

INTRASTATE CROWDFUNDING

Matthew A. Pei*

Crowdfunding is the practice of raising small amounts of money from a large number of people over the Internet. Until now, businesses trying to raise capital over crowdfunding sites such as Kickstarter have solicited contributions by offering rewards instead of a possible return, which allows them to avoid federal securities laws. However, after proposed SEC rules are finalized, it will be legal for issuers to sell securities—such as equities and interest-bearing debt—over crowdfunding platforms without incurring the expense of registration.

The new federal crowdfunding exemption has been the subject of considerable debate and anticipation in both the media and scholarly literature. However, securities-based crowdfunding is already legal in several states so long as the issuers offer and sell securities only to in-state residents. This Note engages in the first sustained comparison of the state and federal exemptions. It claims that although the state exemptions offer issuers access to a smaller pool of potential investors, they present a viable, lower-cost alternative to the federal exemption because they subject issuers to significantly fewer regulatory expenses. It further claims that in spite of their less stringent requirements, certain features of the state exemptions can help to promote investor protection by encouraging the participation of large investors. This Note concludes by offering four recommendations for improving

* J.D. Candidate 2015, Columbia Law School; M.A. 2008, University of Wisconsin-Milwaukee; A.B. 2005, Vassar College. The author would like to thank Jason W. Parsont for his extremely helpful guidance and comments. The analysis here owes much to his recent article *Crowdfunding: The Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. 281 (2014). Additional thanks to Ravi Bhagat for his insightful feedback and to Sarah Abrams for her careful proofreading, as well as to the staff and editors of the *Columbia Business Law Review* for their help in preparing this Note for publication.

both the state and federal laws, in each case urging that the exemptions draw on the best aspects of one another.

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I. INTRODUCTION

On April 5, 2012, President Obama signed the Jumpstart Our Business Startups Act (the “JOBS Act”).¹ Title III of the JOBS Act amends the Securities Act of 1933 by adding a new exemption at section 4(a)(6).² The exemption allows, for the first time, start-ups and entrepreneurs to raise capital through securities-based crowdfunding. Following the finalization of Securities and Exchange Commission (“SEC”) rules, it will be legal for start-ups, small businesses, and entrepreneurs to sell shares of their businesses to retail investors over approved crowdfunding portals without first registering those securities with the Commission. Ideally, the new exemption will “democratize” both entrepreneurship and investing.³ On one hand, it will provide start-ups with access to a new, and presumably needed, source of capital without burdening them with the regulatory expenses associated with traditional sales of securities. On the other hand, retail investors will be given the chance to invest in potentially lucrative opportunities previously only available to venture capitalists, angel investors, and the wealthy and connected. As President Obama framed this potential win-win before signing the bill into law:

[B]ecause of this bill, start-ups and small business will now have access to a big, new pool of potential investors—namely the American people. For the first time ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.⁴

¹ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.).

² Securities Act of 1933 § 4(a)(6) (codified at 15 U.S.C. § 77d(a)(6) (2012)).

³ See, e.g., Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1473–76 (2013).

⁴ Barack Obama, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012), available at <http://perma.cc/VK6-4TZ3>.

Ideally, this merging of previously sidelined capital with new business ideas will provide the economic spark contemplated in the title of the JOBS Act.

However, although the SEC released proposed rules for securities-based crowdfunding on October 23, 2013, those rules still have not been finalized.⁵ Not waiting on the SEC, a number of states have enacted their own crowdfunding exemptions. In March 2011, the Kansas Securities Commission adopted the Invest Kansas Exemption, and Georgia's securities regulator followed suit with its own exemption in November of the same year.⁶ And in late 2013, Wisconsin and Michigan enacted legislation creating statutory exemptions in both states.⁷ In 2014, several more states have passed exemptions of their own,⁸ while still

⁵ See Crowdfunding, SEC Release Nos. 33-9470; 34-70741, 78 Fed. Reg. 66,428 (Nov. 5, 2013) [hereinafter SEC Proposed Rules]. Early this year, SEC Chair Mary Jo White called final implementation of the crowdfunding rules an "important priority in 2014." Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Keynote Address at the 41st Annual Securities Regulation Institute: The SEC in 2014 (Jan. 27, 2014), <http://perma.cc/7NNQ-7L4K>. More recently, White told an audience that, "the staff is in the process of reviewing the comments and developing recommendations for final rules for the Commission's consideration." Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Opening Statement at Investor Advisory Committee Meeting (July 10, 2014), <http://perma.cc/W8CN-4K3M>.

⁶ Patrick Clark, *Kansas and Georgia Beat the SEC on Crowdfunding Rules. Now Others are Trying*, BLOOMBERG BUSINESSWEEK (June 20, 2013), <http://perma.cc/77Q6-JRQU>. See GA. COMP. R. & REGS. 590-4-2-.08 (2013); KAN. ADMIN. REGS. § 81-5-21 (2014).

⁷ See MICH. COMP. LAWS ANN. § 451.2202a (West 2013); WIS. STAT. ANN. § 551.202(26)–(27) (West 2013).

⁸ Alabama, Colorado, Indiana, Maine, Maryland, Tennessee, and Washington have all enacted crowdfunding exemptions in 2014, bringing the total number of states with exemptions to 12. See Georgia Quinn & Anthony Zeoli, *The Definitive Guide: Intrastate Crowdfunding Exemptions*, CROWDFUND INSIDER (July 15, 2014, 8:28 AM), <http://perma.cc/66EQ-6QDD>. Idaho also permits issuers to engage in crowdfunding on a case-by-case basis, using a similar set of requirements to those of the other state exemptions. See Treasure Valley Angel Fund, Idaho Dep't of Fin., Blue Sky L. Rep. (CCH), ¶ 21729 (Jan. 20, 2012).

others are considering similar legislation.⁹ As several members of Congress put it in a recent letter to SEC Chair Mary Jo White, urging her to finish promulgating federal crowdfunding rules: “Due in large part to the lack of finalized federal rulemaking, states are now leading the way, harnessing the power of new technologies to connect entrepreneurs with investors.”¹⁰

But so far, the state exemptions have been used only sparingly. According to one estimate, only about twenty companies have tried to use the Kansas and Georgia exemptions since their adoption in 2011.¹¹ Does this imply that the state exemptions are superfluous, especially now that the federal rules are almost in effect? Or does their underutilization point to problems for the federal exemption?

This Note engages in the first in-depth comparison of the state and federal exemptions. It argues that, in spite of the impending federal exemption, state-level crowdfunding exemptions can still play a useful role in encouraging small business capital formation because they impose significantly lower regulatory burdens on issuers. Thus, they can provide a lower-cost alternative for entrepreneurs seeking to raise relatively small amounts of capital. This Note also argues that, although the state exemptions are less stringent than their federal counterpart, some of their features promote investor protection by encouraging the participation of larger and more seasoned investors.

⁹ See, e.g., H.B. 680, Gen. Assemb. of N.C., Sess. 2013 (N.C. 2013). In all, fourteen states (Alaska, Arkansas, California, Connecticut, Florida, Illinois, Missouri, North Carolina, New Jersey, Pennsylvania, South Carolina, Texas, Utah, and Virginia) are considering crowdfunding legislation. Anthony J. Zeoli & Georgia P. Quinn, *Summary of Enacted Intrastate Crowdfunding Exemptions (as of July, 2014)*, CROWDCHECK BLOG (July 14, 2014), <http://perma.cc/GQ3J-8BJR>.

¹⁰ Letter from Jared Polis, U.S. Rep., et al., to Mary Jo White, Chair, U.S. Sec. & Exch. Comm’n (Aug. 8, 2014), *available at* <http://perma.cc/UK8J-69CR>.

¹¹ Patrick Clark, *State Lawmakers are Getting on the Crowdfunding Bandwagon*, BLOOMBERG BUSINESSWEEK (Jan. 7, 2014), <http://perma.cc/JG7S-XQ6J>.

However, in order to protect investors and encourage capital formation, both the state and federal exemptions should consider modifications that draw on the best aspects of each other. First, the states should eliminate aggregation requirements for issuers that will deter utilization of the exemptions while adding little in the way of investor protection. Second, and most significantly, the state exemptions should, like the federal one, require that crowdfunded securities be sold over registered portals that are charged with vetting issuers and ensuring that investors are appraised of risks. Such a requirement would put the regulatory burdens on the portals—the parties best able to bear them—while at the same time not discouraging issuers from using the exemptions and adding a needed layer of investor protection. The requirement could also reduce some of the transaction costs for issuers: for instance, the portals are better situated to ensure that offerings are made in compliance with SEC Rule 147, which the state exemptions rely on for purposes of federal law. Third, to enhance investor protection, the state exemptions should include an annual aggregate investment limit for retail investors. Finally, the federal exemption should encourage the participation of larger, more sophisticated investors in crowdfunding offerings by following the states in removing the individual investment limit for accredited investors. Doing so would not only expand the pool of available capital, making the exemption more attractive to issuers, but would also enable retail investors to piggyback on accredited investors' diligence, pricing, and monitoring work. Together, these recommendations could improve the usefulness of the state and federal exemptions while strengthening investor protection, potentially enhancing the legitimacy of crowdfunding in the eyes of the investing public, and increasing interest in these exemptions.

Part I of this Note provides a brief introduction to crowdfunding and its current forms as well as the rationale for a crowdfunding exemption. It then provides an overview of the federal and state exemptions, highlighting their most significant differences. Part II provides a more in-depth

comparison of the exemptions along several key dimensions, arguing that the state exemptions can provide a viable, lower-cost alternative. Part III makes the aforementioned recommendations.

II. BACKGROUND

A. Crowdfunding

Defined most broadly, crowdfunding is the process of raising money by soliciting small contributions from a large number of people.¹² Crowdfunding over the Internet is still a relatively new development: ArtistShare, an early online platform, was founded in 2001¹³ and Kiva, “the leading crowdfunding site today,” opened in 2005.¹⁴ Internet-based crowdfunding has grown dramatically in recent years. It has been projected that, in 2013, more than \$5 billion—almost double the amount raised in 2012—would be raised over crowdfunding platforms.¹⁵

The major types of crowdfunding are typically categorized according to what the investor is promised in return for her money. In the donation-based model, the contribution is a straight donation and the backer receives nothing in return.¹⁶ In the rewards-based model, the contributor receives something in return that is often related to the project seeking financing. For example, a crowdfunding

¹² C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 10 (2012).

¹³ Nate Chinen, *Blue Note to Partner With ArtistShare*, N.Y. TIMES ARTSBEAT (May 8, 2013, 8:00 AM), <http://perma.cc/FS6R-9R7V>; *Can You Spare a Quarter? Crowdfunding Sites Turn Fans into Patrons of the Arts*, KNOWLEDGE@WHARTON (Dec. 8, 2010), <http://perma.cc/8NHH-67ZP>.

¹⁴ Bradford, *supra* note 12, at 11. Bradford also claims that the term “crowdfunding” did not enter circulation until 2006. *Id.*

¹⁵ Patrick Clark, *Crowdfunders Are Quietly Donating and Lending Billions*, BLOOMBERG BUSINESSWEEK (Apr. 8, 2013), <http://perma.cc/UQR2-FWW9>.

¹⁶ Political contributions might be thought of as a type of donation-based crowdfunding. Of course, political crowdfunding can be and is done offline as well. See Tim Kappel, *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?*, 29 LOY. L.A. ENT. L. REV. 375, 375 (2009).

effort to finance a movie might offer backers “patronage perks” such as a t-shirt, a signed copy of the script, or the inclusion of the investor’s name in the film’s credits.¹⁷ In the pre-purchase model, the most common type of crowdfunding,¹⁸ the contributor is given the chance to purchase the product that will be made with the proceeds of the funding campaign in advance, usually at a discount to the anticipated retail price.¹⁹ On the lending-based model, the contributor receives the return of his initial investment, sometimes with interest. Finally, in the equity-based model, backers are given a stake in the business in question and are entitled to a “share of the profits or return of the business they are helping to fund.”²⁰

Both the equity-based and interest-bearing debt models (together, “securities-based crowdfunding”) take the rewards concept “one step further.”²¹ For one, by offering the backer an opportunity for profit, they provide an additional incentive to invest. Moreover, they make crowdfunding a real option for businesses that are not well suited to exploit the other popular models.²² For instance, a contractor in the business of rehabbing old apartment complexes would be unlikely to attract investment interest with free t-shirts or

¹⁷ See *id.* at 376. Of course, the rewards need not be tied to the project in question. The University of California recently raised \$1.3 million in scholarship money in a crowdfunding effort that solicited contributions by offering rewards such as car washes by a fraternity house and the chance to receive a private cooking lesson over Skype from the actress Teri Hatcher. One student was able to raise \$200 by promising to wear a costume horse head around the campus of UC-Merced for a week. See Larry Gordon, *UC crowd-funding effort brings in \$1.3 million—and some fun*, L.A. TIMES COLLECTIONS (Nov. 6, 2013), <http://perma.cc/8ZTR-NJU6>.

