The Route to Capitalization: The Transcendent Registration Exemptions for Securities Offerings as a Means to Small Business Capital Formation*

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I. Introduction

The necessity of a new "route to capitalization" for small businesses is born out of costly registration requirements and ongoing reporting requirements under the Securities Acts of 1933 and 1934, respectively. These registration, disclosure, and reporting requirements operated as consumer protection laws by ensuring that investors had access to full and fair disclosure of all material facts associated with the investment.[1] However, compliance with these laws is a costly and burdensome process, which acts as a barrier to small businesses' access to capital markets and goes beyond consumer protection to effectively bar consumer–investors from participation altogether.[2] Accordingly, small businesses and investors alike began lobbying for a change, to which the legislative response was the Jumpstart Our Business Startups (JOBS) Act of 2012.[3]

The underlying issues are the substantive registration requirement for businesses seeking to raise capital by selling equity in their companies and the considerable transaction costs associated with such registration. The requirement originated with the Securities Act of 1933 (the "1933 Act"), which was passed in the wake of the Great Depression in the late 1920s and early 1930s.[4] In response to the market's failure and the public's overwhelming distrust of the stock market, the 1933 Act was ultimately intended to prevent fraud in the sale of securities by providing "full and fair disclosure" of the character of securities sold and of all the material facts associated with those offerings.[5]

In furtherance of that purpose, the 1933 Act requires all "securities" within the meaning of the Act to be registered with the Securities and Exchange Commission (SEC).[6] What constitutes a security is defined broadly by the statute[7] and is interpreted even more broadly by courts.[8] The

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1. *See* Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1741–44 (2012) (summarizing the 1933 Act's registration and disclosure requirements and the 1934 Act's reporting and broker–dealer registration requirements).

2. *See id.* at 1744 (describing the clash with "the regulatory investor protection thrust of the securities laws" and "[e]ncouraging small business formation and capitalization").

3. 158 CONG. REC. S1885–86 (daily ed. Mar. 21, 2012) (statement of Sen. Tester) (cataloguing businesses in Montana that would benefit from changes to SEC regulations and the JOBS Act); *id.* at S1888 (statement of Sen. Bennet) (reading communications from various business and investor advocates in support of the JOBS Act).

4. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)).

5. H.R. REP. NO. 73-85, at 1–3 (1933).

6. 15 U.S.C. § 77e(c).

7. *See* 15 U.S.C. § 77b(a)(1) (defining a security as "any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate,

critical inquiry, as established in *SEC v. W.J. Howey Co.*,[9] is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[10] Sweepingly characterizing offerings as securities for registration purposes, the Supreme Court has elsewhere noted that "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called."[11]

Under that formalization, almost any investment offering by a business capitalizing through outside investment will qualify as a security and accordingly be subject to registration requirements. While this broad application is in line with the prophylactic purpose behind the legislation, it does not come without a cost. In addition to the base filing fee requisite to any registration under the 1933 Act,[12] which can be as much as $100,000 even for a small offering,[13] businesses must also incur substantial legal, accounting, and underwriting fees associated with filing. As estimated by the IPO Task Force, regulatory compliance for an initial public offering (IPO) costs an average of $2.5 million initially, followed by an average ongoing cost of $1.5 million per year.[14]

Take, for example, a small start-up business called Oculus Rift with an unprecedented idea for a virtual-reality headset.[15] First and foremost, the

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certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing").

8. *See, e.g.*, SEC v. Edwards, 540 U.S. 389, 393–94 (2004) (holding that a scheme promising a fixed rate of return is an "investment contract" and thus a security within the meaning of the Securities Act of 1933); SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946) (recognizing that state courts had "broadly construed" the term "investment contract" and holding that it was reasonable to attach that broad understanding to the term as used by Congress).

9. 328 U.S. 293 (1946).

10. *Id.* at 301.

