9

The Regulation of Crowdfunding in the United States

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9.1 Introduction

The regulation of crowdinvesting involves a trade-off between small business capital formation and investor protection. Offerings of securities in the United States, including both equity and debt securities, must ordinarily be registered with the Securities and Exchange Commission (SEC). This registration process involves extensive mandatory disclosure and complicated limits on the offer and sale of the securities. These requirements, designed to protect investors, are too expensive for the small capital offerings typically attracted to crowdinvesting.

The registration requirements do not apply to donation- and reward-based crowdfunding, and these types of crowdfunding have been very popular in the United States. But sales of equity through crowdinvesting and sales of debt securities through crowdlending are subject to the SEC registration requirements; because of the high cost of registration,

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D. Cumming, L. Hornuf (eds.), *The Economics of Crowdfunding*,
https://doi.org/10.1007/978-3-319-66119-3_9

these types of offerings can succeed in the United States only if they are exempted from these requirements.

Four different exemptions are available for crowdinvesting in the United States. Two of these exemptions—federal Rules 506(b) and 506(c)—limit sales to sophisticated or wealthy investors, and therefore are probably not accurately described as crowdinvesting exemptions. They do not allow sales to the "crowd" of public investors. However, Regulation Crowdfunding, finalized by the SEC in 2015 to implement an exemption in section 4(a)(6) of the Securities Act, is specifically aimed at retail crowdinvesting by the general public. In addition, many US states have adopted state crowdfunding exemptions that allow debt and equity offerings limited to the residents of a particular state. These state exemptions are coordinated with a federal intrastate offering exemption, so, like the other exemptions discussed, they provide a coordinated exemption from both federal and state securities law.

There are three different groups involved in crowdinvesting, and thus three different possible loci for any crowdinvesting regulation: the issuers who sell securities to raise capital; the intermediaries who operate the platforms through which these securities are sold; and the investors buying the securities. The Rules 506(b) and 506(c) exemptions focus their regulation almost exclusively on investors, limiting who may invest. The policy idea is to limit investment to those who can protect themselves and therefore do not need mandatory disclosure or other regulation. The absence of other significant restrictions reduces the regulatory cost, but it is not clear that the basic premise of these rules is sound. Many of the investors who qualify for these offerings are not sophisticated investors.

Regulation Crowdfunding and the state exemptions broadly regulate all three groups, imposing substantial regulatory requirements on issuers, intermediaries, and investors. The investor protection motive underlying these extensive regulatory requirements may be admirable, but the cost may be too high for many small business offerings. It is not clear that any of the US exemptions has found the appropriate balance between capital formation and investor protection.

This chapter discusses the various exemptions available for crowdfunding and the policy underlying them. Section 9.2 briefly describes the US registration requirement, its scope, and the problem it poses for crowdfunding. Section 9.3 discusses the Rule 506(b) and 506(c) exemptions. Section 9.4 discusses the crowdfunding exemption in section 4(a)(6) of the Securities Act, and Regulation Crowdfunding adopted to implement it. Section 9.5 discusses the intrastate crowdfunding exemptions. Section 9.6 provides a brief comment on the scope of these exemptions.

9.2 Applicable Regulation in the Absence of a Crowdfunding-Specific Exemption

9.2.1 The Registration and Prospectus Requirements

In the United States, companies selling securities must register their offerings with the SEC unless an exemption is available.[1] The offering company must file an extensive disclosure document known as a registration statement with the SEC and must provide most of that disclosure to investors in a document known as the prospectus. There are also complicated limits on communications with potential investors, including posting on websites, before and during the offering.

The registration process for first-time registrants often takes months (SEC 1996, 88,439; Cohn and Yadley 2007, 7), and the direct cost to prepare and file the registration statement—including legal fees, accounting fees, registration fees, and printing costs—can be hundreds of thousands of dollars (U.S. Government Accountability Office 2000, 23; Prifti 2010, § 1A-17; Sjostrom 2001, 575–576). This cost is simply too high for the smaller amounts entrepreneurial capital start-ups and other small businesses want to raise through crowdinvesting and crowdlending. Because of economies of scale, registration expenses that might be manageable for large offerings are not feasible for smaller offerings (Bradford 2001, 25–27). And the United States, unlike some countries, has no general exemption for smaller offerings.

Registration, however, is not impossible. Two US crowdlending sites, Prosper and Lending Club, register the notes they offer, but they had to completely restructure their business models to make it work (Bradford 2012a, 43–44). The model they use would not work for crowdinvesting.

9.2.2 What Is a Security?

The US registration requirement applies only when a company is selling "securities." The definition of "security" in section 2(a)(1) of the Securities Act[2] is a little vague, but it is reasonably clear that certain kinds of crowdfunding do not involve securities for purposes of federal law.

Donation- and reward-based crowdfunding, including pre-purchases, do not involve the sale of securities (Bradford 2012a, 31–32). Therefore, federal securities law, including the registration requirement, does not apply to them. Donation- and reward-based crowdfunding are essentially unregulated, except for the prohibitions on fraud and false advertising that would apply to any commercial transaction. Neither the federal government nor the states have imposed any special regulation on non-securities crowdfunding.

Crowdlending probably involves a security, and therefore is subject to US securities regulation, unless, as on the Kiva website, lenders do not receive interest. If lenders are entitled only to a return of their principal, with no interest, a security is probably not involved (Bradford 2012a, 34–42). Crowdinvesting, where investors receive equity in the company or any participation in the company's profits, almost certainly involves the sale of a security (Bradford 2012a, 33–34).