¹⁸ Bradford, *supra* note 12, at 16.

¹⁹ One of this author’s former students invited this author to participate in a crowdfunding campaign and pre-purchase a pair of bamboo sunglasses. See *Waybu Sunglasses—Join the Journey*, INDIEGOGO, <http://perma.cc/R5VF-6LQJ> (last visited Nov. 27, 2014).

²⁰ Bradford, *supra* note 12, at 24.

²¹ See Schwartz, *supra* note 3, at 1460.

²² See Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. 281, 292–93 (2014).

other perks, and obviously few would be in a position to pre-purchase the finished product.²³ To raise capital through crowdfunding, it seems that these types of firms must be able to offer some kind of return. The crowdfunding exemptions seek to make this possible.

B. Small Business Capital Formation and the Case for the Federal Crowdfunding Exemption

Supporters of securities-based crowdfunding have argued that it can greatly increase access to capital for start-ups and early-stage small businesses.²⁴ Many argue that such ventures are frequently unable to get the money they need.²⁵ Traditional private sources of capital such as banks, venture capitalists, and angel investors are not available to most new entrepreneurs.²⁶ These ventures often lack the collateral to secure a bank loan,²⁷ and venture capitalists and angel investors tend to focus on high-growth opportunities in which they can make a substantial investment.²⁸ Moreover,

²³ One of the first successful campaigns using the Invest Georgia Exemption was for a similar project. *See Clark, supra* note 11.

²⁴ *See Hearing on the JOBS Act—Importance of Effective Implementation Before the Subcomm. on TARP, Fin. Servs., and Bailouts of Pub. and Private Programs of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 43 (2012) (statement of C. Steven Bradford, Earl Dunlop Distinguished Professor of Law, University of Nebraska College of Law) (“I believe crowdfunding has extraordinary promise for small business capital formation . . .”).

²⁵ Bradford cites estimates that the financial markets “fall \$60 billion short each year in meeting the demand of small companies for early-stage private equity financing.” Bradford, *supra* note 12, at 100 (internal quotation marks omitted). *But see* VLADIMIR IVANOV & SCOTT BAUGUESS, U.S. SEC. & EXCH. COMM’N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009-2012 10 (2013) (arguing that private offerings provide a robust source of capital and that concerns about small business capital formation may be overstated).

²⁶ *See* Bradford, *supra* note 12, at 101–04.

²⁷ *Id.* at 102; SEC Proposed Rules, *supra* note 5, at 328.

²⁸ *See* Bradford, *supra* note 12, at 102–03; SEC Proposed Rules, *supra* note 5, at 331.

it is often too costly for new entrepreneurs to seek out potential investors beyond their friends and family. High information costs similarly prevent potential retail investors from finding new ideas in which to invest their sidelined capital.²⁹ Thus, many ideas go unfunded and potential economic growth, job creation, and innovation are all left unrealized.³⁰ Securities-based crowdfunding has the potential to help close this “capital funding gap”³¹ by connecting entrepreneurs with large numbers of investors, all capable of making a small contribution to the venture.

However, the Securities Act of 1933 prohibits the offer and sale of securities that have not been registered with the SEC unless there is an applicable exemption.³² Since equity-based crowdfunding and lending-based crowdfunding (where the investor is repaid with interest) both involve an expectation of profit on part of the backer, such investments qualify as investment contracts and therefore as securities under the *Howey* test.³³ However, the costs associated with SEC registration are high, potentially running into the hundreds of thousands of dollars.³⁴ Given that crowdfunding offerings are often quite small,³⁵ requiring entrepreneurs to register their securities could completely wipe out their incentive to take advantage of securities-based

²⁹ Bradford calls this an “informational inefficiency—a failure to match potential sources of capital with potential investment opportunities.” Bradford, *supra* note 12 at 101.

³⁰ Bradford, *supra* note 12, at 100.

³¹ *Id.*

³² Securities Act of 1933 § 5 (codified at 15 U.S.C. § 77e (2012)).

³³ *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). Since other models of crowdfunding (donation, reward, pre-purchase, and no-interest-lending) do not involve an expectation of profit, they do not qualify as investment contracts and therefore do not implicate the federal securities laws.

³⁴ See Bradford, *supra* note 12, at 42; Schwartz, *supra* note 3, at 1469 (“Preparation of a registration statement can require over 1,200 hours of work . . .”).

³⁵ See Bradford, *supra* note 12, at 11 (“Crowdfunding offerings are typically rather small. One study found that the median amount raised was only \$28,583.”).

crowdfunding, effectively choking off this new stream of capital. This line of thought provided a rationale for exempting crowdfunded securities from registration requirements.

Nevertheless, freeing issuers from the requirements of SEC registration could expose investors to fraud, self-dealing, and investment losses. Investing in start-ups is already risky.³⁶ Even companies backed by experienced and sophisticated venture capital firms fail at a surprisingly high rate—as frequently as three-quarters of the time, according to a recent study.³⁷ The businesses seeking to raise capital through securities-based crowdfunding would likely be those that were passed over by more traditional sources of financing, suggesting that they might experience even higher failure rates.³⁸

Moreover, many investors in crowdfunded securities are likely unsophisticated.³⁹ And given the small amounts of capital that most retail crowdfunding investors would contribute to a given venture, there is little incentive for any

³⁶ “Approximately 80% of new businesses either fail or no longer exist within five to seven years of formation.” Bradford, *supra* note 12, at 108 (internal quotation marks omitted).

³⁷ “A recent study of more than 2,000 companies that received at least \$1 million in venture funding, from 2004 through 2010, finds that almost three-quarters of these companies failed.” SEC Proposed Rules, *supra* note 5, at 335. See also Bradford, *supra* note 12, at 108 (noting that “[e]ven the small businesses selected for investment by sophisticated venture capital funds are predominantly failures.”).

³⁸ See SEC Proposed Rules, *supra* note 5, at 335 (“[W]e believe that issuers that engage in securities-based crowdfunding may have higher failure rates than those [that receive venture-capital backing].”).

³⁹ See SEC Proposed Rules, *supra* note 5, at 341–42 (“We believe that many [crowdfunding] investors . . . would likely be individual retail investors who currently do not have broad access to investor opportunities in early-stage ventures, either because they do not have the necessary accreditation or sophistication to invest in most private offerings or because they do not have sufficient funds to participate as angel investors. . . . In contrast, larger, more sophisticated or well-funded investors may be less likely to invest in offerings made in reliance on Section 4(a)(6).”).

one of them to thoroughly vet investment opportunities.⁴⁰ This collective action problem⁴¹ persists even after the investments have been made, as the widely dispersed investors will also lack a sufficient motive to engage in the type of monitoring behavior that could act as a check against fraudulent and opportunistic behavior by the issuer. When added to the risks already inherent in investing in early-stage businesses, these factors—the investors' lack of sophistication, and the absence of strong incentives to engage in due diligence or monitoring—only seem to magnify the chances of investment losses, fraud, and self-dealing.

Finally, crowdfunded securities are subject to liquidity risk. Investments in start-ups are not traded on open exchanges, which may create difficulties if investors seek to exit their positions.⁴² The absence of a liquid secondary market may also make it more difficult for investors to make informed initial investment decisions.⁴³ If an issuer has previously issued securities, a competitive market price for existing shares would be a valuable piece of information to have in deciding whether to invest in a new offering. And if the issuer is offering securities for the first time, as many crowdfunding issuers would be, the existence of a liquid secondary market could still provide valuable pricing information about competitors. Finally, the absence of a robust secondary market means that investors cannot rely on the market to accurately price their holdings, depriving them of one way to monitor their investment. Thus, the lack of liquidity in crowdfunded securities exacerbates

⁴⁰ See Parsont, *supra* note 22, at 318–19.

⁴¹ See Parsont, *supra* note 22, at 319 (defining a collective action problem as “a situation where no one in a dispersed group has sufficient incentive to act on behalf of the group (i.e., through collective action) because such actor would have to foot all the costs while only receiving a small share of the benefits”).

⁴² See Bradford, *supra* note 12, at 108 (“Investors in startups also face liquidity risk, because there is no ready public market in which to resell their investments.”).

⁴³ See Parsont, *supra* note 22, at 323 (explaining that “retail investors in [the crowdfunding] market, unlike the public market, will not benefit in the same way from professional investors' competitive pricing work”).

investment risk both before and after the sale. First, it impedes accurate pricing of the securities, and second, it threatens the ability of investors to monitor their holdings and, if necessary, cut their losses by selling their positions.

Taken together, these risks provided a rationale to build significant investor protections into the federal crowdfunding exemption. For if the risks were realized, investors might shy away from the market for crowdfunded securities, impeding the very capital formation that the exemption is meant to foster.

C. The Federal Exemption

The result of this struggle between investor protection on the one hand, and capital formation on the other, is the crowdfunding exemption in Title III of the JOBS Act is.⁴⁴ Under the new Securities Act section 4(a)(6) created by Title III, an issuer may raise up to \$1 million in reliance on the exemption in a given year without filing a registration statement with the SEC.⁴⁵ The offering cap is meant to limit the exemption to issuers who would be genuinely deterred by registration requirements. The exemption also limits the aggregate amount an individual can invest in crowdfunded securities in a given year. If an investor's income or net worth is less than \$100,000, the limit is the greater of \$2,000 or 5 percent of the investor's annual income or net worth.⁴⁶

⁴⁴ See Parsont, *supra* note 22, at 294–300 (describing the legislative history of the crowdfunding exemption).

⁴⁵ 15 U.S.C. § 77d(a)(6)(A) (2012).

⁴⁶ 15 U.S.C. § 77d(a)(6)(B)(i) (2012). The SEC's proposed rules alter this formula slightly in order to remove the ambiguity over which limit would apply to an investor that has an annual income over \$100,000 and a net worth below \$100,000, or vice versa SEC Proposed Rules, *supra* note 5, at 24. "Under the proposed rules . . . if *both* annual income *and* net worth are less than \$100,000, then a limit of \$2,000 or 5 percent of annual income or net worth, whichever is greater, would apply." *Id.* As Bradford clarifies in a recent article, for investors falling below the \$100,000 threshold "the limit is the greatest of three numbers: \$2,000, 5 percent of the investor's annual income, and 5 percent of the investor's net worth." C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195, 200 (2012).

Investors with an income or net worth over \$100,000 are permitted to invest up to 10 percent of their income or net worth, with a hard cap at \$100,000 per year.⁴⁷ These restrictions are meant to limit investor losses to an amount the investor can afford to lose.

In addition, the section 4(a)(6) exemption requires that the securities be sold over a registered funding portal or through a registered broker-dealer portal.⁴⁸ Both the issuer and the portal are subject to a host of disclosure requirements designed to enhance investor protection. An issuer must provide the SEC, the broker or portal, and investors with its name, address, and website, as well as the names of its directors and major shareholders.⁴⁹ It must also disclose details about the investment, including a description of the issuer's business plan and a statement of its financial condition including financial statements and tax returns.⁵⁰ An independent public accountant must review the financial statements if the issuer seeks to raise between \$100,000 and \$500,000; and if the target offering amount exceeds \$500,000, then audited financial statements are required.⁵¹ The issuer must also provide a description containing the following information: the intended use of the funds raised, its target offering amount (along with regular updates on fundraising progress), the public price of the securities and the method used for determining that price, and information about its business's ownership and capital structure.⁵² Issuers are further prohibited from advertising their offerings, except for teaser notices directing investors to the

⁴⁷ 15 U.S.C. § 77d(a)(6)(B)(ii) (2012). The SEC's proposed rules clarify that the limit for investors above the \$100,000 threshold is the *greater* of 10 percent of their annual income *or* 10 percent of their net worth. *See* SEC Proposed Rules, *supra* note 5, at 24. *See also* Bradford, *supra* note 46 at 201 (discussing the original ambiguity in the JOBS Act).