11. Reves v. Ernst & Young, 494 U.S. 56, 61 (1990).

12. *See Filing Fee Rate*, U.S. SEC. & EXCH. COMM'N (Oct. 1, 2015), http://www.sec.gov/ofm/Article/feeamt.html [https://perma.cc/3WUE-JQQL] (setting the filing-fee rate through September 30, 2016, at $100.70 per $1,000,000 offered—i.e., the fee may be calculated by multiplying the aggregate offering amount by .0001007).

13. Stuart Evan Smith, Comment, *The Securities and Exchange Commission's Proposed Regulations Under the CROWDFUND Act Strike a Necessary Balance Between the Burden of Disclosure Placed on Issuers of Securities and Meaningful Protection for Unsophisticated Investors*, 44 U. BALT. L. REV. 127, 136 (2014).

14. IPO TASK FORCE, REBUILDING THE IPO ON-RAMP 9 (2011), http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf [http://perma.cc/B3CQ-2VWA].

15. For a very brief discussion of this company's history, see Adrianne Jeffries, *If You Back a Kickstarter Project That Sells for $2 Billion, Do You Deserve to Get Rich?*, VERGE (Mar. 28,

company will need capital to get off the ground—to research and experiment, to develop a prototype, and to begin limited production. But absent a registration exemption, the company will also need capital to *ask* for capital—an estimated $2.5 million of it.

And clearly for many smaller companies seeking to capitalize, the aforementioned cost is prohibitive. However, with public investment otherwise unavailable, small businesses cannot easily turn to other options. Debt financing is not readily accessible for smaller companies like Oculus Rift, especially early-stage start-ups without a history of revenue to rely on.[16] These loans, assuming attainability, may also be excessively expensive.[17]

From the individual investor's standpoint, this situation is similarly unideal. Due to a maximum of thirty-five unaccredited investors to whom the securities may be sold[18] and a recently antiquated prohibition on general solicitation under Rule 506,[19] ordinary individuals could not meaningfully participate in these investment opportunities.

With the advent of social media—and mass public participation and interaction with companies on the Internet—start-ups began to take advantage of the readily available platform for fundraising purposes.[20] The initial model of crowdfunding was not based on equity at all but rather on

2014, 10:13 AM), http://www.theverge.com/2014/3/28/5557120/what-if-oculus-rift-kickstarter-backers-had-gotten-equity [http://perma.cc/HTH8-XVR8].

16. *See* Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21,806, 21,865 (Apr. 20, 2015) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 240, 249, 260) [hereinafter Amendments to Regulation A] (stating that many of the potential issuers of securities under new regulations "may be small companies, particularly early-stage and high-growth companies, seeking capital through equity-based financing because they do not have sufficient collateral or the cash flows necessary to support the fixed repayment schedule of debt financing").

17. *Id.* at 21,872 ("Borrowing is relatively costly for many early-stage issuers as they may have low revenues, irregular cash-flow projections, insufficient assets to offer as collateral and high external monitoring costs.").

18. 17 C.F.R. § 230.506(b)(2)(i) (2013). Under Rule 501(a), the definition of an accredited investor included a person (1) "whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000" excluding the value of the person's primary residence; or (2) "who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year." *Id.* § 230.501(a)(5)–(6).

19. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771 (July 24, 2013) (codified at 17 C.F.R. pts. 230, 239, 242) (announcing a rule change that "permits an issuer to engage in general solicitation or general advertising in offering and selling securities pursuant to Rule 506").

20. *See, e.g.*, Stuart Dredge, *Kickstarter's Biggest Hits - Why Crowdfunding Now Sets the Trends*, GUARDIAN (Apr. 17, 2014, 8:18 AM), http://www.theguardian.com/technology/2014/apr/17/kickstarter-crowdfunding-technology-film-games?CMP=EMCNEWEML6619I2 [http://perma.cc/N5DN-CVA5] (surveying successful crowdfunding efforts).