9.3 Accredited Investor Crowdfunding

Two US exemptions allow unregistered Internet offerings limited to "accredited investors," or, in the case of one of the exemptions, also sophisticated investors who are not accredited investors. One of these exemptions, Securities Act Rule 506(b),[3] has been in place for many years. The other, Rule 506(c),[4] was added by the SEC in 2013 in response to Congressional direction in the ambitiously titled Jumpstart Our Business Startups (JOBS) Act.[5]

The term "accredited investor" is defined to include, among others, institutional investors such as banks, brokers, insurance companies, professionally directed employee benefit plans, and, more generally, any business entity with more than USD 5 million in assets.[6] But it also includes individual investors with either (1) a net worth of at least USD 1 million (excluding the value of their home and related mortgage indebtedness up to the value of the home)[7] or (2) an annual income of more than USD 200,000 (or joint income with a spouse of at least USD 300,000).[8]

The argument for exempting offers to sophisticated investors such as brokers and insurance companies is apparent: these investors can fend for themselves and do not need the regulatory protection that registration provides.[9] The extension of this argument to wealthy, unsophisticated investors is more controversial. Wealth is a very imperfect proxy for investor sophistication; the person who wins USD 5 million in a lottery, for example, may know absolutely nothing about investing. One might argue that wealthy people can afford to lose the money they are investing, and do not need as much protection for that reason. But the wealth and income levels necessary to qualify as an accredited investor are relatively low; many of these people do not have money to burn. In addition, there are no limits on how much of their wealth accredited investors may invest. An investor who has a net worth of USD 1 million and invests the entire USD 1 million in a single offering certainly cannot afford to lose that money. There has been some discussion at the SEC about restructuring the definition of accredited investor or limiting how much accredited investors may invest (SEC 2015c), but the SEC has not yet taken any action on these proposals.

Because of the limits on who may purchase, securities cannot be sold to the general public in Rule 506(b) and 506(c) offerings. Since the issuer is not selling to the "crowd," it is probably inappropriate to call these offerings crowdinvesting or crowdfunding. But these terms have been applied to Rule 506 offerings, and therefore these offerings are discussed here.

Rule 506(b) and Rule 506(c) share some common requirements. First, they contain so-called bad actor disqualifications barring issuers from using the exemption if they or certain related persons have been found to have engaged in various types of wrongdoing in the past.[10] The theory is that companies and individuals who have been involved in past wrongdoing are more likely to engage in similar behavior now; barring them helps to protect investors in the current offering. There are no other limits on the companies that may use the Rule 506(b) and 506(c) exemptions; any company not barred by the "bad actor" disqualifications is eligible.

The two exemptions also share resale restrictions. Securities acquired in a Rule 506(b) or (c) offering may not be resold without registration or an exemption for the resale.[11] The most commonly applicable resale exemption in the United States would allow resale after a 6- or 12-month holding period.[12]

9.3.1 The Rule 506(b) Exemption

To qualify for the Rule 506(b) exemption, sales must be made only to accredited investors or up to 35 non-accredited investors who satisfy a sophistication requirement.[13] Each *non-accredited* investor must "either alone or with his purchaser representative(s) … [have] … such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."[14] Accredited investors are not required to meet this standard. Even if a particular purchaser does not fall within one of these two categories, the issuer's exemption is still protected as long as the issuer reasonably believed the purchaser qualified.[15]

Otherwise, Rule 506(b) offerings are lightly regulated. Rule 506(b) does not limit either the size of the offering or the amount each investor may invest. The issuer is not required to use an intermediary and, if it does sell through an intermediary, Rule 506(b) imposes almost no requirements on that intermediary. However, if an intermediary is involved, depending on how the intermediary operates, there is a risk that it could be a securities broker or investment adviser, and in violation of federal securities law if it is not registered as such (Bradford 2012a, 51–80).

No mandatory disclosure is required if the issuer sells only to accredited investors. If, however, the issuer also sells to non-accredited, sophisticated investors, it must furnish those investors with detailed information about the issuer, including financial statements.[16] The balance sheet must generally be audited and, in larger offerings, the issuer's other financial statements must also be audited.[17] Because of that and because of the uncertainty of the sophistication standard, Rule 506(b) offerings are typically limited to accredited investors only (Ivanov and Bauguess 2012, 6).

The biggest problem with using Rule 506(b) for crowdinvesting is that the rule prohibits "any form of general solicitation or general advertising," including "[a]ny advertisement, article, notice or other communication, published in any newspaper, magazine, or similar media or broadcast over television or radio."[18] The SEC staff has read this broadly to prohibit any offers to investors with whom the issuer or its sales agents do not have a preexisting relationship (Sjostrom 2004, 13).

This interpretation has two important implications for crowdinvesting. First, although Rule 506(b) does not require the use of an intermediary, an issuer using an intermediary can take advantage of the intermediary's customer base—the intermediary already has a preexisting relationship with those investors. Second, the staff interpretation effectively prohibits putting information about an offering on a website accessible to the general public because the posting would reach investors with whom the issuer and its intermediary have no preexisting relationship (SEC 2000, 25,851–25,852). The issuer could sell through a website, but the offering materials would have to be placed behind a gateway through which only investors with a preexisting relationship could pass.

However, SEC staff interpretations make the general solicitation restriction slightly less draconian and slightly more amenable to crowdinvesting. The SEC staff has allowed intermediary brokers to solicit potential investors publicly, qualify them as eligible for Rule 506(b) offerings, and then allow them access to Rule 506(b) offerings—but only to offerings that postdate their initial solicitation.[19] This interpretation allows Rule 506(b) to be used for what some people call "crowdfunding," but it is crowdfunding in a very limited sense. Public websites advertise for investors without mentioning any specific offering, and offering materials appear behind a firewall that only accredited or sophisticated investors are allowed through.

9.3.2 The Rule 506(c) Exemption

Rule 506(c) is much more amenable to crowdinvesting than Rule 506(b). General solicitation and advertising are allowed, so the offering may be posted on a publicly accessible website. However, actual sales are limited to accredited investors, and Rule 506(c) enforces this requirement a little more stringently than Rule 506(b). The issuer must "take reasonable steps to verify that purchasers … are accredited investors."[20] If it does not do so, the exemption is lost, even if it turns out that all of the investors actually were accredited. Rule 506(c) does not mandate any particular steps to verify accredited investor status, but it does provide some non-exclusive alternatives, such as looking at tax forms to verify income.[21]

These are the only significant limitations in Rule 506(c). There are no mandatory disclosure requirements, limits on the size of the offering or the amount each investor may invest, or restrictions on the web portal hosting the offering. As with Rule 506(b), the issuer is not even required to use an intermediary. It could post the offering on its own website.