⁴⁸ 15 U.S.C. § 77d(a)(6)(C) (2012).

⁴⁹ 15 U.S.C. § 77d-1(b)(1)(A)–(B) (2012).

⁵⁰ 15 U.S.C. § 77d-1(b)(1)(C)–(D) (2012).

⁵¹ 15 U.S.C. § 77d-1(b)(1)(D)(ii)–(iii) (2012).

⁵² 15 U.S.C. § 77d-1(b)(1)(E)–(H) (2012).

portal or broker.⁵³ Finally, after the securities are sold, issuers must provide financial statements and reports containing operations results to investors and the SEC at least once a year.⁵⁴ Under the proposed rules, those statements would also have to be reviewed by a public accountant or audited if the original statements were subject to those standards.⁵⁵

The federal exemption also requires crowdfunding sites to take steps to screen-out potential bad actors by performing background and securities enforcement checks on all issuers and their officers and major investors.⁵⁶ Portals are required to warn investors of risks by ensuring that each investor reviews investor education materials.⁵⁷ And portals must also help mitigate investor risk by ensuring that investors stay under the individual caps.⁵⁸ Additional regulations imposed on portals include rules designed to protect investor privacy⁵⁹ and prevent conflicts of interest: portals are prohibited from compensating issuers, and their directors and officers are banned from investing in or otherwise

⁵³ 15 U.S.C. § 77d-1(b)(2) (2012). This prohibition has been relaxed somewhat in the SEC's proposed rules. According to the proposal, notices advertising the terms of an offering could include limited information concerning the amount, nature, and price of the offered securities. See SEC Proposed Rules, *supra* note 5, at 109–10.

⁵⁴ 15 U.S.C. § 77d-1(b)(4) (2012).

⁵⁵ SEC Proposed Rules, *supra* note 5, at 95.

⁵⁶ 15 U.S.C. § 77d-1(a)(5) (2012).

⁵⁷ 15 U.S.C. § 77d-1(a)(4) (2012).

⁵⁸ 15 U.S.C. § 77d-1(a)(8) (2012). Although the JOBS Act is ambiguous on the question of what steps portals must take to verify that investors do not exceed the individual investment limits, the SEC's proposed rules would allow intermediaries to rely in good faith on investors' representations that they are under the applicable cap. An intermediary may choose to satisfy this requirement by providing a function on its platform that prompts investors to enter amounts of their annual income, net worth, and the amount of total investments made over the past twelve months on all intermediaries' platforms that would then generate the amount of investment the investor would be permitted to make at that time pursuant to the investment limitations. SEC Proposed Rules, *supra* note 5, at 169–70.

⁵⁹ 15 U.S.C. § 77d-1(a)(9) (2012).

having a financial stake in an issuer's business.⁶⁰ Finally, portals are prohibited from distributing any funds raised to an issuer before the target offering amount is met.⁶¹

Finally, securities sold in reliance on the federal exemption are subject to resale restrictions. Purchasers cannot sell their holdings for one year from the date of purchase, although the restriction is relaxed if the securities are transferred to the issuer, an accredited investor, a family member, or as part of a registered offering.⁶²

All in all, while allowing securities-based crowdfunding, the federal exemption places a large number of requirements on both issuers and portals. Some aspects of the exemption, such as the offering and individual investment limits, will likely serve to help protect investors, but some commentators fear that the requirements are still too burdensome and will significantly deter capital formation.⁶³

D. The State Exemptions

Despite the JOBS Act, securities-based crowdfunding on a national level is still not legal. Almost a full year after the deadline to issue crowdfunding rules set forward in the Act,⁶⁴ the SEC released proposed rules on October 23, 2013, which were subject to a 90-day public comment period and now await final implementation.⁶⁵ Not waiting on the SEC, 12 states—Alabama, Colorado, Georgia, Idaho, Indiana, Kansas, Maine, Maryland, Michigan, Tennessee, Washington, and Wisconsin—recently adopted their own

⁶⁰ 15 U.S.C. § 77d-1(a)(10)–(11) (2012).

⁶¹ 15 U.S.C. § 77d-1(a)(7) (2012).

⁶² 15 U.S.C. § 77d-1(e) (2012); SEC Proposed Rules, *supra* note 5, at 517.

⁶³ See Bradford, *supra* note 46, at 215, 216–17.

⁶⁴ See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.). The Act gave the SEC 270 days from the enactment of the legislation to issue rules, meaning that the original deadline was December 31, 2012.

⁶⁵ See SEC Proposed Rules, *supra* note 5; Press Release, U.S. Sec. & Exch. Comm'n, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013), <http://perma.cc/LS4G-4TZD>.

crowdfunding exemptions.⁶⁶ For the sake of clarity and space, the analysis below will focus on four of the earliest exemptions: Kansas, Georgia, Wisconsin, and Michigan.⁶⁷ Nonetheless, the state crowdfunding exemptions share many structural similarities, and significant differences in the newer exemptions will be noted throughout.

Like Title III of the JOBS Act, the Kansas, Georgia, Wisconsin and Michigan laws all allow issuers to engage in securities-based crowdfunding without registering those securities with the state regulator. Wisconsin's legislation actually creates two separate exemptions at sections 26 and 27 of the Wisconsin Uniform Securities Law: the former for traditional crowdfunding offerings that are advertised and made via an Internet portal, and the latter for private offerings that are not advertised and thereby freed from the intermediary requirement and many of the mandatory disclosures. The state exemptions all rely on SEC Rule 147, which excludes securities that are offered and sold purely *intrastate* from federal registration requirements.⁶⁸ The intrastate safe-harbor is meant to "apply only to issues genuinely local in character," meaning that both the issuer and all the investors must be residents of the same state.⁶⁹ In Wisconsin and Michigan, issuers must obtain evidence, such as a driver's license or voter registration, that the

⁶⁶ See Georgia Quinn & Anthony Zeoli, *The Definitive Guide: Intrastate Crowdfunding Exemptions*, CROWDFUND INSIDER (July 15, 2014, 8:28 AM), <http://perma.cc/66EQ-6QDD>.

⁶⁷ See MICH. COMP. LAWS ANN. § 451.2202a (West 2013); WIS. STAT. ANN. § 551.202(26)–(27) (West 2013); GA. COMP. R. & REGS. § 590-4-2-.08 (2013); KAN. ADMIN. REGS. § 81-5-21 (2014).

⁶⁸ 15 U.S.C. § 77c(a)(11) (2012); 17 C.F.R. § 230.147 (2014). The newer exemptions also rely on Rule 147. The lone exception is Maine, which requires that offerings meet the requirements of Rule 504 of Regulation D in order to avoid federal registration requirements. See ME. REV. STAT. ANN. Tit. 32, § 16304(6-A)(D) (2014).

⁶⁹ 17 C.F.R. § 230.147 (2014). Issuers must also be "doing business within" the state in question, meaning that they must receive most of their revenues, hold most of their assets, and use most of the proceeds of the offering within the state. See *id.* § 230.147(c).

purchaser is a state resident.⁷⁰ The Kansas and Georgia exemptions are silent on what steps an issuer should take to ensure Rule 147 compliance.⁷¹

The state exemptions share several structural features with the federal statute.⁷² Like section 4(a)(6), the state exemptions include a default offering cap of \$1 million, although both Wisconsin and Michigan increase the ceiling to \$2 million if the issuer has audited financial statements.⁷³ The state exemptions also provide that offers and sales to “controlling persons” of the issuer, which includes officers, directors, partners, and persons owning 10 percent or more of the outstanding shares, do not count against the offering cap.⁷⁴ And under Wisconsin’s exemptions, contributions from

⁷⁰ MICH. COMP. LAWS ANN. § 451.2202a(1)(i)(ii) (West 2013); WIS. STAT. ANN. § 551.202(26)(j) (West 2013). Some of the newer exemptions also contain a similar verification requirement. *See, e.g.*, ALA. CODE § 8-6-11(a)(14)(b) (2014).

⁷¹ Nonetheless, the SEC has recently released new Compliance and Disclosure Interpretations addressing what steps an intrastate crowdfunding issuer should take to comply with Rule 147. The interpretations stress that issuers and portals must take significant measures to avoid offering securities to out-of-state investors. *See* SEC Compliance and Disclosure Interpretation, Questions 141.03–05 (Apr. 10, 2014), *available at* <http://perma.cc/7ZC5-KGMJ>.

⁷² *See infra* Table 1 (providing a side-by-side comparison of federal, Kansas, Georgia, Wisconsin, and Michigan exemptions).

⁷³ MICH. COMP. LAWS ANN. § 451.2202a(1)(c)(i)–(ii) (West 2013); WIS. STAT. ANN. §§ 551.202(26)(c)(1)a–b, 551.202(27)(c)(1)a–b (West 2013); GA. COMP. R. & REGS. 590-4-2-.08(1)(c) (2013); KAN. ADMIN. REGS. § 81-5-21(a)(3) (2014). Indiana also allows issuers with audited financial to raise up to \$2 million, while Idaho’s exemption places a \$2-million cap on all issuers. *See* IND. CODE ANN. § 23-19-2-2(27)(C)(ii) (West 2014); Treasure Valley Angel Fund, Idaho Dep’t of Fin., Blue Sky L. Rep. (CCH), ¶ 21729 (Jan. 20, 2012).

⁷⁴ MICH. COMP. LAWS ANN. § 451.2202a(4) (West 2013); WIS. STAT. ANN. §§ 551.202(26)(c)(2), 551.202(27)(c)(2) (West 2013); GA. COMP. R. & REGS. 590-4-2-.08(2)(a)–(b) (2013); KAN. ADMIN. REGS. § 81-5-21(a)(9)(b) (2014). Unlike the other laws, the Kansas exemption does not explicitly list the types of purchasers who do not affect the cap. However, it exempts sales to a “controlling person [of the issuer],” which is defined as “(1) [a]n officer, director, partner, or trustee of an individual occupying similar status or performing similar functions; or (2) a person owning 10 percent

accredited,⁷⁵ “certified,”⁷⁶ and institutional investors also do not count against the offering cap.⁷⁷

Like the federal exemption, the state exemptions also cap how much a non-accredited investor may invest in a crowdfunding offering: the Kansas law at \$5,000⁷⁸ and the Georgia, Wisconsin, and Michigan exemptions at \$10,000.⁷⁹

or more of the outstanding shares of any class or classes of securities.” KAN. ADMIN. REGS. § 81-1-1(i) (2014). Several of the newer exemptions (Alabama, Idaho, Indiana, and Tennessee) also include this feature. However, it is not universal—the exemptions in Maine, Washington, Maryland, and Colorado do not mention a carve-out for controlling persons.

⁷⁵ Accredited investors include people who, either individually or jointly with their spouse, have a net worth (not including their primary residence) of over \$1 million or who consistently earn more than \$200,000 per year individually, or \$300,000 jointly. *See* 17 C.F.R. § 230.501 (2014).

⁷⁶ “Certified investors” are a new category of investor created along with the crowdfunding exemptions in Wisconsin’s CASE (crowdfunding and securities exemptions) for the JOBS Act. A certified investor is a Wisconsin resident who either has a net worth of at least \$750,000 (including primary residence) *or* has an individual income in excess of \$100,000, or joint income over \$150,000, for each of the previous two years and has a reasonable expectation of reaching that same level in the year in which the securities are purchased. WIS. STAT. ANN. § 551.102(4m) (West 2013).

⁷⁷ WIS. STAT. ANN. §§ 551.202(26)(c)(1), 551.202(27)(c)(1) (West 2013). Indiana’s new exemption also excludes sales to accredited and institutional investors from counting against the offering limit. IND. CODE ANN. § 23-19-2-2(27)(C) (West 2014).

⁷⁸ Kansas originally set the individual investment cap at \$1,000. KAN. ADMIN. REGS. § 81-5-21(a)(4) (2014). Perhaps because of underutilization, the Invest Kansas Exemption was modified on June 21, 2013 by special order of the Securities Commissioner, raising the individual limit to \$5,000. The change was intended to “enhance the usefulness of [the Invest Kansas Exemption] for Kansas businesses to raise capital without registration.” JOSHUA A. NEY, KAN. OFFICE OF THE SEC. COMM’R, SPECIAL ORDER (June 21, 2013).