rewards, donation, or lending.[21] Not classified as "securities" within the meaning of the 1933 Act, these initial crowdfunding transactions were entirely outside the regulatory scope of the SEC.[22] The rewards-based crowdfunding model, which comprises about 43% of crowdfunding transactions, is structured to allow individuals to pay a sum of money to a business seeking capitalization in return for some promised reward or product.[23] Under the lending model, which makes up about 14% of crowdfunding transactions, consumers interested or passionate about a business's project can simply lend small amounts of money to the business at a fixed interest rate with the expectation of full repayment.[24] Finally, under the donation model—making up about 28% of crowdfunding transactions—consumers can simply give money to a business they want to support with no expectation of repayment or reward.[25] In 2011, almost $1.5 billion was contributed in some sort of crowdfunding capacity.[26] This number increased to $16.2 billion in just three years.[27]

However, neither the preexisting registration-exemption schemes nor these nonequity methods of crowdfunding allowed ordinary investors to meaningfully participate in the equity market. Resultantly, an individual interested in investing in a start-up like Oculus Rift could donate $300 towards the cause and receive a poster or a prototype in return, but the would-be investor could never receive a share of dividends in the advent of the start-up's success ten years later.[28] This upside potential—albeit

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21. Crowdfunding, 78 Fed. Reg. 66,428, 66,514 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249) [hereinafter Crowdfunding Proposed Rules]. However, an industry report suggests that "equity-based crowdfunding is the fastest-growing of all the crowdfunding categories, at a 114% compound annual growth rate . . . in 2011." *Id.*

22. *See* 15 U.S.C. § 77b(a)(1) (2012).

23. *See* CROWDSOURCING.ORG, CROWDFUNDING INDUSTRY REPORT: MARKET TRENDS, COMPOSITION AND CROWDFUNDING PLATFORMS 17, 25 (2012), http://www.crowdfunding.nl/wp-content/uploads/2012/05/92834651-Massolution-abridged-Crowd-Funding-Industry-Report1.pdf [http://perma.cc/Z4T7-4AXP] (showing that 62 out of 143 crowdfunding platforms in 2011 were reward based).

24. *See id.* (indicating that the lending-based category made up 20 out of 143 total crowdfunding platforms in 2011).

25. *See id.* (showing 40 of 143 crowdfunding platforms in 2011 were donation based).

26. *Id.* at 11.

27. *Crowdfunding Market Grows 167% in 2014: Crowdfunding Platforms Raise $16.2 Billion, Finds Research Firm Massolution*, MARKETWIRED (Mar. 31, 2015), http://www.marketwired.com/press-release/crowdfunding-market-grows-167-2014-crowdfunding-platforms-raise-162-billion-finds-research-2005299.htm [http://perma.cc/6UHN-ZZWA].

28. *See* Jeffries, *supra* note 15. After raising $2.4 million on Kickstarter through nonequity crowdfunding, Oculus Rift was sold to Facebook for $2 billion in cash and stock. *Id.* Individuals who invested in the company in its early stages saw none of this money, leaving them wishing they had been allowed access to the security market at that time. *See id.* (quoting an early backer, who lamented that he "would have rather bought a few shares of Oculus rather than [his] now-worthless $300 obsolete VR headset").

accompanied with greater risk to the investor—was largely reserved for those investors dubbed sufficiently wealthy and sophisticated by the SEC.

Thus, the growing popularity of crowdfunding coupled with investors' inadequate access to small-business capitalization put pressure on regulators to create an SEC-registration exemption to allow for equity crowdfunding—whereby individuals could invest in the businesses they wanted to support in return for traditional equity interest in that company.[29] The JOBS Act, signed into law by President Obama on April 5, 2012, embodies the legislative response to this demand for change.[30] The JOBS Act focused particularly on lowering the above-mentioned barriers to capitalization for small businesses, and sought "[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."[31] The hope was that new exemptions and amendments would "give small businesses . . . greater access to capital by making online securities offerings" to a wide array of investors, without the extreme cost of traditional SEC-registration requirements.[32] On the investor side, this would lift preexisting barriers to participation in the traditional equity market, allowing ordinary investors—now shareholders—to make potential profit from their investment's success.[33]