9.4 Section 4(a)(6) and Regulation Crowdfunding

The Section 4(a)(6) crowdfunding exemption was added to the Securities Act by the JOBS Act in 2012.[22] However, the SEC did not adopt the required implementing regulations, known as Regulation Crowdfunding, until November 2015; these regulations became effective on May 16, 2016 (SEC 2015b). The statutory requirements of the crowdfunding exemption lie primarily in sections 4(a)(6) and 4A of the Securities Act.[23] Regulation Crowdfunding incorporates these requirements and adds additional ones.[24] For convenience, I will refer to the exemption as the section 4(a)(6) exemption, even though one must look to the regulation to see the full set of requirements.

The section 4(a)(6) exemption, unlike the Rule 506(b) and 506(c) exemptions, is designed for and limited to crowdfunded securities offerings. Section 4(a)(6) is also much more regulatory than those other exemptions, imposing significant restrictions on all three groups involved in crowdinvesting: the issuers selling securities; the intermediaries through whom the securities are sold; and the investors purchasing the securities. Section 4(a)(6) also imposes structural requirements on the offerings themselves.

Section 4(a)(6) offerings are open to the general public, and many of these requirements are designed to protect unsophisticated investors. But the cost to comply with these regulatory requirements, although less than the cost of registration, is significant. Crowdfunding regulation requires a careful balancing of cost and investor protection, and the section 4(a)(6) exemption may have tilted too far to the investor protection side. Hence, many small business issuers may find section 4(a)(6) too expensive, and it is unlikely to be the capital formation panacea many of its supporters hoped for.

9.4.1 Restrictions on Investors

Section 4(a)(6) offerings are open to the general public. Anyone—from the most sophisticated institutional investor to the financially illiterate—may invest in a section 4(a)(6) offering. But section 4(a)(6) restricts investors in other ways. The amount they may invest in crowdfunded offerings is limited; they must be provided with "investor education"; and there are restrictions on the resale of the securities they purchase.

9.4.1.1 Investment Limits

Section 4(a)(6) limits how much each investor may invest; the limit depends on each investor's net worth and annual income, and there are special rules for calculating these.[25] Net worth may be calculated jointly with the investor's spouse, as long as the aggregate investment of the two does not exceed the limits that would apply to the two of them individually.[26] Generally, the investor's principal residence, and related mortgage indebtedness up to the value of that residence, is excluded from the net worth calculation.[27]

If the investor's annual income and net worth each exceed USD 100,000, the investor's investment limit is 10 percent of annual income or net worth, whichever is less. If not, then the limit is 5 percent of annual income or net worth, whichever is less. However, there is a USD 2000 minimum and a USD 100,000 maximum. Every investor may invest USD 2000, no matter how small their annual income and net worth. And no one may invest more than USD 100,000, no matter how great their annual income and net worth.

These are annual investment limits; an investor may not exceed his or her limit in any 12-month period. But there are no limits on the total investment in his or her portfolio. For example, an investor whose limit is USD 7000 could invest USD 7000 now and an additional USD 7000 12 months later, even if he or she still owns the prior investment.

However, the limits are applied collectively to all section 4(a)(6) investments, not just on a per-offering basis. The total amount an investor invests annually in *all* section 4(a)(6) offerings cannot exceed the investor's limit. Assume again that the investor's limit is USD 7000. If the investor, in a single 12-month period, invests in section 4(a)(6) offerings by issuers A, B, and C, the total of the investments in A, B, and C may not exceed USD 7000.

The intermediary must disclose these limits to the investor when the investor opens an account.[28] The intermediary is also required to enforce these limits at the time of any investment. Before accepting any investment commitment, the intermediary must "have a reasonable basis for believing that the investor satisfies … [these] … limitations."[29] The intermediary usually will not know what amounts the investor has invested through other intermediaries, of course. But the intermediary is allowed to rely on the investor's representations as to annual income, net worth, and the amount of the investor's other section 4(a)(6) investments unless the intermediary has some reason to question those representations.[30] Therefore, the intermediary's burden is nominal.

The policy argument for these investment limits is straightforward. They limit each investor's risk so that, even if the investor loses the entire amount invested, the loss will be less than catastrophic. Of course, even a USD 2000 loss will be catastrophic to many poorer investors, and it is not clear whether more sophisticated investors need this paternalistic protection. Moreover, investors can easily circumvent these limits by lying about their net worth or annual income. Hence, the limits might not be very effective.

9.4.1.2 Investor "Education" Requirements

The crowdfunding regulation also includes a series of "education" requirements, but these are really only glorified risk disclosure. To invest in an offering pursuant to the crowdfunding exemption, investors must open an account with the intermediary. When an investor opens such an account, the intermediary must provide materials that explain various aspects of crowdinvesting to the investor "in plain language."[31] These educational materials must disclose the following:

- how the section 4(a)(6) process works and the risks associated with section 4(a)(6) crowdfunding;
- the types of securities offered on the intermediary's platform and the risks associated with each type of security, including the risk of dilution in voting power;
- the restrictions on the resale of securities purchased in section 4(a)(6) offerings;
- the types of information the issuer is required to provide, including annual reports, and the possibility that these disclosure obligations might terminate in the future, leaving the investor without current financial information about the issuer;
- the limits on how much investors may invest;
- the rules regarding cancellation of an investment commitment, either by the investor or by the issuer;
- the need for the investor to consider whether the investment is appropriate for the investor; and
- the fact that the relationship between the issuer and the intermediary might terminate after the offering.

The intermediary must keep this disclosure posted on its platform at all times, and, if it materially revises this disclosure, it must make the revisions available to all investors before accepting any additional investment commitments.[32]

In addition, each time before an investor invests in an offering, the intermediary must obtain a representation from the investor that the investor has reviewed this educational material, understands that his or her entire investment may be lost, and can bear the loss.[33] The intermediary must also, again each time before an investor invests, require the investor to complete a questionnaire that shows the investor understands that

- the investor's ability to cancel an investment commitment and get his or her money back is limited;
- it may be difficult for the investor to resell the securities;
- the investment is risky and the investor should not invest unless he or she can afford to lose the entire amount invested.[34]

It is unlikely that these requirements will result in any serious education of investors. The regulation does not mandate the format or wording of the required questionnaire, so intermediaries may just ask leading questions directing investors to the required response. The rest of the "education" requirement is essentially just a risk disclosure document. None of this will make unsophisticated investors sophisticated, but it will at least expose them to warnings about the risks of investing in these offerings. Whether they will benefit from such an exposure is a separate question.