⁷⁹ MICH. COMP. LAWS ANN. § 451.2202a(1)(d) (West 2013); WIS. STAT. ANN. § 551.202(26)(d) (West 2013); GA. COMP. R. & REGS. 590-4-2-.08(1)(d) (2013). The newer state exemptions are mostly within this range, with some notable exceptions: Maryland’s exemption contains a \$100 limit, Washington adopted the same formula as the JOBS Act, Idaho limits non-accredited investors to the lesser of \$2,500 or 10% of the investor’s net

However, unlike under section 4(a)(6), the state individual investment limits are only *per offering*. For example, the Michigan exemption requires that “[t]he issuer has not accepted more than \$10,000 from any single purchaser. . .”⁸⁰ Thus, there is no limit on the aggregate amount a retail investor can invest in intrastate crowdfunding offerings in a given year, as long as each investment is within the limit—a Michigan resident could invest as much as she liked, as long as each discreet purchase was no more than \$10,000.

In another significant departure from the federal law, there is no individual investment limit for accredited investors under the state exemptions.⁸¹ And Wisconsin’s legislation creates a new, more expansive category of certified investors,⁸² for whom there are also no individual

worth, and Colorado’s exemption has no individual investment limit. *See* COLO. REV. STAT. ANN. § 11-51-304(6); 2014 MD. LAWS Ch. 557 (S.B. 811); Treasure Valley Angel Fund, Idaho Dep’t of Fin., Blue Sky L. Rep. (CCH), ¶ 21729 (Jan. 20, 2012); WASH. REV. CODE ANN. § 21.20.00001(1)(g).

⁸⁰ MICH. COMP. LAWS ANN. § 451.2202a(1)(d) (West 2013). The JOBS Act actually contains the same structure, requiring that an issuer not accept more than the amount specified by the formula laid out in § 4(a)(6)(B) of the Securities Act. 15 U.S.C. § 77d(a)(6)(B). Thus, by itself, § 4(a)(6)(B) creates no limit on an individual’s total crowdfunding purchases. But the annual aggregate investment limit gets in via § 4A(a)(8), which requires intermediaries to “make such efforts . . . to ensure that no investor in a 12-month period has purchased securities offered pursuant to § 4(6) that, in the aggregate, from all issuers, exceed the investment limits set forth in § 4(6)(B).” 15 U.S.C. 77d-1(a)(8); *see also* Bradford, *supra* note 46 at 201–02 (discussing the aggregate investment limit). Most of the state exemptions do not require issuers to use a crowdfunding portal. And in the states that do require the use of an online intermediary, the statutes do not place a similar requirement on portals that would create an annual aggregate limit.

⁸¹ MICH. COMP. LAWS ANN. § 451.2202a(1)(d) (West 2013); WIS. STAT. ANN. § 551.202(26)(c) (West 2013); GA. COMP. R. & REGS. 590-4-2-.08(1)(d) (2013); KAN. ADMIN. REGS. § 81-5-21(a)(4) (2014). The newer laws all exclude accredited investors from the investment limits. Washington, which applies the same cap to both accredited and non-accredited investors, is the lone exception. *See* WASH. REV. CODE ANN. § 21.20.00001(1)(g) (West 2014).

⁸² *See supra* note 76.

investment limits.⁸³ Similar to the federal requirement placed on portals to ensure that investors stay under applicable limits, issuers in Wisconsin and Michigan are tasked with verifying that investors are accredited or certified, as applicable.⁸⁴

The state exemptions also include disclosure requirements, although they are generally less stringent than those in the federal exemption. In Kansas and Georgia, issuers need only file a short form with the state regulator disclosing their name, the names of the people involved in the offer and sale of the securities, and the name of their bank.⁸⁵ And these requirements are not triggered until the sale of the twenty-fifth security or until the issuer engages in general solicitation, whichever comes first.⁸⁶ Wisconsin and Michigan require more thorough disclosures, including the issuer's business plan and more detailed information about the securities being offered.⁸⁷ However, neither state requires financial statements to be reviewed by an independent accountant or auditor unless the issuer seeks to raise more than \$1 million.

Issuers in all states must also inform investors that the securities are unregistered and therefore subject to resale limitations.⁸⁸ And in Wisconsin and Michigan, issuers must obtain a certification from each purchaser confirming that he understands the risky, speculative nature of his investment.⁸⁹ As the above implies, issuers (except for those

⁸³ WIS. STAT. ANN. §§ 551.202(26)(d), 551.202(27)(d) (West 2013).

⁸⁴ MICH. COMP. LAWS ANN. § 451.2202a(1)(i)(ii) (West 2013); WIS. STAT. ANN. § 551.202 (26)(j) (West 2013).

⁸⁵ GA. COMP. R. & REGS. 590-4-2-.08(1)(f) (2013); KAN. ADMIN. REGS. § 81-5-21(a)(7) (2014).

⁸⁶ *Id.*

⁸⁷ MICH. COMP. LAWS ANN. § 451.2202a(1)(e) (West 2013); WIS. STAT. ANN. § 551.202(26)(f) (West 2013).

⁸⁸ MICH. COMP. LAWS ANN. § 451.2202a(1)(g) (West 2013); WIS. STAT. ANN. § 551.202(26)(h) (West 2013); GA. COMP. R. & REGS. 590-4-2-.08(1)(h) (2013); KAN. ADMIN. REGS. § 81-5-21(a)(9).

⁸⁹ MICH. COMP. LAWS ANN. § 451.2202a(1)(h) (West 2013); WIS. STAT. ANN. § 551.202(26)(i) (West 2013). These requirements are similar to those placed on portals under the JOBS Act. *See* 15 U.S.C. § 77d-1(a)(4)(B).

using Wisconsin's section 27 exemption) are permitted to advertise their offerings as long as they comply with disclosure requirements.

In perhaps their largest departure from section 4(a)(6), all but one of the state exemptions do not require issuers to use a registered portal.⁹⁰ In fact, the Kansas and Georgia exemptions make no mention of portals whatsoever. Their use is contemplated under the Michigan statute, but not required.⁹¹ In Wisconsin, issuers wishing to use section 26 must employ an intermediary,⁹² but those willing to refrain from general solicitation are not required to do so.⁹³ Thus the statutes would allow issuers to sell securities over their own platforms,⁹⁴ or without any Internet intermediary at all.

Finally, like the federal rule, the state-level exemptions also subject crowdfunded securities to resale restrictions. In Kansas, securities cannot be resold unless they are registered or qualify for another exemption.⁹⁵ Georgia, Wisconsin, and Michigan all require that investors hold their securities for the length of time required by Rule 147,⁹⁶

⁹⁰ This trend has continued with the newer exemptions enacted in 2014. Of those, only Indiana requires issuers to employ an intermediary. IND. CODE ANN. § 23-19-2-2(27)(O) (West 2014).

⁹¹ MICH. COMP. LAWS ANN. § 451.2202a(1)(i) (West 2013).

⁹² WIS. STAT. ANN. § 551.202(26)(e) (West 2013).

⁹³ *Id.* § 551.202(27) (West 2013).

⁹⁴ However, issuers using their own websites or social media presence to offer and sell securities in reliance on the state exemptions must be very cautious to avoid violating Rule 147. As the SEC has noted in a recent Compliance and Disclosure Interpretation, “[i]ssuers generally use their websites and social media presence to advertise their market presence in a broad, indiscriminate manner. Although whether a particular communication is an ‘offer’ of securities will depend on all the facts and circumstances, using such established Internet presence to convey information about specific investment opportunities would likely involve offer to residents outside the particular state in which the issuer did business.” SEC Compliance and Disclosure Interpretation (July 3, 2014), <http://perma.cc/5GYQ-LKXL>.

⁹⁵ KAN. ADMIN. REGS. § 81-5-21(a)(9) (2014).

⁹⁶ MICH. COMP. LAWS ANN. § 451.2202a(1)(g) (West 2013); WIS. STAT. ANN. § 551.202 (26)(h) (West 2013); GA. COMP. R. & REGS. 590-4-2-.08(1)(h) (2013).

which means that they must hold the securities for at least nine months unless the shares are resold within the state.⁹⁷

III. A COMPARISON OF THE FEDERAL AND STATE EXEMPTIONS

This section offers an in-depth comparison of the state and federal exemptions along several key dimensions. The analysis will focus on how the differences impact both capital formation and investor protection. Overall, the section will argue that the state exemptions offer a less expensive alternative to the federal law, and that certain features of the exemptions may help to address investor protection concerns.

A. Access to Capital: Eligible Investors and Offering Limits

From the perspective of a potential issuer, the single largest difference between the state and federal exemptions is that the former only give an issuer access to investors in its home state. That is, in order to stay within the SEC Rule 147 registration exemption, all of the buyers must be residents of that state.⁹⁸ This restriction would clearly present the largest drawback for an issuer choosing between the state and federal exemptions. Nevertheless, in more populous states, issuers would still have access to a fairly large pool of potential investors. And given the relatively small average size of crowdfunding offerings,⁹⁹ and the fact that an offering cannot exceed \$2 million in any case,

⁹⁷ 17 C.F.R. § 230.147(e) (2014).

⁹⁸ Again, Maine is the lone exception in not requiring issuers to satisfy Rule 147. *See supra* note 68.

⁹⁹ According to the SEC's proposed rules, one crowdfunding industry report found that the average successful project received less than \$10,000. However, the same report also found that sixty-eight percent of securities-based offerings exceeded \$50,000. Nonetheless, that still leaves a large fraction of securities-based offerings that solicit only a very small amount. *See* SEC Proposed Rules, *supra* note 5, at 333. *See also* Bradford *supra* note 12, at 11.

limiting the potential investor pool to the residents of a single state may not be as serious a drawback as it originally seems. The lack of an individual contribution limit for accredited investors (as well as certified investors in Wisconsin) under the state exemptions also expands the pool of available capital, despite the lower absolute number of potential investors. The absence of annual aggregate investment limits for retail investors also has the same effect, since an investor's contribution to another crowdfunding campaign would not prevent him from investing up to the limit in additional offerings.

Moreover, certain features of the state exemptions enable issuers to raise more than would be possible under the federal exemption. Most straightforwardly, the Wisconsin and Michigan statutes allow a company with audited financials to raise up to \$2 million—double what is allowed by section 4(a)(6).¹⁰⁰ Moreover, under the state exemptions, sales to “controlling persons”—officers, directors, partners, trustees, or persons owning more than 10 percent or more of the outstanding shares—do not count against the offering limit.¹⁰¹ The federal exemption contains no comparable carve-out. Therefore, an issuer would potentially be able to raise more than \$1 million under the state exemptions by obtaining investments from these sources. The Wisconsin exemption also excludes sales to accredited, certified, and institutional investors from counting against the cap.¹⁰² Again, it becomes more likely that investors can raise over \$1 million. Finally, the federal exemption prohibits portals or brokers from distributing offering proceeds to issuers, unless the capital raised is equal to or greater than the target offering amount.¹⁰³ Clearly, not all offerings will be

¹⁰⁰ Indiana and Idaho also allow up to a \$2 million raise. *See supra* note 73.

¹⁰¹ However, some of the newer exemptions do not contain this carve-out. *See supra* note 74.

¹⁰² Indiana's new exemption also excludes accredited investors. *See supra* note 77.

¹⁰³ 15 U.S.C. § 77d-1(a)(7) (2012). As Bradford points out, there are some sensible reasons for this all-or-nothing approach. First, it allows

sufficiently subscribed to meet their targets, meaning that some money will be left on the table. The state exemptions in Kansas and Georgia contain no such all-or-nothing condition and thus offer better access to capital in this respect.¹⁰⁴

Despite these advantages, one significant drawback of the structure of the state-law offering limits is that they are impacted by prior sales of securities within the preceding year. The language in the Georgia exemption is representative:

The sum of all cash and other consideration to be received for all sales of the security in reliance upon this exemption shall not exceed \$1,000,000, less the aggregate amount received for *all* sales of securities by the issuer within the 12 months *before the first offer or sale made in reliance upon this exemption*.¹⁰⁵

The federal exemption contains similar language, requiring that

the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the

individual investors to harness the wisdom of the crowd because one cannot invest unless many other investors are also persuaded that the investment is a good one. Bradford, *supra* note 12, at 140 (“Unless the entrepreneur can convince other, more rational, investors to participate, the foolhardy are not at risk.”). Second, the all-or-nothing approach forces entrepreneurs to be realistic in their offerings. *Id.* (“Since overreaching could cause the offering to fail, the entrepreneur has an incentive to request only the true minimum amount needed to fund the project.”).