II. Traditional Capitalization Methods

Against this backdrop, there are a number of traditional options available to businesses seeking initial capitalization. The choice of method inevitably depends on the size of the business issuing the securities, the type of investors the issuer seeks to attract, and the amount of capital the issuer is seeking in connection with the issuance. Ultimately, an issuer's choice will be largely influenced by the various exemptions from registration available to him or her and by the unfailing fallback option of taking on the expense of registering as a public offering. The potential economic impact of any new exemption will depend on how those methods compare to existing methods that small businesses currently use to raise capital. Below is a brief summary of the broader spectrum of capitalization options generally available to issuers in the past—the economic baseline against which new capitalization methods may be measured.

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29. Alan R. Palmiter, *Pricing Disclosure: Crowdfunding's Curious Conundrum*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 373, 392–93 (2012).

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

31. 126 Stat. at 306; Palmiter, *supra* note 29, at 391.

32. Palmiter, *supra* note 29, at 391.

33. *See id.* at 392 (discussing how an exemption from SEC registration for for-profit crowdfunding would encourage investment by allowing investors to earn a profit on their investment).

A. *Registered Offering*

By registering a class of securities with the SEC under the 1933 Act, a business is largely free to offer the security to all potential investors—not just accredited ones—and to seek an unlimited amount of money in connection with that issuance.[34] Essentially, such registration was previously necessary to make a substantial initial public offering to a broad array of investors.[35] However, as formerly mentioned, there are very high costs associated with issuance and ongoing disclosure requirements.[36] Fees paid to underwriters, lawyers, and accountants are often too costly for smaller issuers and thus render this route to capitalization an impossible one. The cost is not just monetary. According to an IPO Task Force report, 89% of CEOs who participated in an IPO listed "Administrative Burden of Regulatory Compliance" as one of the most significant challenges associated with the process.[37] These high costs have led to the issuance of very few IPOs; faced with the choice between committing resources to achieve and maintain compliance with regulations in an already uncertain market, or forgoing the IPO altogether to allocate much-needed capital elsewhere, management often—quite reasonably—chooses the latter.[38] Since 1996, the yearly number of IPOs in the United States has plummeted from a high of 791 to an average of less than 157 per year between 2001 and 2008.[39] Smaller IPOs have taken the worst hit, with offerings less than $50 million comprising only about 15% of those issued.[40] Accordingly, although 96% of emerging growth companies surveyed by the IPO Task Force felt that a "strong and accessible" market for smaller business offerings was important, "only 13% agreed that the current market is easily accessible for small companies."[41]

As previously mentioned, the capital requirement to register creates a "chicken or the egg" problem for companies like Oculus Rift, which originally needed capital to start their business in the first place. Similar to the way a chicken cannot exist without an egg, and vice versa, initial capital cannot be raised without initial capital.

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34. *See, e.g.*, Securities Act of 1933, 15 U.S.C. § 77e (2012) (providing a general prohibition on communications regarding unregistered securities to potential investors, but providing an exception for communications with interested accredited investors); *id.* §§ 77f–77g (detailing the registration process and disclosure requirements, but omitting any language limiting offering amounts).

35. *See id.* § 77c(b)(1) (specifying that the SEC may never exempt offerings that exceed $5 million from registration).

36. *See supra* notes 12–14 and accompanying text.

37. IPO TASK FORCE, *supra* note 14, at 12.

38. *See id.* at 10 (describing the impact of regulatory and market roadblocks on the supply of IPOs).

39. *Id.* at 6.

40. *See id.*

41. *Id.* at 9.

B. *Debt Financing*

Capitalization through debt financing is another route that has been traditionally available to small businesses seeking initial capital. Equity through such financing can be obtained through loans from commercial banks, private investors, or finance companies.[42] However, borrowing money under these circumstances can be extremely costly—if not entirely impossible—for many small or early-stage businesses with limited or nonexistent revenues and collateral.[43] According to a report cited by the SEC, approximately 92% of all small businesses' debt to financial institutions is secured, and 52% of that debt is personally guaranteed by business owners.[44] This suggests that, absent substantial assets or an owner's willingness to take on personal liability, small businesses may not easily take advantage of this method of capitalization.