9.4.1.3 Restrictions on Resale

Investors who purchase securities in a section 4(a)(6) offering generally may not resell or otherwise transfer these securities for one year.[35] However, there are a number of exceptions. The securities may be transferred within the one-year holding period (1) to the issuer; (2) to any accredited investor; (3) to anyone, in a registered offering; (4) to a family member, broadly defined; (5) to a trust controlled by the transferor or created for the benefit of a family member; or (6) in connection with the transferor's death, divorce, or similar circumstances.[36]

Resale restrictions such as these are commonly applied to exempted offerings in the United States (Campbell 1995, 1331–1384). But, in this case, they seem counterproductive, hurting investors rather than protecting them in any way. The resale restrictions make these small business investments even less liquid than they already are, with one additional risk—the risk of illiquidity—added to what is already a very risky investment.

9.4.2 Restrictions on Issuers

Section 4(a)(6) limits the companies that may use the exemption and the amount of money these companies may raise. It also imposes significant disclosure requirements on these issuers. Issuers must provide extensive disclosure, including in some cases audited or certified financial statements, to potential investors and to the SEC at the time of the offering. In addition, issuers who successfully complete a section 4(a)(6) offering must subsequently file annual reports that include audited or certified financial statements. These disclosure requirements may prove too costly for many of these small offerings, reducing the usefulness of the section 4(a)(6) exemption.

9.4.2.1 Who May Use the Exemption

There are a number of limits on the issuers that may use the crowdfunding exemption. The issuer must be incorporated or organized under US law.[37] It cannot be a public company already subject to the reporting requirements of the Securities Exchange Act of 1934,[38] and certain other types of companies are also excluded.[39]

Finally, the crowdfunding rules contain an extensive list of what are known as "bad actor" disqualifications. The exemption is not available if the issuer, or specified parties related to the issuer, have been found to have engaged in any of a long list of violations in the past.[40] These disqualifications apply to the issuer; any predecessor or affiliated issuer; any director, officer, general partner, or managing member of the issuer; anyone who beneficially owns at least 20 percent of the issuer's voting securities; any promoter connected with the issuer; any person who will be compensated for soliciting purchasers in the offering; or any general partner, director, officer, or managing member of any such solicitor.[41] The policy basis for these "bad actor" disqualifications is obvious: one of the best ways to protect investors is to exclude past violators.

9.4.2.2 Offering Amount

The total amount of securities sold by the issuer pursuant to the crowdfunding exemption cannot exceed USD 1 million in any 12-month period.[42] There is no cumulative limit; nothing would keep the issuer from using the crowdfunding exemption to sell securities again and again, as long as the amount raised in any 12-month period never exceeds USD 1 million.

9.4.2.3 Disclosure Requirements

The crowdfunding exemption imposes disclosure obligations on issuers at two points: (1) when the issuer makes the offering; and (2) on an annual basis after the offering is successfully completed. There is no general obligation to promptly disclose material information at other times. US securities law does not ordinarily impose such a duty and the crowdfunding exemption does not create any special duty of this sort just for crowdfunding issuers.

Some of the crowdfunding exemption's disclosure requirements are complicated; a lawyer will probably be necessary to avoid violations. Preparing and verifying this information will significantly add to the cost of using the exemption.

Offering-Related Disclosure

The issuer must provide detailed disclosure about the company, the securities being offered, and the offering process. If, during the course of the offering, the issuer makes any material changes to its disclosure or the terms of its offering, it must notify all investors who have already committed to invest.[43] All investment commitments are automatically canceled unless the investor reconfirms the commitment within five business days after the notice.[44] If a material change occurs within five business days of the end of the offering, the offering deadline must be extended to allow investors the full five business days.[45]

Information About the Issuer

The issuer must provide detailed disclosure about itself and its principals, including:

- Its name, legal status (including its form of organization, jurisdiction in which it is organized, and date of organization), physical address, and web site[46]
- How many employees it has[47]
- A description of its business and its anticipated business plan[48]
- The names of its directors and officers, all the positions those people hold with the company, and when they have served in those positions[49]
- The business experience of its directors and officers in the last three years, including details on their employment by other companies[50]
- The name of each person who is a beneficial owner of equity securities holding 20 percent or more of the voting power, and the ownership level of each such person[51]
- A description of recent transactions or proposed transactions with various related parties (including officers, directors, and 20 percent equity owners) that exceed 5 percent of the amount raised under the crowdfunding exemption[52]
- A description of the issuer's ownership and capital structure, including
  - the terms of the securities being offering and every other class of securities, including how the rights of the securities being offered might be limited or diluted by the rights of other classes[53]
  - how the securities being offered are being valued and how they might be valued by the issuer in the future[54]
  - the risks to purchasers of minority ownership and the risks associated with corporate actions the issuer might take in the future[55]

   - the restrictions on transfer of the securities[56] and
   - a description of how the exercise of rights held by the principal shareholders could affect the purchasers of the securities being offered[57]

- A discussion of the material factors that make an investment in the issuer speculative or risky[58]
- The material terms of any indebtedness of the issuer, including the amount of the indebtedness, interest rates, and maturity dates[59]
- A description of any exempt securities offerings the issuer has conducted within the past three years[60]
- Any matters that would have disqualified the issuer from using the exemption, but which occurred before the effective date of the exemption[61]
- Where on the issuer's website investors will be able to find the annual report required by the exemption (discussed later) and when that report will be available[62]
- Whether the issuer or its predecessors previously failed to comply with the annual reporting requirement of the exemption[63]

Financial Information

The issuer is required to discuss its financial condition, including, to the extent material, its liquidity, capital resources, and historical results of operations.[64] Some of this discussion is clearly intended to be forward-looking. If the issuer has no operating history, its discussion must focus on "financial milestones and operational, liquidity and other challenges."[65] If it has an operating history, it should focus on "whether historical results and cash flows are representative of what investors should expect in the future."[66] The discussion must include how the proceeds from the offering will affect liquidity and other available sources of capital.[67]

The amount of additional financial disclosure required depends on the target amount of the offering.[68]

- *USD 100,000 or less*. If the target amount is USD 100,000 or less, the issuer must disclose the total income, taxable income, and total tax reported on its most recent federal income tax returns. The chief executive officer (CEO) must certify the accuracy of these figures. However, if certified or audited financial statements are available, the issuer must provide those instead.