¹⁰⁴ *But see* the Michigan and Wisconsin statutes, which each contain nearly identical language requiring that the issuer maintain an escrow account into which investor funds are deposited and held until the target offering amount is met or exceeded. MICH. COMP. LAWS ANN. § 451.2202a(1)(e)(3) (West 2013); WIS. STAT. ANN. § 551.202(26)(f)(3). Most of the newer exemptions also contain all-or-nothing conditions. They are not universal, however; Colorado and Maryland do not include such a condition. *See* Anthony J. Zeoli & Georgia P. Quinn, *Summary of ENACTED Intrastate Crowdfunding Exemptions*, CROWDCHECK BLOG (July 14, 2014), <http://perma.cc/GQ3J-8BJR>.

¹⁰⁵ GA. COMP. R. & REGS. 590-4-2-.08(1)(c) (2013) (emphasis added).

12-month period preceding the date of such transaction, is not more than \$1,000,000.¹⁰⁶

The federal statute is ambiguous as to whether all sales of securities, or only those that rely on the crowdfunding exemption, count towards the \$1 million limit.¹⁰⁷ To resolve this confusion and to further “the goal of alleviating the funding gap faced by startups and small businesses,” the SEC has proposed that only capital raised in reliance on the crowdfunding exemption should be counted against the offering limit.¹⁰⁸ But the state exemptions are unambiguous—they require an issuer to subtract *all* sales of securities made *before* the first offer or sale made in reliance on the crowdfunding exemption. Thus, it is impossible that the deducted sales could include, much less be limited to, other sales made in reliance on the crowdfunding exemption. Plainly, the exemptions require that all prior sales be aggregated.¹⁰⁹ This requirement could significantly limit the usefulness of the exemption to an issuer who has already raised capital using other methods.

In sum, although the state exemptions grant access to a much smaller pool of potential investors than their federal counterpart, they compensate in part by allowing issuers to potentially raise more money than they could under federal law. Thus, because crowdfunding offerings are generally

¹⁰⁶ 15 U.S.C. § 77d(a)(6)(A) (2012).

¹⁰⁷ See Parsont, *supra* note 22, at 301 (discussing the ambiguity in the federal exemption).

¹⁰⁸ SEC Proposed Rules, *supra* note 5, at 17. See also *id.* at 473–74 (revising the rule to read: “[t]he aggregate amount of securities sold to all investors by the issuer in reliance on § 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)(6)) during the 12-month period preceding the date of such transaction, including the securities sold to such investor in such transaction, shall not exceed \$1,000,000”).

¹⁰⁹ A handful of the new exemptions—Washington, Idaho, and Maryland—have managed to avoid this problem by adopting similar language to that proposed by the SEC. For example, Washington’s exemption requires that “[t]he aggregate purchase price of all securities sold by an issuer pursuant to the exemption provided by this section does not exceed one million dollars during any twelve-month period.” WASH. REV. CODE § 21.20.880(1)(f) (2014).

small and subject to relatively low offering limits, it seems that the state exemptions could offer access to an adequately large capital market for many issuers. Nevertheless, the aggregation requirement is a distinct disadvantage for the state exemptions, assuming that the SEC's proposed aggregation rule is kept.

From an investor protection standpoint, there may seem to be little difference between the state and federal exemptions when comparing the offering caps. Since the exemptions (excluding the carve-out for companies with audited financials in Wisconsin and Michigan) all set the same offering limit, investors risk the same amount. However, some features of the state offering limits may have an upside in terms of investor protection. The fact that sales to controlling persons do not count against the offering cap encourages entrepreneurs who use the state exemptions to seek out significant investments from within their existing management. Doing so gives management "skin in the game" and aligns their incentives with those of investors. This would help check insiders' opportunistic behavior by essentially enlisting their self-interest in service of investor protection.

The carve-out for controlling persons, which includes anyone owning more than 10 percent of outstanding shares, also encourages entrepreneurs to seek out large investors who own significant stakes in their businesses.¹¹⁰ Such investors would have a large incentive, which smaller crowdfunding investors presumably lack, to perform due diligence on offerings and to monitor the issuer after the sale, thereby providing a further check against fraud and opportunistic behavior.¹¹¹ Smaller investors would then

¹¹⁰ The same point can be made with respect to the fact that the Indiana and Wisconsin statutes do not count contributions from accredited and institutional investors towards the offering cap. IND. CODE ANN. § 23-19-2-2(27)(C) (West 2014); WIS. STAT. ANN. §§ 551.202(26)(c)(1), 551.202(27)(c)(1) (West 2013).

¹¹¹ See Parsont, *supra* note 22, at 320, 323–30, 335 (arguing that regulators can enhance investor protection in the accredited crowdfunding context by encouraging the participation of large investors).

benefit from this monitoring at no cost to themselves. And they would also benefit from large investors' up-front diligence and pricing work. Many issuers will presumably want to attract such investors in order to secure their financing quickly and to reduce their transaction costs in terms of required disclosure and investor eligibility verification. Thus, these issuers will have an incentive to negotiate with such investors and adjust their offering price to an attractive level. Smaller investors would then benefit by receiving more accurately priced securities, again without doing any work themselves. Finally, if the securities are sold over a portal that provides communication channels for potential investors to discuss offers, smaller investors could benefit from larger investors' diligence work in that way as well; that is, by relying on the opinions of more sophisticated and motivated investors to help screen opportunities.¹¹²

B. Individual Limits

The individual investment limits also present several significant differences between the state and federal exemptions. For one, the state exemptions allow much larger contributions from less wealthy investors. Under the section 4(a)(6) formula, an investor with a net worth of \$99,999 and an annual income of \$50,000 would be permitted to invest a maximum of \$4,999.95 (5 percent of her net worth) per year in crowdfunded securities.¹¹³ Under the state regimes, *any* investor, including investors worth much less, could contribute more than that—\$5,000 in Kansas, and \$10,000 in Georgia, Wisconsin, and Michigan. Moreover, that investment would not limit the investor's eligibility to contribute to subsequent offerings. Wealthier investors are also provided more latitude. Accredited investors, as well as

¹¹² See SEC Proposed Rules, *supra* note 5, at 354–55 (arguing that more experienced and knowledgeable investors “could add value to the discussions taking place through an intermediary’s communication channels about a potential offering by providing their views on financial viability”).

¹¹³ 15 U.S.C. § 77d(a)(6)(B)(i) (2012).

certified investors in Wisconsin, are not subject to an individual limit under the state exemptions, while the federal law caps even the wealthiest at \$100,000. Thus, the state exemptions appear to do more to encourage capital formation at both ends of the wealth spectrum. Moreover, both the higher limits for less wealthy investors and the absence of a cap on accredited investors could also help to reduce transaction costs for issuers and their intermediaries (should they use them), since the offering targets could be met through fewer discrete transactions, meaning less time and money spent on disclosures and investor eligibility verification.

Despite these advantages of the state exemptions, there is a large middle ground of investors who are not accredited but who exceed the \$100,000 federal threshold. For them, the federal exemption would allow for larger investments in an offering than its state-law counterparts. For example, an investor making \$100,000 a year with a net worth of \$500,000 (including primary residence) would be able to invest up to \$50,000 in an offering under the federal rule, while being capped at \$5,000 in Kansas and \$10,000 in Georgia, Michigan, and Wisconsin—and this calculation accounts for the more permissive “certified investor” category. Thus, neither the federal nor the state approaches to individual limits seems to have a decisive advantage in terms of capital formation, although the state exemptions may have a slight edge since they allow unlimited contributions from the wealthy and do not impose annual aggregate limits on retail investors.

With respect to investor protection, the state limits, on their face, seem poorly equipped to prevent catastrophic losses. In *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, Professor C. Steven Bradford criticizes even the less permissive federal cap as “excessive,” writing that \$2,000 is “more than some people can afford to lose” and that “it is doubtful that most people, especially those in the lower income categories, have sufficient free cash flow or savings to afford to lose five or ten percent of their net

income.”¹¹⁴ Obviously, the same objection could be leveled at the more generous state limits, especially because the state exemptions place no cap on the aggregate amount a retail investor may invest in crowdfunded securities.

In response, it could be argued that given that issuers using the state exemptions have access to a smaller number of potential investors, it is appropriate that they should be able to accept more capital from each individual in order to encourage adequate capital formation. Proponents might also contend that, because the effects of the state exemptions are only felt within the state in question, a higher level of risk is tolerable, and perhaps, even beneficial.¹¹⁵ After all, if higher investment limits prove beneficial at the state level, it might suggest that the federal limits could be raised as well. Of course, this rationale would be cold comfort to an investor who has suffered a crippling loss made possible by an imprudently high limit.

Finally, much as was argued above,¹¹⁶ the absence of investment limits for accredited investors in the state exemptions encourages the participation of investors with large stakes in the issuer’s business. Issuers seem to have an incentive to seek out such investors, as it would allow them to meet their financing targets more quickly, and with potentially lower transaction costs. Again, large investors would have an incentive to do up-front diligence and pricing work on offerings, and to monitor issuers after the sale, providing downstream benefits to smaller investors.¹¹⁷

¹¹⁴ Bradford, *supra* note 46, at 218.

¹¹⁵ This is Brandeis’ famous point that an individual state may “serve as a laboratory[,] and try novel social and economic experiments without risk to the rest of the country.” *New State Ice Co. v. Liebman*, 285 U.S. 262, 311 (1932); *see also* *Gregory v. Ashcroft*, 501 U.S. 452, 458 (1991) (observing that one of the merits of federalism is that it “allows for more innovation and experimentation in government”).

¹¹⁶ *See supra* Part III.A.

¹¹⁷ Parsont makes this same point with respect to “accredited crowdfunding”: “[A]ccredited crowdfunding has no annual investment limits. So some deals could have investors with significant skin in the game. Such large stakes could help overcome the collective action problem and thus prevent the lemons problem by incentivizing some investors to do

Ironically, by limiting the participation of large investors with the aim of promoting investor protection, the federal exemption may deny these safeguards to small investors. The SEC Proposed Rules appear to acknowledge this: “Limiting the participation of [more experienced and knowledgeable] investors would be likely to negatively affect the informational efficiency of the securities-based crowdfunding market, because sophisticated investors are better able to accurately price such offerings.”¹¹⁸

C. Disclosure Requirements

A third area of significant divergence between the state and federal crowdfunding laws is the disclosure requirements placed on issuers and intermediaries. As detailed above, issuers under the federal rules are subject to complex financial disclosure requirements that require issuers to spend significantly on legal fees, and potentially on outside accountants and auditors.¹¹⁹ The SEC’s proposed rules estimate that an issuer seeking to raise \$1 million could incur as much as \$150,000 in costs, while a \$100,000 offering could cost the issuer as much as \$18,560.¹²⁰ Issuers are also required to engage in annual post-offering disclosures, which may also require hiring outside accountants and auditors.¹²¹

While no comparable estimates exist for the state exemptions, it seems clear that they would provide a significantly less expensive source of capital. Kansas and Georgia require only that issuers file minimal disclosures—the relevant forms are only one and three pages in length, respectively, and could be completed without the

the necessary due diligence, pricing, and other work on behalf of the rest of the crowd.” Parsont, *supra* note 22, at 320. For a description of accredited crowdfunding, see *infra* note 153 and accompanying text.

¹¹⁸ SEC Proposed Rules, *supra* note 5, at 354.

¹¹⁹ Bradford, *supra* note 46, at 217 (“[C]omplicated filing and disclosure requirements invariably demand lawyers and accountants, increasing the expense of using the exemption.”).

¹²⁰ See SEC Proposed Rules, *supra* note 5, at 358–59.