C. *Traditional Exemptions from Registration*

Although a traditional IPO or loan may be inaccessible, small businesses are otherwise permitted to raise capital through unregistered offerings under certain exemptions from registration under the 1933 Act. The traditional exemptions are those pursuant to § 3(a)(11),[45] § 4(a)(2),[46] Regulation A,[47] and Regulation D.[48] Each exemption has unique conditions and limitations that may limit utility for small businesses depending on the issuer's particular capitalization needs.

For example, because the exemption under § 3(a)(11) is limited to purely intrastate state offerings, it cannot be used by any small business hoping to raise capital from investors across state lines.[49] Similarly limited in utility is the exemption under § 4(a)(2), which is available only to issuers engaging in nonpublic offerings.[50] Offerings made pursuant to old Regulation A are rare—there was a relatively low offering limit of

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42. Amendments to Regulation A, *supra* note 16, at 21,872.

43. *See id.* (asserting that a technology startup "without steady revenues or substantial tangible assets is likely to have trouble obtaining" a bank loan because of difficulty in proving its ability to repay).

44. *Id.* (citing Allen N. Berger & Gregory F. Udell, *Relationship Lending and Lines of Credit in Small Firm Finance*, 68 J. BUS. 351, 361 (1995)).

45. 15 U.S.C. § 77c(a)(11) (2012) (relating to securities that are "part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory"); *see also* Securities Exchange Act of 1934, Pub. L. No. 73-291, sec. 202, § 3(a)(11), 48 Stat. 881, 906 (codified as amended at 15 U.S.C. §§ 78a–78pp (2012)) (amending the Securities Act of 1933 to include § 3(a)(11) as an additional exemption).

46. 15 U.S.C. § 77d(a)(2) (relating to transactions not involving a public offering).

47. 17 C.F.R. §§ 230.251–.263 (2015).

48. *Id.* §§ 230.500–.508.

49. 15 U.S.C. § 77c(a)(11).

50. *Id.* § 77d(a)(2).

$5 million, and issuers relying on the exemption were required to prepare offering materials, obtain a qualification statement by the Commission, and in some cases, go through qualification and registration in multiple states.[51] From 2012 to 2014, the average time to obtain this qualification was over three hundred days.[52] This exceedingly lengthy time frame, in addition to the costs and effort to comply with various securities laws and applicable procedures across states, is a major factor contributing to Regulation A's limited use.[53]

Although these various exemptions are available to small businesses whose goals align with these limited specifications, "the most common way to issue up to $50 million of securities is pursuant to an offering under a Regulation D exemption."[54] Within Regulation D, there are three different rules under which an exemption may be made: Rule 504,[55] Rule 505,[56] and Rule 506.[57] Rules 504 and 505 are limited to offerings under $1 million and $5 million, respectively, and are not heavily relied on as a practical matter; the SEC has noted that most issuers choose to rely on Rule 506 even when their offering size would have potentially permitted use of Rule 504 or Rule 505.[58] This may be due to the fact that, of the three, only Rule 506 provides for preemption of state securities law and accordingly saves issuers cost and effort to ensure supplementary state compliance.[59]

D. Rule 506

For the foregoing reasons, Rule 506 has been, and will likely continue to be, an important method of capitalization for small businesses. In terms of affordability, the exemption performs well. Notably, *de minimis* disclosure and qualification requirements, flexible yet nonmandatory intermediary options, state preemption, and high barriers to liability allow

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51. *See* Amendments to Regulation A, *supra* note 16, at 21,867; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-839, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS 11 (2012), http://www.gao.gov/assets/600/592113.pdf [http://perma.cc/3TCH-96MM] (reporting single-digit numbers of offerings under Regulation A between 2008 and 2011).

52. Amendments to Regulation A, *supra* note 16, at 21,869.

53. *See id.* at 21,868–69.