- *USD 100,000–USD 500,000*. If the target amount is more than USD 100,000 but not more than USD 500,000, the issuer must furnish financial statements reviewed by an independent public accountant. However, if audited financial statements are available, the issuer must provide those instead.
- *More than USD 500,000*. If the target amount of the offering is more than USD 500,000, the issuer must furnish audited financial statements, unless this is its first section 4(a)(6) offering. In that case, financial statements reviewed by an independent public accountant are sufficient (unless it already has audited financial statements available).

Information About the Offering

The issuer must also include detailed disclosure about the offering and the offering process:

- The purpose and intended use of the offering proceeds[69]
- The offering price, or the method of determining the price[70]
- The name and identification of the intermediary through which the offering is being conducted[71]
- A description of the intermediary's financial interest in the offering, including the compensation the intermediary is to receive, and any financial interest the intermediary has, or is expected to acquire, in the issuer[72]
- The target amount of the offering and the deadline to reach that target[73]
- Whether the issuer will accept investments in excess of the target amount and, if so, how much and how any oversubscriptions will be allocated[74]
- A description of the offering process, including how and when investors can cancel investment commitments[75]
- A statement that, if an investor does not reconfirm his or her commitment after a material change to the offering, the commitment will be canceled[76]

The issuer must also post updates on its progress in meeting the target offering amount.[77] At a minimum, it must disclose when it reaches 50 percent of its target offering amount and when it reaches 100 percent of its target offering amount.[78] If it sells more than its target amount, it must within five business days of the offering deadline disclose the total amount of securities it sold.[79]

Catch-All Disclosure Provision

The disclosure requirements also include a catch-all provision requiring disclosure of any additional material information necessary to keep the statements made in the issuer's disclosure from being misleading.[80]

Annual Reports

Issuers which have successfully sold securities using the section 4(a)(6) exemption are required to provide subsequent annual reports. These annual reports must be filed with the SEC no later than 120 days after the end of the issuer's fiscal year, and must be posted on the issuer's website, but they are not required to be provided directly to investors.[81]

If the issuer has available financial statements that have been reviewed or audited by an independent public accountant, these financial statements must be included in the annual report. If not, the issuer must provide financial statements that its CEO certifies are true and complete in all material respects.[82] These annual reports must also include much of the disclosure that was required at the time of the offering, except for the disclosures related to the offering and the offering process.[83]

The issuer's annual reporting obligation generally continues until it becomes a reporting company required to file reports under the Securities Exchange Act; it (or someone else) repurchases all of the securities it sold pursuant to the crowdfunding exemption; or it liquidates or dissolves its business.[84] There are also two size-based exceptions to the annual reporting requirement. The issuer no longer has to provide annual reports if (1) after it has filed at least one annual report, it has fewer than 300 record shareholders[85]; or (2) if it has filed annual reports for the past three years and has total assets of less than USD 10 million.[86]

9.4.3 Restrictions on Intermediaries and the Manner of the Offering

One way that section 4(a)(6) attempts to protect investors is to require that offerings be conducted through a neutral intermediary, which has an enforcement role. Section 4(a)(6) also imposes requirements on the conduct of the offerings on the intermediary's platform.

9.4.3.1 The Intermediary Requirement

The offering must be conducted through a web platform operated by a registered securities broker or a registered funding portal.[87] Funding portals are a new type of regulated entity limited to operating section 4(a)(6) crowdfunding platforms; they may not engage in many of the other activities that ordinary securities brokers engage in.[88]

Neither the intermediary nor its directors, officers, or partners may have any financial interest in the issuer.[89] This requirement is designed to protect investors from conflicts of interests that might arise if the intermediary had a financial stake in the outcome of the offering (SEC 2013, 66,461). The intermediary may, however, receive some of the same securities being sold on the platform as compensation for its services.[90] The intermediary must disclose to investors establishing accounts on its platform how it is being compensated.[91]

9.4.3.2 Off-Platform Activities

The issuer must sell the crowdfunded securities through the crowdfunding platform. The issuer and its representatives may not even advertise the offering off-platform.[92] Nor may the issuer compensate anyone else for promoting an offering off the intermediary's platform.[93] The issuer may, however, publish a brief notice that directs investors to the intermediary's platform and contains limited information about the issuer and the offering, including the type and amount of securities being offered, the price, and the closing date.[94]

9.4.3.3 Communications Channels

The crowdfunding regulation requires the intermediary to establish communications channels on its platform that allow potential investors to communicate with the issuer, and with each other, about the offering.[95] These communications channels must be publicly accessible, but only investors who have opened an account with the intermediary may post comments.[96] The issuer and persons acting on its behalf may post comments, but only if they disclose their affiliation in each such communication.[97] The issuer may compensate people to promote its offering on the intermediary's communications channels, but only if it takes reasonable steps to ensure that the compensation is disclosed in each communication the promoter posts.[98]

These communications channels are an attempt to take advantage of the "wisdom of the crowd," the idea that the collective decision-making of a group of people is better than individual decision-making and, sometimes, even better than expert decision-making (Surowiecki 2004). Surowiecki (2004) argues that crowds can be collectively wiser than individual decision-makers, but only when their decisions are independently made. Communications channels eliminate this independence and could lead to irrational herding behavior. Nevertheless, these communications channels do allow investors to share information they might have about the issuer and its business, reducing the risk of fraud (Bradford 2012b, 219).