¹²¹ See *id.* at 95.

assistance of an attorney or accountant. Wisconsin and Michigan require more disclosure to both investors and regulators, but do not require accountant reviewed or audited financials. Such statements are, according to the SEC's estimates, the second largest expense for an issuer complying with the federal law; the proposed rules estimate the cost for audited financial statements to be \$28,700 for a raise of \$500,000 or more.¹²²

Therefore, the federal exemption seems to be much more expensive to use than the state exemptions, which could chill capital formation. It is also not clear whether the disclosure rules included in the federal exemption will enhance investor protection. Given the small purchases that many crowdfunding investors make, they lack a strong incentive, and likely the sophistication, to wade through the complex disclosures required by the federal law. As Jason W. Parsont states in a forthcoming article: "Annual investment limits, in particular, will discourage retail investors from using disclosed information to make informed investment decisions. Why take the time to read disclosure and kick the tires when doing so would be more costly than the payment to invest?"¹²³ Thus, the state exemptions appear to be much less expensive in terms of mandatory disclosure, while there may be less downside in terms of investor protection than one would predict.

D. Other Elements: Intermediaries, Advertising, and Resale Restrictions

Unlike the federal law, the state exemptions in Kansas, Georgia, and Michigan do not require the use of a crowdfunding intermediary, whereas Wisconsin's section 26 exemption does (but not section 27). The SEC's proposed rules estimate that the fees paid to an intermediary would be the single greatest expense for an issuer using the federal exemption.¹²⁴ Thus, as with the disclosure requirements, the

¹²² See *id.* at 358–59.

¹²³ Parsont, *supra* note 22, at 318.

¹²⁴ See SEC Proposed Rules, *supra* note 5, at 358–59.

state exemptions also impose lower costs on issuers in this respect. The state exemptions, with the exception of Wisconsin section 27, also do not restrict advertising, while the federal exemption limits issuers to notices about the amount, nature, and price of the offered securities. Finally, the state and federal exemptions all impose resale restrictions, with most of the state exemptions (with the exception of Kansas) allowing for immediate resale within the state and unconditional resale after nine months (three months sooner than the federal law). Thus, with respect to each of these elements, the state exemptions appear to be less costly and restrictive (or at least not more so) than their federal counterpart.

E. Summary

In sum, although the state exemptions suffer from a clear disadvantage in terms of access to eligible investors, they nevertheless provide a lower-cost option for issuers than their federal counterpart. The types of small entrepreneurs who are likely to take advantage of crowdfunding probably lack the legal and financial sophistication to navigate the federal disclosure requirements on their own, which would force them to spend scarce funds on attorneys and possibly on accountants and auditors as well. Thus, the state-law exemptions may provide a valuable alternative for raising capital for some small issuers despite the availability of the federal option.

However, the less stringent state requirements raise legitimate concerns about investor protection. Investors are allowed to risk more of their money with issuers who are less scrutinized and who are required to disclose less. It has been argued that some aspects of the state exemptions encourage the participation of large investors, whose diligence, pricing, and monitoring work may also benefit small investors. Thus, the state exemptions may achieve a measure of investor protection without placing additional regulatory burdens on issuers. Nonetheless, the next section suggests some adjustments to the state exemptions designed to enhance investor protection.

IV. RECOMMENDATIONS

It is not clear that the state and federal crowdfunding exemptions need to be or should be uniform. For one, there may be some benefits to diversity: as Justice Brandeis famously argued, it is one of the “happy accidents of the federal system” that an individual state may serve as a “laboratory” in which to conduct a low-risk test run of a policy.¹²⁵ Heterogeneity in the state exemptions could lead to improvements on both the state and federal levels. Moreover, it does not seem that uniformity in the state exemptions would increase efficiency. To meet the requirements of Rule 147, an issuer must be a resident of *and* doing business in the state in question.¹²⁶ In keeping with the “genuinely local” nature of Rule 147 offerings, this second condition requires the issuer to maintain eighty percent of its assets and operations, as well as its principal office, in the state in question.¹²⁷ Thus, it would be impossible for an issuer to make Rule 147 offerings in multiple states, and in turn to take advantage of multiple intrastate crowdfunding exemptions. As a result, an issuer would not benefit from decreased transaction costs created by uniformity across state borders.

Nonetheless, this section recommends convergence between the state and federal exemptions at four points. The first three recommendations urge the states to adopt certain features of the federal exemption: first by eliminating aggregation requirements for issuers, second by mandating that issuers use a registered portal, and third by placing an annual investment limit on retail investors. The fourth recommendation argues in the reverse direction, contending that the federal exemption should mirror certain state exemptions in its treatment of accredited investors.

¹²⁵ See source cited *supra* note 115.

¹²⁶ 17 C.F.R. § 230.147(c) (2014).

¹²⁷ 17 C.F.R. § 230.147(c)(2) (2014).

Some of the recently enacted exemptions, particularly Washington's, contain provisions that are in line with these recommendations.¹²⁸ However, they remain a small minority.

A. The States Should Remove Aggregation Requirements for Issuers

As discussed above, access to capital is perhaps the largest barrier to the viability of the state exemptions. Because they only offer access to investors in the issuer's home state, it would be natural, all else being equal, for an issuer to prefer the federal exemption. Counting all of the securities sold by the issuer in the past twelve months towards the offering limit adds a second disadvantage to the state exemptions *vis-à-vis* the federal one.¹²⁹ If an issuer chooses to use a state exemption, then it is effectively limited to raising only \$1 or \$2 million from *all* sales of securities that year—making the exemption useful to only a limited group. Of course, an offering limit for *crowdfunded* securities makes sense since such securities involve risky enterprises that are generally advertised to retail investors. But if the issuer has engaged in prior fundraising in reliance on other exemptions, then those offerings would carry their own protections. For example, suppose a prospective issuer has already sold \$500,000 in securities under Rule 506(c), meaning all of the sales would have had to be to accredited investors, who are presumably better able to understand and bear the risks involved.¹³⁰ The rationale for limiting crowdfunding offerings does not apply to these 506(c) sales. Thus, there does not seem to be much reason to then limit sales to the crowd to only \$500,000 because of those prior sales—the risk has already been contained by the limits imposed on the earlier sale. To encourage capital formation, the state exemptions should, like the proposed federal rule, only aggregate other offerings made in reliance on the

¹²⁸ See WASH. REV. CODE ANN. § 21.20.0001 (West 2014).

¹²⁹ See *supra* note 105 and accompanying text (discussing the aggregation problem).

¹³⁰ 17 C.F.R. § 230.506 (2014).

crowdfunding exemption itself. Washington's recently enacted exemption contains language that does just this, requiring that "The aggregate purchase price of all securities sold by an issuer pursuant to the exemption provided by this section does not exceed one million dollars during any twelve-month period."¹³¹ Here it is clear that only prior crowdfunding sales count against the offering cap. Other states should follow this model.

B. The State Exemptions Should Require Issuers to Use an Intermediary

Currently, only the Wisconsin and Indiana exemptions require issuers to use an Internet intermediary.¹³² However, as Bradford argues in *Crowdfunding and the Federal Securities Laws*, there are several reasons why portals are the appropriate "locus" of regulation.¹³³ First, the issuers likely to use crowdfunding are probably "poorly capitalized and legally unsophisticated," and consequently may be deterred from using the exemptions if they are left to navigate complicated regulations on their own.¹³⁴ Crowdfunding sites, however, are "repeat players."¹³⁵ They have adequate skin in the game, in terms of both money and reputation, and they "can spread any regulatory costs over a large number of offerings."¹³⁶ As a result, they are less likely to be deterred by regulations. Moreover, portals "are more visible . . . for regulatory enforcement purposes": they can ensure that issuers stay within offering limits and provide mandatory disclosures, and that investors stay under individual investment caps.¹³⁷ Regulators can then look to

¹³¹ WASH. REV. CODE ANN. § (1)(f) (West 2014).

¹³² IND. CODE ANN. § 23-19-2-2(27)(O) (West 2014); WIS. STAT. ANN. § 551.202(26)(e) (West 2013).

¹³³ See Bradford, *supra* note 12, at 117–18.

¹³⁴ *Id.* at 117.

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.*

the portals to ensure compliance as opposed to trying to monitor the offline activities of many scattered issuers.

Thus, the use of an intermediary has benefits in terms of both lightening the regulatory burdens placed on issuers as well as ensuring regulatory compliance, which should in turn strengthen investor protection. But these benefits can only be realized if all issuers are required to use an intermediary. Suppose that a state shifted some requirements (such as acquiring an investor's certification that he understands the risks involved) to crowdfunding sites without also requiring that issuers use an intermediary. This would incentivize issuers to avoid both regulatory costs and the issuer's fee by making the offering offline.

Of course, requiring the use of an intermediary will likely add to an issuer's costs and could deter capital formation. Again, payments to an intermediary are an issuer's single largest expense according to the SEC's projections.¹³⁸ Nonetheless, although mandating the use of an intermediary would add some costs, they could be partially offset by gains in efficiency. For example, portals could help ensure Rule 147 compliance by verifying that all offers and sales are made only to state residents.¹³⁹ The Wisconsin and Michigan exemptions, as well as several of the newer laws, require

¹³⁸ See SEC Proposed Rules, *supra* note 5, at 358–59.

¹³⁹ A recent SEC Compliance and Disclosure Interpretation has clarified what steps a portal must take to comply with Rule 147. According to the Commission, a portal must take “adequate measures” to avoid offering the securities to investors outside the state in question. 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 . . .” SEC Compliance and Disclosure Interpretation, Question 141.04 (Apr. 10, 2014), *available at* <http://perma.cc/Q787-T4LC>. Although this interpretation places burdens on portals that will likely increase costs for portals and their customers, an issuer that did not use a portal would also have to avoid making offers and sales outside of their home state. As another recent Compliance and Disclosure Interpretation makes clear, this may be very difficult to do using an issuer's existing website or social media presence. *See supra* note 94.

issuers to collect evidence—such as state-issued ID, voter registration, or an affidavit indicating property ownership in the state—that the purchasers are state residents.¹⁴⁰ Although the Kansas and Georgia exemptions do not affirmatively require issuers to take steps to verify investor eligibility, they both require offerings to meet the requirements of Rule 147, so an issuer who wants to avoid blowing the exemption will have to do this verification work. These are costs that issuers will be forced to incur no matter what: if intermediaries pass some of the costs on to the issuer, that would not represent a net increase. Moreover, intermediaries seem better positioned to verify investor eligibility than issuers by taking advantage of economies of scale. An intermediary could verify that a given investor is a state resident once (or once per some reasonable interval) and then rely on that verification for subsequent purchases, thereby avoiding duplicative work on the part of issuers. It could also set up a way for purchasers to provide proof of residence through their website. There would be some up-front costs associated with creating such a system, but those costs would be spread out over many offerings. Such a system would almost certainly represent a savings over one in which each individual issuer creates its own verification procedure from scratch. The issuer and portal could then split these savings to their mutual advantage.

This same argument can be made with respect to the verification of an investor's accredited status.¹⁴¹ As suggested in the SEC proposal, an intermediary could set up a function on its platform through which a user could enter his income and net worth or provide documentation as required.¹⁴² Again, the intermediary could spread the costs of creating the verification system over all its offerings, meaning the

¹⁴⁰ WIS. STAT. ANN. § 551.202(26)(j) (West 2013); MICH. COMP. LAWS ANN. § 451.2202a(1)(i)(ii) (West 2013).

¹⁴¹ Again, Wisconsin and Michigan affirmatively place these verification burdens on the issuer while Kansas and Georgia are silent. See MICH. COMP. LAWS ANN. § 451.2202a(1)(i)(ii) (West 2013); WIS. STAT. ANN. § 551.202(26)(j) (West 2013).

¹⁴² See SEC Proposed Rules at 169–70 *supra* note 5.

cost per offering would almost certainly be less than what an individual issuer could achieve. And the same argument could be made for the Wisconsin and Michigan requirements that issuers acquire written or electronic certification that an investor understands the risky and speculative nature of her investment, and that she can afford a total loss. In each case, requiring that the offerings take place over a registered portal shifts compliance responsibilities from issuers to the portals, removing barriers that could deter issuers from using the exemptions. It has been suggested that intermediaries could also perform these functions more efficiently by taking advantage of economies of scale which, in theory, would allow them to operate profitably while still saving money for issuers. Finally, the use of an intermediary would likely enhance compliance and thereby investor protection, a welcome result for the more permissive state exemptions.

C. The State Exemptions Should Include an Annual Aggregate Investment Limit for Retail Investors

Given the inherent risks associated with investing in start-ups,¹⁴³ many investors' lack of sophistication, and the less regulated nature of crowdfunded securities, annual aggregate investment limits for retail investors seem "sensible."¹⁴⁴ The fact that the state exemptions limit how much an individual retail investor can invest in a particular crowdfunding offering demonstrates that the states are concerned about containing these risks. But the absence of an aggregate limit on individual investment strips the state caps of much of their protective power; there is no real limit

¹⁴³ See *supra* note 36 and accompanying text.