54. *Id.* at 21,869. In calendar year 2014, Regulation D offerings accounted for over $1 trillion in the United States. *Id.*

55. 17 C.F.R. § 230.504 (2015).

56. *Id.* § 230.505.

57. *Id.* § 230.506.

58. *See* Amendments to Regulation A, *supra* note 16, at 21,869 (noting that in 2014, 11,228 offerings made pursuant to Regulation D would have likewise been permissible under Regulation A—"[o]f those, 10,671 offerings relied on Rule 506, 376 on Rule 504, and 181 on Rule 505").

59. *See id.* at 21,869 n.899 ("This tendency could, in part, be attributed to two features of Rule 506: State securities law preemption and unlimited offering amount.").

issuers to raise an unlimited amount of capital at a minimal cost.[60] Additionally, almost any issuer is free to take advantage of the exemption, save felons and other "bad actors" within the meaning of Rule 506(d).[61]

The downside to capitalization pursuant to Rule 506 is that investments may, as a practical matter, be obtained from accredited investors only.[62] Accordingly, access to potential investors is not a strong point. Because ordinary individuals cannot partake in the offerings, the accredited-investor limitation effectively precludes what is commonly understood to be "crowdfunding."

And this is a critical downside for companies like Oculus Rift, which sought to raise small amounts of money from a large—unaccredited—fan base. While the cost-effectiveness of the Rule 506 exemption serves as a solution for a company that needs capital but has no capital with which to raise it, the rule fails to offer a solution for companies hoping to capitalize with small donations from real people. And on the investor side, it fails to offer a place "where fans can support and connect with [businesses] they love."[63]

1. To Whom the Securities May Be Sold.—Under Rule 506, there is no monetary cap on the size of the issuance; rather, businesses are free to make offerings as large or small as desired.[64] The limitation comes from a requirement that, as a practical matter, only accredited investors may partake in the investment opportunity.[65] Although offerings may be made to thirty-five unaccredited investors in addition to an unlimited number of accredited investors,[66] this is a concession without consequence for two reasons.

Firstly, the limited number of permissible unaccredited investors and the difficulty in reaching them impedes a meaningful opportunity for ordinary individuals seeking to invest in these businesses. Issuers either limit unaccredited investors to insiders—i.e., friends and family—or refrain from selling to unaccredited investors at all to avoid potential conflict with the regulation.[67] In 2012, the SEC estimated that only 9.4% of

60. *See infra* sections II(D)(1)–(6).

61. *See* 17 C.F.R. § 230.506(d) (2015).

62. *See infra* notes 65–66 and accompanying text.

63. *See* Jeffries, *supra* note 15 (explaining that Oculus Rift's fundraising platform, Kickstarter, does not offer donors an option to acquire equity in a business).

64. *See* 17 C.F.R. § 230.506(b)(2)(i) (2015).

65. *See id.* Unaccredited investors are those who do not fall into the definition of accredited investors under Rule 501(a). Generally, these are individuals whose net worth is less than $1 million or whose annual income is less than $200,000. 17 C.F.R. § 230.501(a)(5)–(6) (2015).

66. 17 C.F.R. § 230.506(b)(2)(i) (2015).

67. *See* Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, 79 Fed. Reg. 3926, 3980 (Jan. 23, 2014) (reporting that of the

Regulation D offerings involved even one unaccredited investor—even though these individuals make up over 92% of the population.[68] This exclusion has widespread consequences. It leaves millions of individuals who would otherwise be interested in investing in small businesses with no meaningful opportunity to do so.

Secondly, the allowance for thirty-five unaccredited investors is made even more meaningless by the fact that issuers may not advertise to these individuals or solicit their investments. Rather, the recently lifted ban on solicitation under Rule 506(c) is applicable only to accredited investors.[69] This double incentive to sell exclusively to accredited investors reinforces the status quo under which only friends and family of the issuer—i.e., those individuals who can be reached without solicitation within the meaning of the 1933 Act—have a meaningful chance of participation in Rule 506 offerings.