9.4.3.4 The Intermediary's Enforcement Role

The crowdfunding intermediary has an enforcement role under the exemption. As indicated earlier, the issuer is subject to mandatory disclosure requirements. The intermediary is required to make the issuer's disclosure available to the general public on its platform; that disclosure must remain publicly available until the offering is completed or canceled.[99] The intermediary must also have a reasonable basis for believing that various requirements of the exemption are satisfied:

- *Investment Limits*. The intermediary must have a reasonable basis for believing that each investor satisfies the investment limits of the exemption. However, the intermediary may rely on the investor's representations concerning compliance unless the intermediary has reason to question the reliability of those representations.[100]
- *Issuer's Compliance*. The intermediary must have a reasonable basis for believing that the issuer is in compliance with the requirements of the exemption. However, the intermediary may rely on the issuer's representations to that effect unless the intermediary has reason to question the reliability of the issuer's representations.[101]
- *Issuer's Record-Keeping*. The intermediary must have a reasonable basis for believing that the issuer has established means to keep accurate records of the holders of the securities it is offering through the intermediary's platform. However, the intermediary may rely on the issuer's representations to that effect unless the intermediary has reason to question the reliability of those representations.[102]

In satisfying these requirements, the intermediary can usually rely on others' statements; no independent investigation is required. However, at least one enforcement requirement requires an independent check by the intermediary. The intermediary must deny an issuer access to its platform if it has a reasonable basis for believing that the "bad actor" disqualifications, discussed earlier, apply.[103] To satisfy this requirement, the intermediary must, "at a minimum," conduct a background and securities enforcement regulatory check on the issuer and on each officer, director, and 20 percent beneficial owner of the issuer's voting securities.[104]

The issuer must also deny access to its platform if it believes the issuer or the offering "presents the potential for fraud or otherwise raises concerns about investor protection."[105] This requirement raises more questions than it answers. When exactly is a "potential" for fraud present? And when does a non-fraudulent offering otherwise raise concerns about investor protection? Most importantly, does this provision require an intermediary to investigate each offering or is it enough that the intermediary is unaware of any facts that might raise suspicion? The answer to all of these questions is unclear (Bradford 2015, 376–377), and their resolution will have an important impact on the investor protection/capital formation trade-off made by the exemption. The stronger the intermediary's due diligence role, the more protection the intermediary's presence provides to investors. But stronger due diligence requirements also increase the intermediary's compliance costs, and thus the cost of using the exemption.

9.4.3.5 Conduct of the Offering

Section 4(a)(6) contains specific requirements as to how offerings are to be conducted. The issuer, in its disclosure, must specify a target amount it wants to raise in the offering and a deadline for raising that amount.[106] The offering must be open for at least 21 days.[107] Investors may cancel their investment commitments until 48 hours prior to the specified deadline.[108]

The issuer cannot access any investor funds until the target amount is reached. If the offering does not reach the target amount by the deadline, or the offering is not completed for some other reason, the intermediary must, within five business days, direct the return of investors' funds.[109] If the issuer reaches the target amount prior to the deadline, it may close the offering early, as long as the offering has been open for at least 21 days.[110] However, the issuer must notify investors of the new closing deadline and the new deadline must be at least five business days after the notice.[111]

9.5 Intrastate Crowdfunding

Securities offerings in the United States are regulated by both the federal government and the individual states in which the offerings occur. However, the Securities Act of 1933 exempts purely intrastate offerings from the federal registration requirement, essentially relegating these offerings to regulation by the particular state in which they occur.[112] The exact outlines of that statutory exemption are uncertain, but the SEC has adopted a safe harbor rule, Securities Act Rule 147,[113] that provides more certainty. To qualify for that intrastate offering safe harbor, all of the *offerees* (not just the ultimate purchasers) must be residents of the same state as the issuer. The issuer must be organized or incorporated under that state's laws and have its principal office in the state.[114]

Until recently, the issuer also had to meet several other requirements: (1) at least 80 percent of its gross revenues had to be from operations in that state; (2) at least 80 percent of its assets had to be located in the state; and (3) at least 80 percent of the offering proceeds had to be used in connection with operations in that state.[115] *All* of these requirements had to be met. However, the SEC amended Rule 147 in 2016 (effective in 2017) to phrase these requirements in the alternative. Now, *only one* of these requirements *or* a new fourth requirement—that a majority of the issuer's employees be based in the state—must be met (SEC 2016, 197). The SEC (2016, 202–207) also adopted a new intrastate exemption, Rule 147A, that does not require the issuer to be incorporated in the state and allows *offers* to non-residents, as long as the securities are *sold* only to residents.

The intrastate offering exemption, as I indicated, is only from *federal* registration requirements; it does not free issuers from the registration requirements imposed by the law of the state in which the offering occurs. However, many states have adopted crowdfunding exemptions under state law that free intrastate crowdfunded offerings of securities from *state* registration requirements as well. The exact requirements of these state crowdfunding exemptions vary from state to state, but they generally mimic many of the requirements of the federal crowdfunding exemption (Pei 2014, 869–876). They limit the amount of the offering; limit the amounts investors may invest; require risk disclosures; require disclosure by the issuer; require that the offering be conducted through a state-regulated portal; and restrict how these portals operate.[116] However, there is considerable variation among the states. Some state exemptions remove investment limits for certain categories of investors; some of them allow advertising; and some of them do not even require the use of an intermediary (Pei 2014, 869–876).

It is not clear how successful these intrastate provisions will be. The requisite connections to a single state may be too restrictive, particularly in smaller states, although the recent amendments to Rule 147 ease these restrictions a bit. The SEC staff has also provided some relief, indicating that an offer is not made to out-of-state offerees merely because it appears on a web platform accessible from out of state. According to the SEC (2015a), the offering would be intrastate as long as the portal makes it clear that the offering is limited to residents of a particular state; the offeree confirms his or her residence before accessing the offering materials; and sales are made only to residents of the state. New Rule 147A makes it even easier, completely eliminating the requirement that all offerees be residents, but many of the state exemptions will have to be amended to take advantage of that new rule.

9.6 The Extent of the Exemptions

The exemptions discussed in this chapter free crowdinvesting and crowdlending from both state and federal securities registration requirements. They do not, however, completely exempt these offerings from securities regulation. Federal and state antifraud provisions would still apply.

9.6.1 State and Federal Registration Requirements

All of the exemptions discussed in this chapter exempt offerings from the registration and prospectus requirements of both federal and state law.

Securities offered and sold pursuant to the Rule 506(b) or 506(c) exemptions are "covered securities" as defined in section 18 of the Securities Act of 1933.[117] Securities sold pursuant to the crowdfunding exemption in § 4(a)(6) of the Securities Act are also covered securities.[118] Section 18(a) of the Securities Act expressly excludes offerings involving covered securities from state registration, offering, and prospectus requirements.[119]

The state crowdfunding exemptions are, by definition, exemptions from state registration and prospectus requirements. But since these state exemptions require that the offering also be in compliance with the federal intrastate offering exemption, these offerings would also be exempted from the federal registration requirement.[120]

9.6.2 Antifraud Rules

Issuers selling securities pursuant to one of the exemptions discussed in this chapter would still be subject to federal and state securities law rules prohibiting fraud. The crowdfunding exemptions only exempt offerings from the registration and prospectus delivery requirements, not the antifraud rules.