¹⁴⁴ Bradford, *supra* note 12, at 112. See also SEC Proposed Rules, *supra* note 5, at 354 ("Offerings made in reliance on Section 4(a)(6) would not be subject to review by Commission staff prior to the sale of securities, but the aggregate investment limits would provide some measure of protection for investors.").

on how much one can risk.¹⁴⁵ Of course, retail investors intent on investing heavily in crowdfunded securities would have to spread their money out over several offerings (i.e., by investing \$5,000 or \$10,000 at a time). They would be forced to diversify to some extent, and the costs associated with identifying and investigating each offering may deter some from embarking on such a strategy. Nonetheless, the potential downside for such an individual would be limited only by the amount she had to invest. Thus, in order to provide a substantive measure of investor protection, the state exemptions should, like the federal exemption, adopt an annual aggregate limit on the amount retail investors can invest in crowdfunding offerings. To do this, the states could also adopt a sliding scale based on income and net worth, which would actually increase the amount an issuer could accept from many retail investors.¹⁴⁶ As under the federal exemption, portals could be charged with enforcing the limits and permitted to rely in good faith upon investors' disclosure of their previous crowdfunding purchases to determine the amount an investor is eligible to invest.¹⁴⁷

The recent Washington legislation is the first state crowdfunding exemption to include language creating an aggregate limit. It requires that “[t]he aggregate amount sold to any investor by *one or more issuers* during the twelve-month period preceding the date of the sale does not exceed” the investment limits.¹⁴⁸ As a result, the exemption does not simply limit the amount of money a single issuer can accept from an investor, but rather the amount that all issuers can accept in a given year, creating an annual aggregate limit on the amount any given investor can purchase.

¹⁴⁵ See, e.g., MICH. COMP. LAWS ANN. § 451.2202a(1)(d) (West 2013); see also *supra* note 80 and accompanying text (discussing this feature of the state exemptions).

¹⁴⁶ See *supra* Part III.B (explaining that because of the sliding scale, the federal exemption is actually more permissive with respect to non-accredited investors who earn or are worth more than \$100,000).

¹⁴⁷ See SEC Proposed Rules, *supra* note 5, at 169–70.

¹⁴⁸ WASH. REV. CODE ANN. § 21.20.0001(1)(g) (West 2014) (emphasis added).

D. The Federal Exemption Should Encourage the Participation of Large Investors by Removing Investment Limits for Accredited Investors

This Note previously argued that certain features of the state exemptions may enhance investor protection by encouraging the involvement of large investors.¹⁴⁹ The fact that sales to large shareholders do not count towards the offering caps, as well as the absence of individual investment limits for accredited and certified investors, permits wealthy investors to take large stakes in crowdfunded businesses. Again, such investors would have sufficient incentive to engage in diligence, pricing, and monitoring work that would redound to the benefit of smaller investors. Moreover, this extra protection to retail investors comes at no additional cost in terms of heightened regulatory burdens, while at the same time expanding the pool of available capital.

The federal section 4(a)(6) exemption should follow the state exemptions by adopting a similar carve-out for accredited investors. Doing so would encourage their participation in crowdfunding offerings and it would not substantially increase their risk. Crowdfunding issuers are already able to raise unlimited amounts from accredited investors using the new Rule 506(c) exemption in Regulation D.¹⁵⁰ Rule 506(c), which was created by section 201(a) of the JOBS Act,¹⁵¹ allows issuers to raise capital subject to no offering caps, individual investment limits, or advertising restrictions, provided that all investors are accredited. Section 201(c) of the JOBS Act also permits issuers to make Rule 506(c) offerings over crowdfunding sites, again with no limitations on general solicitation, and without exposing the site to broker-dealing regulation.¹⁵² Together, these provisions in the JOBS Act create the possibility of “accredited crowdfunding,” with considerably relaxed

¹⁴⁹ See *supra* Part III.A–B.

¹⁵⁰ 17 C.F.R. § 230.506 (2014).

¹⁵¹ Jumpstart Our Business Startups Act, JOBS Act, Pub. L. No. 112-106, §201(a) 126 Stat. 306 (2012) (codified at 15 U.S.C. 77d (2012)).

¹⁵² *Id.* at § 201(c)(codified as amended at 15 U.S.C. § 77d(b) (2012)).

restraints.¹⁵³ Notably, issuers who choose this route are not subject to mandatory disclosure or intermediary requirements.

As several commentators have pointed out, the most significant change ushered in by the JOBS Act may in fact be these alterations to Regulation D.¹⁵⁴ Some have argued that in response to the significantly lower burdens imposed on 506(c) offerings, issuers will prefer to use the lower-cost accredited crowdfunding model, while retail crowdfunding offerings made in reliance on section 4(a)(6) may be made predominantly by issuers unable to attract backing from accredited investors.¹⁵⁵ Such a situation could cause retail crowdfunding to deteriorate into a “market for lemons,”¹⁵⁶ chilling investment and cutting retail investors out of the best opportunities. The existence of the more permissive state crowdfunding exemptions only seems to increase the likelihood that issuers will engage in regulatory arbitrage.

To help prevent such a result, the federal exemption should adopt the treatment of accredited investors found in

¹⁵³ See Parsont, *supra* note 22, at 284 n.12 (defining “accredited crowdfunding” as “Rule 506(c) offerings that are sold through crowdfunding websites with the aid of § 201(c) of the JOBS Act”).

¹⁵⁴ See, e.g., Bradford, *supra* note 46, at 222.

¹⁵⁵ See Parsont, *supra* note 22, at 317 (concluding after an extensive comparison of accredited and retail crowdfunding that “accredited crowdfunding will generally be the logical choice for issuers seeking to crowdfund”); *The JOBS Act in Action: Overseeing Effective Implementation That Can Grow American Jobs Before the Subcomm. on TARP, Fin. Servs., and Bailouts of Pub. & Private Companies of the H. Comm. on Oversight and Gov’t Reform*, 112th Cong. 44 (2012) (statement of John C. Coffee, Jr., Professor of Law, Columbia University Law School) (“In my judgment, new Section 4(6) of the Securities Act of 1933 will be much less used than Title II’s liberalized private placement exemption”); SEC Proposed Rules, *supra* note 5, at 342 (“[I]t is possible that professional investors would prefer, instead, to invest in a Rule 506 offering, which is not subject to the investment limitations applicable to offerings made in reliance on Section 4(a)(6).”).

¹⁵⁶ Parsont, *supra* note 22, at 318.

the state exemptions.¹⁵⁷ That is, there should be no individual investment limits on accredited investors. And as in the Wisconsin and Indiana exemptions, contributions from accredited investors should not count towards the \$1 million offering cap.¹⁵⁸ There seems to be little reason, in terms of investor protection, to limit accredited investor contributions. Crowdfunding issuers are already permitted to raise unlimited funds from these investors through 505(c) offerings, and the lack of mandatory disclosures for such offerings underscores lawmakers' apparent confidence that wealthy investors are capable of fending for themselves. Placing investment limits on accredited investors in the retail crowdfunding context seems neither consistent nor substantively protective.

Of course, the participation of retail investors in the offering does present a reason to adopt stronger protections with respect to *those* investors. But their presence does not seem to make the offering riskier for accredited investors. If anything, accredited investors would benefit from free access to mandatory disclosures that they would have previously had to obtain on their own, as well as from the screening efforts of funding portals. Thus, investing alongside retail investors may actually be a safer option for accredited investors. Also, as the SEC has acknowledged,¹⁵⁹ the presence of more experienced and knowledgeable investors can provide benefits to retail investors in the form of more accurately priced securities. Therefore, allowing accredited investors to make unlimited contributions to section 4(a)(6) offerings, while not counting those contributions against the offering cap, could potentially benefit all parties involved. Issuers would retain access to the full crowd while enjoying a larger pool of available capital. Retail investors would be able to piggyback off of the diligence, pricing, and monitoring

¹⁵⁷ Again, Washington's is the only state exemption that limits accredited investor contributions. See WASH. REV. CODE ANN. § 21.20.0001(1)(g) (West 2014).

¹⁵⁸ See IND. CODE ANN. § 23-19-2-2(27)(c) (West 2014); WIS. STAT. ANN. §§ 551.202(26)(c)(1), 551.202(27)(c)(1) (West 2013).

¹⁵⁹ See SEC Proposed Rules, *supra* note 5, at 354.

work of more seasoned investors. Finally, accredited investors would benefit from mandatory disclosures and the efforts of crowdfunding sites to screen out untrustworthy issuers.

V. CONCLUSION

The federal crowdfunding exemption has received a large amount of attention from the press, business community, and legal scholars. The state exemptions, although they are gaining momentum in terms of popularity, have received relatively scant attention from both commentators and investors. This Note engages in the first sustained comparison of the state and federal exemptions, and thus attempts to address the first of these deficits. By implementing the first three recommendations made in Part IV, it has been argued, states may begin to address the second deficit as well. Finally, this Note has argued that interstate crowdfunding may be able to avoid the underutilization that has so far befallen the state exemptions by removing individual investment limits for accredited investors.

APPENDIX

TABLE 1: COMPARISON OF FEDERAL, KANSAS, GEORGIA, WISCONSIN, AND MICHIGAN EXEMPTIONS¹⁶⁰

JOBS Act Securities Act of 1933 § 4(a)(6) (codified in 15 U.S.C.)	Invest Kansas Exemption KAN. ADMIN. REGS. § 81-5-21	Invest Georgia Exemption GA. COMP. R. & REGS. § 590-4- 2-.08	CASE for Jobs Act WIS. STAT. ANN. § 551.202(26)	Michigan Invests Locally Exemption MICH. COMP. LAWS ANN. § 451.2202a
Issuer Eligibility				
§ 77d-1(f): The issuer must be organized under the law of a U.S. state. Issuer may not be a reporting company or investment company.	(a)(1): The issuer must be a business or organization formed under the laws of KS and registered with the secretary of state.	(1)(a): The issuer must be a for-profit business entity formed under the laws of GA and registered with the secretary of state.	(26)(a): The issuer of the security is a business entity organized under the laws of WI and authorized to do business in the state.	(1)(a): The issuer of the security is an entity that is incorporated or organized under the laws of this MI and is authorized to do business in the state.
N/A	(a)(2): The transaction shall meet the requirements of the federal exemption for intrastate offerings.	(1)(b): The transaction shall meet the requirements of the federal exemption for intrastate offerings.	(26)(b): The transaction meets the requirements of the federal exemption for intrastate offerings.	(1)(b): The transaction meets the requirements for the federal exemption for intrastate offerings.

¹⁶⁰ Although the formats and content vary, the table here is indebted to the very useful table provided by Carolyn Meade in her article. See Carolyn P. Meade, *States Pilot Crowdfunding Initiatives to Increase Funding for Small Business*, BLOOMBERG LAW, (Sep. 10, 2014), <http://perma.cc/GY4Q-B69M>. For a very detailed chart comparing all of the state crowdfunding exemptions enacted as of July, 2014, see Anthony J. Zeoli and Georgia P. Quinn, *Summary of ENACTED Intrastate Crowdfunding Exemptions* (as of July, 2014), CROWDCHECK BLOG (July 14, 2014), <http://perma.cc/GQ3J-8BJR>.

TABLE 1: COMPARISON OF FEDERAL, KANSAS, GEORGIA, WISCONSIN, AND MICHIGAN EXEMPTIONS (CONT.)