In order to verify that these investors actually fall within the accredited category, the issuer must take reasonable steps to ensure accredited status.[70] The issuer is deemed to have taken reasonable steps, and thereby satisfied the burden, by using one of four statutory nonexclusive and nonmandatory verification options or by taking other reasonable steps.[71] Thus, compliance with these investor-verification measures imposes an additional expense on Rule 506 offerings—one that may be only relatively mitigated by use of a preprescribed safe harbor.

2. Availability of Advertising or General Solicitation.—Before the recent Rule 506(c) amendment under the JOBS Act, issuers hoping to rely on a Rule 506 exemption could not conduct advertising or engage in general solicitation regarding the sale.[72] Resultantly, promotion of offerings through traditional media—e.g., newspaper, television, or radio advertisement—or through the Internet was prohibited.[73]

Under the JOBS Act's recent revision of Rule 506, the prohibition against general solicitation or advertising was lifted, provided that all

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Regulation D offerings below $50 million by issuers that would have been eligible for Regulation A exemption, less than 10% included any unaccredited investors).

68. *See id.* (noting that in 2010 only 7.4% of all U.S. households qualified as accredited investors).

69. 17 C.F.R. § 230.506(c)(2)(i) (2015).

70. *Id.* § 230.506(c)(2)(ii).

71. *Id.*

72. Usha Rodrigues, *In Search of Safe Harbor: Suggestions for the New Rule 506(c)*, 66 VAND. L. REV. EN BANC 29, 31 (2013). *Compare* 17 C.F.R. § 230.506 (2013), *with* 17 C.F.R. § 230.506(c) (2015) (amending Rule 506 to exempt offerings issued under the rule from the prohibition on solicitation under 17 C.F.R. § 230.502(c)(1)).

73. *See* 17 C.F.R. § 230.502(c)(1) (2013).

purchasers of securities are accredited investors.[74] As previously mentioned, the burden is on the issuer to take reasonable steps to verify that prospective purchasers are, in fact, accredited.[75] This allows issuers relying on Rule 506 to more easily reach institutional and accredited investors, which may in turn make it less necessary for them to obtain investment from a broader, nonaccredited investor base.[76]

3. Disclosure Requirements.—Playing a significant role in the exemption's affordability is the lack of express disclosure requirements, SEC review, and ongoing reporting requirements under Rule 506. Unlike exemptions under the JOBS Act, Regulation D filings require no SEC "qualification" of an offering statement—a process that, as previously mentioned, has taken up to a year to complete in the past.77 Thus, the only disclosure requirements are those requiring disclosure of bad actor events under Rule 506(e).78

4. Intermediary Requirements.—Not only are Rule 506 offerings unhampered by disclosure requirements, they are likewise not subject to a requirement that an intermediary be employed in the sales process.[79] Rather, issuers may employ traditional securities firms acting as broker–dealers at their behest—a decision that may be hugely cost-efficient.[80] Because underwriting fees paid to these intermediaries can equal as much as 7% of the value of the offering, the inherent flexibility in this option and the availability of the choice to proceed without an intermediary is an important benefit associated with Rule 506.[81]

74. 17 C.F.R. § 230.506(c) (2015); *see also Rule 506 of Regulation D*, U.S. SEC. & EXCHANGE COMMISSION (Oct. 6, 2014), https://www.sec.gov/answers/rule506.htm [http://perma.cc/AGK8-Y36Q] (confirming under the amended Rule 506 that an issuer can advertise the offering provided that the company has taken reasonable steps to verify that the investors are all accredited).

75. 17 C.F.R. § 230.506(c)(2)(ii) (2015).

76. Amendments to Regulation A, *supra* note 16, at 21,866.

77. *See* 17 C.F.R. § 230.506 (2015); Amendments to Regulation A, *supra* note 16, at 21,869 (stating that the average qualification period from 2012 to 2014 for exemptions under Regulation A was over three hundred days).

78. 17 C.F.R. § 230.506(d)–(e) (2015).

79. 15 U.S.C. § 77d(b)(1) (2012).