US securities law includes a number of general antifraud provisions that could apply to crowdinvesting and crowdlending[121] and one new antifraud rule, section 4A(c) of the Securities Act, that applies specifically to section 4(a)(6) crowdfunding.[122] Rule 10b-5, for example, makes it unlawful, in connection with the sale of any securities, "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made … not misleading."[123] State securities laws contain similar prohibitions on securities fraud (Long 2015, ch. 9).

Issuers making materially false statements in selling securities to crowdinvestors could be liable under these antifraud provisions. Crowdfunding intermediaries might also be liable for false statements made by issuers, although their liability risk is less clear (Bradford 2015, 371–410).

The existence of an antifraud remedy does not mean that it will be used, however. Crowdinvesting typically involves relatively small investments by each investor; the section 4(a)(6) exemption even limits how much each investor may invest. Hence, the cost of bringing a private antifraud action would often exceed the potential recovery (Palmiter 2012, 416). Given the relatively small amount raised, even class actions brought on behalf of all the investors in an offering might not be feasible (416–417). Thus, private enforcement actions are unlikely in many cases.

The SEC and state securities regulators can bring actions against issuers engaged in fraudulent crowdinvesting and crowdlending offerings, but these regulators are unlikely to focus their limited resources on such relatively low-profile offerings. Therefore, even public enforcement of the antifraud provisions could be limited (Palmiter 2012, 375).

9.7 Conclusion

The regulation of crowdinvesting and crowdlending involves a trade-off between capital formation and investor protection. Disclosure requirements, structural limitations on crowdfunded offerings, investment limits, and other regulatory requirements designed to protect investors increase the cost of crowdinvesting and crowdlending. As the regulatory cost increases, crowdfunding become a less viable option for small business capital formation. But, absent adequate investor protection, losses due to fraud and manipulation may drive investors away from crowdfunded securities offerings.

The two federal exemptions limited to accredited or sophisticated investors—Rule 506(b) and Rule 506(c)—impose the least regulatory cost. Issuers can avoid mandatory disclosure requirements, limits on the structure of their offerings, and offering and investment amount limits. But these two exemptions essentially take the “crowd” out of crowdinvesting. Issuers may sell only to sophisticated or wealthy investors and, in the case of Rule 506(b), may not even advertise the offering on a publicly accessible Internet site.

These exemptions also raise investor protection concerns. Their basic premise—that investors who meet the wealth and income requirements to qualify as accredited investors do not need regulatory protection—is questionable, particularly since the amounts these investors may invest is unlimited.

The Section 4(a)(6) crowdfunding exemption and the many intrastate crowdfunding exemptions widen the scope of permissible investors. The intrastate exemptions still limit the investors to the residents of a particular state, a troublesome, perhaps archaic restriction in the global Internet age. But all of the crowdinvesting-specific exemptions, state and federal, allow the general public to invest, without any restrictions based on wealth or sophistication.

That breadth comes at a regulatory price. The federal and state regulators have imposed significant regulatory costs on these offerings—investment limits, sales through neutral intermediaries, limits on the structure of offerings, and, probably the costliest part of these rules, substantial mandatory disclosure requirements. The regulatory price paid to access non-accredited investors is significant.

It is too early to say whether any of these four possibilities has struck the right balance. The Rule 506 exemptions may prove too limited. The Section 4(a)(6) exemption may prove too costly. The intrastate offering exemptions may be both too limited and too costly. On the other hand, one of these exemptions may allow crowdinvesting to explode, substantially expanding small business capital formation opportunities and providing investors with significant new opportunities to invest in small entrepreneurial enterprises.

Notes

1. Section 5(c) of the Securities Act of 1933 provides that no one may offer securities until a registration statement has been filed with the SEC. 15 U.S.C. § 77e(c). Section 5(a)(1) of the Act prohibits sales of those securities until the registration statement has become effective. 15 U.S.C. § 77e(a)(1).
2. 15 U.S.C. § 77b(a)(1). Hazen (2016, §§ 1:49–1:79) provides a good general discussion of the interpretation of that definition.
3. 17 C.F.R. § 230.506(b). Before 2013, when the Rule 506(c) exemption was added, this exemption was known simply as the Rule 506 exemption.
4. 17 C.F.R. § 230.506(c).
5. Pub. L. 112–106, 126 Stat. 306 (2012).
6. See Securities Act Rule 501(a), 17 C.F.R. § 230.501(a).
7. Securities Act Rule 501(a)(5), 17 C.F.R. § 230.501(a)(5). A spouse's net worth may also be included to reach the USD 1 million limit. *Id.*
8. Securities Act Rule 501(a)(6), 17 C.F.R. § 230.501(a)(6).
9. See, for example, SEC v. Ralston Purina Co., 346 U.S. 119 (1953). In *Ralston Purina*, the court held that the US private offering exemption (now in section 4(a)(2) of the Securities Act) applies to offerings to those who are "able to fend for themselves" and therefore do not need the protection of registration. *Id.*, at 125.
10. Securities Act Rule 506(d), 17 C.F.R. § 230.506(d).
11. Securities Act Rule 502(d), 17 C.F.R. § 230.502(d).

