under the current rule. This addresses the major concern relating to geographic constraints of the Northeast in particular, as no longer would an offering be disqualified when made to the New Jersey resident viewing an offering while working in New York City. Lastly, the proposed amendments would expand the current Rule 147 integration safe harbor, making the concerns pertaining to

\textsuperscript{262} Id.
\textsuperscript{263} Id.
\textsuperscript{264} Id. at 69817. Notice also that if an issuer does not meet a requirement of the 80-80-80 test, the issuer may still qualify by having the majority of employees within that state or territory. Id.
\textsuperscript{265} See id. at 69816.
\textsuperscript{266} Id. at 69819.
integration in previous sections of this Comment less worrisome. The
changes would provide issuers with greater certainty that they can engage
in other exempt or registered offerings either prior to or near in time with
an intrastate offering without risk of becoming ineligible to rely on the
Rule 147 safe harbor.\textsuperscript{267} From a free market standpoint, these changes also
allow for advertisement and solicitation of intrastate offerings to more
readily compete for investors with Rule 504, 506(c), and Regulation A
offerings already capable of general solicitation.\textsuperscript{268}

The SEC also proposed to amend Rule 504 and Rule 147 to increase
the aggregate amount of securities that may be offered and sold pursuant to
Rule 504 in any twelve-month period from $1,000,000 to $5,000,000 and
to disqualify certain bad actors from participation in Rule 504 offerings.\textsuperscript{269}
While much more limited in terms of enumerated changes proposed, the
effect is expected to appreciably facilitate the utilization of Rule 504. As
noted above in the concerns with Rule 504, which have kept the exemption
from being used, the raising of the maximum aggregate amount of
securities that may be offered and sold to $5,000,000 is of paramount
importance. The ability to immediately offset registration costs should spur
issuer utilization of the rule, and it is expected that a forthcoming
coordinated review program through CR-SCOR will further reduce costs of
registering and conducting general solicitation within an entire group of
states.

While the proposed amendments are SEC recommendations for
change, the comment period is available to address concerns with those
proposals or provide for an alternative proposal. Some suggestions will
come in the form of comment letters and others in the form of content
within this Comment. The SEC should consider the state legislation
currently enacted before making changes that would render those laws
ineffective. By viewing the states’ legislative enactments, which have
paved the way for raising local capital, alongside much of the proposed
amendments, the SEC can get it right.

CONCLUSION

Finalization of the most beneficial proposed amendments to Rule 147
and Rule 504 will dictate whether the local solution created by state action
will continue to coexist alongside now-finalized JOBS Act Title III
Regulation Crowdfunding. If the SEC allows the proposed amendments to

\begin{footnotes}
\item 267. \textit{Id.}
\item 268. \textit{Id.} at 69816.
\item 269. \textit{Id.} at 69787.
\end{footnotes}
fail or the aforementioned key aspects of those proposals lose the elements that strengthen the two rules, a gap will remain where local and regional crowdfunding efforts could have provided capital for small businesses unable to afford the cost of Regulation Crowdfunding. The prospects created by raising the ceiling on the Rule 504 and Rule 147 offering amount to $5,000,000 and the much-loosened restriction proposed by Rule 147 changes may provide capital investment to companies that otherwise would fail for lack of access to funding. Furthermore, the benefits of limiting disqualification of an intrastate offering to only considering sales—but not offers that have been made to unqualified investors—can be extended to Rule 504. The protection to investors is maintained and the issuer is more capable of reaching investors who may have been otherwise excluded by limitations from overly cautious offers.

The additional factors and suggested regulatory action within this Comment that would facilitate use of the exemptions should also be ambitions for state and federal regulators. The opportunity to update the CR-SCOR program and offer coordinated review for Rule 504 offerings should do nothing but enhance opportunities to solicit investment from a greater and more diverse population, thereby improving access to the capital they hold. Rule 504 has the potential to garner more use and serve as a pragmatic exemption under which regionally-designed offerings can be made. Even if states choose only to enable a short-form registration statement or disclosure filing that fulfills registration requirements of 504(b)(1)(i), they can facilitate Rule 504 offerings. States do not have to wait for coordinated review from a CR-SCOR update to implement measures to improve the utility of Rule 504. The concept that Rule 504 is more practical follows the substantial discussion regarding the restrictive nature of Rule 147, as it currently stands. With potential for amendment, the analysis of Rule 147 changes, but without any SEC action, states can improve the Rule 504 exemption without much effort at all. The short-form registration can be easily intertwined into existing securities division rules, while the problems associated with the intrastate exemption and compliance with the Rule 147 safe harbor depend on the amendments for relief.

While investments from Regulation Crowdfunding might be a future option on a federal level, and the SEC-proposed amendments to Rule 147 and 504 sit idle, now is the time for states to act. At present, Rule 504 can be improved by legislation or amendment of securities rules enabling the efficiencies embodied in Maine, Washington, or Mississippi. Rule 504 has the capability of providing small businesses with the capital they have been promised for half of a decade. Access to capital is promoted when issuers are afforded the opportunity to conduct offerings of differing parameters,
directly benefitting both investors and small business by aligning interests and capabilities. When other exemptions are unavailable, investors are scarce, or costs are too high, Rule 504 fills a gap created by these challenges. In line with the objective of the SEC Advisory Committee on Small and Emerging Companies’ Charter, facilitation of capital formation is only improved with a revitalized Rule 504.270

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