JOBS Act Securities Act of 1933 § 4(a)(6) (codified in 15 U.S.C.)	Invest Kansas Exemption KAN. ADMIN. REGS. § 81-5-21	Invest Georgia Exemption GA. COMP. R. & REGS. § 590-4- 2-.08	CASE for Jobs Act WIS. STAT. ANN. § 551.202(26)	Michigan Invests Locally Exemption MICH. COMP. LAWS ANN. § 451.2202a
Deposit and Release of Funds				
§ 77d-1(a)(7): intermediary must ensure that all offering proceeds are only provided to the issuer when the capital raised is equal to or greater than the target offering amount.	(a)(6): All funds received from investors must be deposited in a bank or depository institution authorized to do business in KS, and all funds shall be used in accordance with representations made to investors.	(1)(e): All funds received from investors must be deposited in a bank or depository institution authorized to do business in GA, and all funds shall be used in accordance with representations made to investors.	(26)(f)3; (26)(k): all payments for purchases of securities must be held in a bank chartered in WI and held in an escrow account that is released to the issuer only when the capital raised meets of exceeds the target offering amount.	(1)(e)(iii); (1)(j): Purchaser funds will be deposited in an escrow account in a bank or other depository institution located in MI and offering proceeds will be released to the issuer only when the aggregate capital raised from all purchasers is equal to or greater than the minimum target offering amount
Offering Limit				
§77d(a)(6)(A): \$1 million	(a)(3); (b): \$1 million (<i>but</i> sales to “controlling persons,” i.e., officers, directors, partners, trustees, or persons owning 10 percent or more of the outstanding shares, do not count towards the cap).	(1)(c); (2)(a)– (b): \$1 million (<i>but</i> sales to “controlling persons,” i.e., officers, directors, partners, trustees, or persons owning 10 percent or more of the outstanding shares, do not count towards the cap).	(26)(c)(1)–(2): \$1 million if the issuer does not have audited financials; \$2 million if the issuer has audited financials. Sales to accredited, certified, or institutional investors do not count against the cap, nor do sales to controlling persons.	(1)(c)(i)–(ii); (4): \$1 million if the issuer does not have audited financials; \$2 million if the issuer has audited financials. Sales to controlling persons do not count towards the cap.

TABLE 1: COMPARISON OF FEDERAL, KANSAS, GEORGIA,
WISCONSIN, AND MICHIGAN EXEMPTIONS (CONT.)

JOBS Act Securities Act of 1933 § 4(a)(6) (codified in 15 U.S.C.)	Invest Kansas Exemption KAN. ADMIN. REGS. § 81-5-21	Invest Georgia Exemption GA. COMP. R. & REGS. § 590-4- 2-.08	CASE for Jobs Act WIS. STAT. ANN. § 551.202(26)	Michigan Invests Locally Exemption MICH. COMP. LAWS ANN. § 451.2202a
Individual Investment Limit				
77d(a)(6)(B): The greater of \$2,000 or 5 percent of the annual income or net worth of the investor, if either the annual income or the net worth of the investor is less than \$100,000. ¹ 10 percent of the annual income or net worth of the investor, if the investor's income or net worth is greater than \$100,000, not to exceed \$100,000.	(a)(4): \$1,000 unless the purchaser is an accredited investor. (n.b. limit raised to \$5,000 on June 21, 2013 by Special Order of the Securities Commissioner).	(1)(d): \$10,000, unless the purchaser is an accredited investor.	(26)(d): \$10,000 unless the purchaser is an accredited or certified investor.	(1)(d): \$10,000 unless the purchaser is an accredited investor.
Intermediary				
§ 77d (a)(6)(C): The transaction must be conducted through a broker or funding portal that complies with § 77d-1(a).	None required	None required	(26)(e): The offering must be made exclusively through one or more internet sites registered with the division. ¹	(1)(i): Use of an internet website is permitted but not required.

TABLE 1: COMPARISON OF FEDERAL, KANSAS, GEORGIA, WISCONSIN, AND MICHIGAN EXEMPTIONS (CONT.)

JOBS Act Securities Act of 1933 § 4(a)(6) (codified in 15 U.S.C.)	Invest Kansas Exemption KAN. ADMIN. REGS. § 81-5- 21	Invest Georgia Exemption GA. COMP. R. & REGS. § 590- 4-2-.08	CASE for Jobs Act WIS. STAT. ANN. § 551.202(26)	Michigan Invests Locally Exemption MICH. COMP. LAWS ANN. § 451.2202a
Notice to Investors				
<p>§ 77d-1(a)(4): The broker or portal must ensure that each investor (A) reviews investor-education information; (B) affirms that the investor understands that he/she is risking loss of the entire investment, and that he/she can bear the loss; and (C) answers questions demonstrating an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers; an understanding of the risk of illiquidity; and an understanding of such other matters as the Commission determines appropriate. § 77d-1(a)(4)</p>	<p>(a)(9): The issuer must inform purchasers that the securities are unregistered and are subject to resale restrictions.</p>	<p>(1)(h): The issuer must inform purchasers that the securities are unregistered and subject to resale restrictions.</p>	<p>(26)(h): The issuer must display a legend on the cover page of their disclosure document informing prospective purchasers that the securities are unregistered and subject to resale restrictions. (26)(i): Issuers must require each purchaser to certify that they understand and acknowledge that they are investing in a high-risk, speculative venture that may lead to the loss of their entire investment, and that they can afford this loss. Investors must also certify that they understand that the securities have not been reviewed by any regulator, are illiquid, and subject to appropriate taxes. (26)(l): The issuer must provide investors with the disclosure document given to the administrator under § (26)(f).</p>	<p>(1)(g): The issuer must display a legend on the cover page of their disclosure document informing prospective purchasers that the securities are unregistered and subject to resale restrictions. (1)(h): Issuers must require each purchaser to certify that they understand and acknowledge that they are investing in a high-risk, speculative venture that may lead to the loss of their entire investment, and that they can afford this loss. Investors must also certify that they understand that the securities have not been reviewed by any regulator, are illiquid, subject to appropriate taxes, and that they are MI residents. (1)(m): The issuer must provide investors with the disclosure document given to the administrator under § (1)(e)(ii).</p>

TABLE 1: COMPARISON OF FEDERAL, KANSAS, GEORGIA, WISCONSIN, AND MICHIGAN EXEMPTIONS (CONT.)

JOBS Act Securities Act of 1933 § 4(a)(6) (codified in 15 U.S.C.)	Invest Kansas Exemption KAN. ADMIN. REGS. § 81-5-21	Invest Georgia Exemption GA. COMP. R. & REGS. § 590-4- 2-.08	CASE for Jobs Act WIS. STAT. ANN. § 551.202(26)	Michigan Invests Locally Exemption MICH. COMP. LAWS ANN. § 451.2202a
Notice to Regulators				
<p>§ 77d-1(b)(1): The issuer must provide the SEC, the broker or funding portal, and investors with (A) their name, legal status, address, and website (B) the names of the directors and officers and each person holding more than 20 percent of shares (C) a description of their business and anticipated business plan (D) a description of financial condition of the issuer, including income tax returns and financial statements, which may have to be reviewed by an independent public accountant or audited, depending on the size of the offering. (E) a description of the purpose and intended use of the</p>	<p>(a)(7): Before the use of any general solicitation or the twenty-fifth sale of the security, whichever occurs first, the issuer shall file a notice with the administrator specifying the names and addresses of (1) the issuer, (2) all persons who will be involved in the offer or sale of securities on behalf of the issuer, and (3) the bank or other depository institution in which investor funds will be deposited.</p>	<p>(1)(f): Before the use of any general solicitation or the twenty-fifth sale of the security, whichever occurs first, the issuer shall file a notice with the Commissioner specifying the names and addresses of (1) the issuer, (2) all persons who will be involved in the offer or sale of securities on behalf of the issuer, and (3) the bank or other depository institution in which investor funds will be deposited.</p>	<p>(26)(f): Not less than 10 days prior to the offering of securities in reliance on the exemption, the issuer must file with the administrator a notice of claim of exemption from registration and (a) A description of the company and its type of entity, address, history, business plan and intended use of the proceeds including payments to management (b) The identity of all persons owning more than 10 percent of any class of securities of the company (c) The identities of officers, directors, and managers, including titles and prior experience (d) The terms and conditions of the securities being offered (e) The identity of any person</p>	<p>(1)(e): At least 10 days before an offer of securities is made in reliance on the exemption, the issuer must file with the administrator a notice of claim of exemption from registration and (A) A description of the issuer, including its type of entity, address, history, business plan and intended use of the proceeds including payments to management (B) The identity of each person that owns more than 10 percent of any class of securities of the issuer (C) The identities of officers, directors, and managers, including titles and prior experience (D) The terms and conditions of the securities being offered (E) The</p>

<p>proceeds (F) the target offering amount, the deadline to meet the target, and updates on the progress of the issuer in meeting the target (G) the price for the securities and the method for determining the price (H) a description of the ownership and capital structure of the issuer</p>			<p>who has been or will be retained by the issuer to assist in the offering and sale of the securities (f) For each person identified under (e), a description of their consideration (g) A description of any litigation, legal proceedings, or pending regulatory action involving the company (h) The name and address of the intermediary (i) A discussion of significant factors that make the offering speculative or risky.</p>	<p>identity of any person who has been or will be retained by the issuer to assist in the offering and sale of the securities (F) A description of any litigation or legal proceedings involving the issuer of its management (G) The name and address of any website that the issuer intends to use in connection with the offering.</p>
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TABLE 1: COMPARISON OF FEDERAL, KANSAS, GEORGIA, WISCONSIN, AND MICHIGAN EXEMPTIONS (CONT.)

JOBS Act Securities Act of 1933 § 4(a)(6) (codified in 15 U.S.C.)	Invest Kansas Exemption KAN. ADMIN. REGS. § 81-5-21	Invest Georgia Exemption GA. COMP. R. & REGS. § 590-4- 2-.08	CASE for Jobs Act WIS. STAT. ANN. § 551.202(26)	Michigan Invests Locally Exemption MICH. COMP. LAWS ANN. § 451.2202a
Resale Restrictions				
§ 77d-1(e): May not be resold for one year unless they are transferred to (A) the issuer, (B) an accredited investor, (C) as part of a registered offering, or (D) to a member of the family of the purchaser or in connection with death or divorce.	(a)(9): Securities cannot be resold unless they are registered or qualify for an exemption from registration.	(1)(h): Securities are subject to resale limitations contained in SEC Rule 147. (i.e., securities cannot be resold for 9 months from the date of the last sale unless it's to a person in the state. <i>See</i> CFR § 230.147(e))	(26)(h): Securities are subject to resale limitations contained in SEC Rule 147. (i.e., securities cannot be resold for 9 months from the date of the last sale unless it's to a person in the state. <i>See</i> CFR § 230.147(e))	(1)(b)(iii): Securities are subject to resale limitations contained in SEC Rule 147. (i.e., securities cannot be resold for 9 months from the date of the last sale unless it's to a person in the state. <i>See</i> CFR § 230.147(e))
Advertising				
§ 77d-1(b)(2): the issuer may not advertise the terms of the offering, except for notices, which direct investors to the funding portal or broker. ¹	(a)(7): General solicitation permitted as long as the issuer provides the disclosures required by § (a)(7).	(1)(f): General solicitation permitted as long as the issuer provides the disclosures required by § (1)(f)	Not affirmatively mentioned but presumably permitted since § (27) allows a less regulated version of intrastate crowdfunding that prohibits advertising.	General solicitation permitted after filing with state.

TABLE 1: COMPARISON OF FEDERAL, KANSAS, GEORGIA,
WISCONSIN, AND MICHIGAN EXEMPTIONS (CONT.)

JOBS Act Securities Act of 1933 § 4(a)(6) (codified in 15 U.S.C.)	Invest Kansas Exemption KAN. ADMIN. REGS. § 81-5-21	Invest Georgia Exemption GA. COMP. R. & REGS. § 590-4- 2-.08	CASE for Jobs Act Wis. STAT. ANN. § 551.202(26)	Michigan Invests Locally Exemption MICH. COMP. LAWS ANN. § 451.2202a
Post-Offering Reporting				
<p>§ 77d-1(b)(4): not less than annually, file with the Commission and provide to investors reports of the results of operations and financial statements of the issuer. (n.b. issuer must provide audited or CPA reviewed financials if they were required to do so initially under § 77d- 1(b)(1)(D). See SEC Proposed Rules, <i>supra</i> note 20, at 95.)</p>	Not mentioned	Not mentioned	<p>Wis. STAT. ANN. § 551.205(2): For as long as securities issued under the exemption remain outstanding, issuers must provide a quarterly report to investors containing (a) compensation received by directors and officers and (b) an analysis by management of the issuer of the business operations and financial condition of the issuer.</p>	<p>(3) For as long as securities issued under the exemption remain outstanding, issuers must provide a quarterly report to investors containing (i) compensation received by directors and officers and (ii) an analysis by management of the issuer of the business operations and financial condition of the issuer.</p>