12. See Securities Act Rule 144, 17 C.F.R. § 230.144.
13. Securities Act Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii).
14. *Id.*
15. Securities Act Rules 501(a), 506(b)(2)(ii), 17 C.F.R. §§ 230.501(a), 230.506(b)(2)(ii).
16. Securities Act Rule 502(b), 17 C.F.R. 230.502(b).
17. See Securities Act Rule 502(b)(2), 17 C.F.R. § 230.502(b)(2).
18. Securities Act Rule 502(c), 17 C.F.R. § 230.502(c).
19. See, for example, *IPOnet*, SEC No-Action Letter (July 26, 1996).
20. Securities Act Rule 506(c)(2)(ii), 17 C.F.R. § 230.506(c)(2)(ii).
21. Securities Act Rule 506(c)(2)(ii)(A)–(B), 17 C.F.R. § 230.506(c)(2)(ii)(A)–(B).
22. See 15 U.S.C. § 77d(a)(6).
23. 15 U.S.C. §§ 77d(a)(6), 77d-1.
24. See 17 C.F.R. § 227.10 *et seq.*
25. 17 C.F.R. § 227.100(a)(2)(i),(ii).
26. 17 C.F.R. § 227.100, Instruction 2 to paragraph (a)(2).
27. 17 C.F.R. § 227.100, Instruction 1 to paragraph (a)(2); 17 C.F.R. § 230.501(a)(5)(i).
28. 17 C.F.R. § 227.302(b)(1)(v).
29. 17 C.F.R. § 227.303(b)(1).
30. *Id.*
31. 17 C.F.R. § 227.302(b)(1).
32. 17 C.F.R. § 227.302(b)(2).
33. 17 C.F.R. § 227.303(b)(2)(i).
34. 17 C.F.R. § 227.303(b)(2)(ii).
35. 17 C.F.R. § 227.501.
36. *Id.*
37. 17 C.F.R. § 227.100(b)(1).
38. 17 C.F.R. § 227.100(b)(2).
39. Investment companies and companies that would be investment companies except for certain statutory exemptions are excluded. 17 C.F.R. § 227.100(b)(3). Also excluded are companies that have no specific business plan or whose business plan is to engage in a merger or acquisition with an unspecified company. 17 C.F.R. § 227.100(b)(6). Companies that have used the crowdfunding exemption in the past and have not filed the required annual reports in the past two years are also excluded. 17 C.F.R. § 227.100(b)(5).
40. See 17 C.F.R. §§ 227.100(b)(4); 227.503.

41. 17 C.F.R. § 503(a).
42. 17 C.F.R § 227.100(a)(1).
43. 17 C.F.R. § 304(c).
44. *Id.*
45. *Id.*
46. 17 C.F.R. § 227.201(a).
47. 17 C.F.R. § 227.201(e).
48. 17 C.F.R. § 227.201(d).
49. 17 C.F.R. § 227.201(b).
50. 17 C.F.R. § 227.201(b).
51. 17 C.F.R. §§ 227.201(c); 227.201(m)(3).
52. 17 C.F.R. § 227.201(r).
53. 17 C.F.R. § 227.201(m)(1).
54. 17 C.F.R. § 227.201(m)(4).
55. 17 C.F.R. § 227.201(m)(5).
56. 17 C.F.R. § 227.201(m)(6).
57. 17 C.F.R. § 227.201(m)(2).
58. 17 C.F.R. § 227.201(f).
59. 17 C.F.R. § 227.201(p).
60. 17 C.F.R. § 227.201(q).
61. 17 C.F.R. § 227.201(u).
62. 17 C.F.R. § 227.201(w).
63. 17 C.F.R. § 227.201(x).
64. 17 C.F.R. § 227.201(s).
65. 17 C.F.R. § 227.201(s), Instruction 2.
66. *Id.*
67. *Id.*
68. See 17 C.F.R. § 227.201(t).
69. 17 C.F.R. § 227.201(i).
70. 17 C.F.R. § 227.201(l).
71. 17 C.F.R. § 227.201(n).
72. 17 C.F.R. § 227.201(o).
73. 17 C.F.R. § 227.201(g).
74. 17 C.F.R. § 227.201(h).
75. 17 C.F.R. § 227.201(j).
76. 17 C.F.R. § 227.201(k).
77. 17 C.F.R. § 227.201(v)
78. 17 C.F.R. § 227.203(a)(3)(i).
79. 17 C.F.R. § 227.203(a)(3)(ii).

80. 17 C.F.R. § 227.201(y).
81. 17 C.F.R. § 227.202(a).
82. 17 C.F.R. § 227.202(a).
83. See 17 C.F.R. § 227.202(a).
84. 17 C.F.R. § 227.202(b)(1),(4),(5).
85. 17 C.F.R. § 227.202(b)(2).
86. 17 C.F.R. § 227.202(b)(3).
87. 17 C.F.R. § 227.300(a).
88. See Securities Exchange Act of 1934 § 3(a)(80), 15 U.S.C. § 78c(a)(80); 17 C.F.R. §§ 227.401–227.402.
89. 17 C.F.R. § 227.300(b).
90. 17 C.F.R. § 227.300(b)(1),(2).
91. 17 C.F.R. § 227.302(d).
92. 17 C.F.R. § 227.204(a).
93. 17 C.F.R. § 227.205(b).
94. 17 C.F.R. § 227.204(b).
95. 17 C.F.R. § 227.303(c).
96. 17 C.F.R. § 227.303(c)(2),(3).
97. 17 C.F.R. §§ 227.204(c), 227.303(c)(4).
98. 17 C.F.R. § 227.205(a).
99. 17 C.F.R. § 227.303(a)(1),(3).
100. 17 C.F.R. § 227.303(b)(1).
101. 17 C.F.R. § 227.301(a).
102. 17 C.F.R. § 227.301(b).
103. 17 C.F.R. § 227.301(c)(1).
104. *Id*.
105. 17 C.F.R. § 227.301(c)(2).
106. 17 C.F.R. § 227.201(g).
107. 17 C.F.R. § 227. 303(a)(2).
108. 17 C.F.R. § 227.304(a).
109. 17 C.F.R. § 227.304(d).
110. 17 C.F.R. § 227.304(b).
111. 17 C.F.R. § 227.304(b)(2),(3).
112. Section 3(a)(11) of the Securities Act exempts "[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory" 15 U.S.C. § 77c(a)(11).

113. 17 C.F.R. § 230.147.
114. 17 C.F.R. § 230.147(c)(1).
115. 17 C.F.R. § 230.147(c)(2).
116. For a fairly typical example of such a state exemption, see NEB. REV. STAT. § 8-1111(24).
117. Securities Act of 1933 § 18(b)(4)(E), 15 U.S.C. § 77r(b)(4)(E).
118. Securities Act of 1933 § 18(b)(4)(C), 15 U.S.C. § 77r(b)(4)(C).
119. Securities Act of 1933 § 18(a), 15 U.S.C. § 77r(a).
120. See Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11); Securities Act Rule 147, 17 C.F.R. § 230.147.
121. See Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2); Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a); Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5.
122. Securities Act of 1933 § 4A(c), 15 U.S.C. § 77d-1(c).
123. Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5.

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