80. *See id.* That merely 10% of Regulation D offerings involved an intermediary in 2014 points towards the cost-effectiveness of self-selling securities. *See* Amendments to Regulation A, *supra* note 21, at 21,872.

81. *See* Amendments to Regulation A, *supra* note 21, at 21,871.

In the same flexible view, an issuer opting to employ a securities firm to administer the issuance is permitted to use a wide range of intermediaries—brokers or funding portals, a private equity fund, or a venture capital fund—to facilitate the issuance.[82]

5. State Law Preemption.—In addition to aforementioned costs associated with compliance with federal securities law, issuers generally may also face additional expenses associated with supplementary compliance with state securities law. However, issuances pursuant to Rule 506 benefit from state law preemption and avoid these additional costs as a result.[83]

6. Liability.—Liability exposure is one of the most significant costs associated with a securities offering,[84] yet offerings under Rule 506 incur relatively minimal costs associated with potential liability. The most important limitation on a Rule 506 offering's liability exposure, and attendant costs, is the inapplicability of § 12(a)(2) liability under the 1933 Act.[85] And although Rule 506 offerings are not exempt from antifraud provisions under SEC Rule 10b-5, the risk of liability under Rule 10b-5 is considerably less.

Under Rule 10b-5, it is generally unlawful to make false or misleading statements in connection with a securities offering.[86] However, the risk of culpability under this section is relatively low. As a preliminary matter, a plaintiff bears the burden of producing facts giving rise to a strong inference of scienter—an intent to deceive—or illustrating an action with a highly reckless disregard for the truth.[87] Mere negligence is not enough.[88] Furthermore, the Supreme Court has interpreted what it means to "make" a

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82. 15 U.S.C. § 77d(a)(6)(C) (allowing use of nonbroker alternatives in connection with Rule 506 offerings to accredited investors); *see also id.* § 77d-1(a) (describing the requirements for such intermediary alternatives).

83. *See* 15 U.S.C. § 77r(a)(1) (2012) (mandating that "no law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof . . . requiring, or with respect to . . . registration or qualification of securities transactions, shall directly or indirectly apply to a security that . . . is a covered security").

84. Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. 281, 302 (2014).

85. Securities Act of 1933, Pub. L. No. 73-22, § 12, 48 Stat. 74, 84 (codified as amended at 15 U.S.C. § 77*l*(a)(2) (2012)). In *Gustafson v. Alloyd Co.*, 513 U.S. 561, 578–84 (1995), the Supreme Court interpreted § 12 of the 1933 Act to reach, in effect, only public offerings made by the use of a prospectus or similar offering circular, and thus it does not apply to offerings made pursuant to Rule 506.

86. 17 C.F.R. § 240.10b-5 (2015).

87. *See, e.g.*, Stoneridge Inv. Partners v. Sci.-Atlanta, Inc., 552 U.S. 148, 157 (2008) (articulating plaintiff's burden); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that scienter is a prerequisite to establishing a Rule 10b-5 violation).

88. *Hochfelder*, 425 U.S. at 201.

statement very narrowly—it is insufficient to show the issuer *created* the material misstatement or omission; rather, the issuer must have actually *made* the statement.[89] Finally, the plaintiff must prove that each investor seeking damages relied on the misstatement or omission.[90] The clearance of all of these hurdles is made even more difficult by the fact that, in the context of a private company issuing securities through a Rule 506 exemption, there will be no public filings to cite in the complaint.[91] Accordingly, in terms of the liability prong of cost-effectiveness, Rule 506 is the most preferable method of capitalization for issuers seeking to limit potential loss.

III. New Capitalization Options Under The JOBS Act

In addition to the option to capitalize under Rule 506, the JOBS Act provides two new capitalization methods aimed at improving access to capital markets for smaller businesses: (1) Title IV, which amended Regulation A;[92] and (2) Title III, which provides for a crowdfunding exemption under § 4(a)(6) of the Securities Act of 1933.[93] The SEC's recently adopted Final Rules and Amendments to Regulation A implements § 401 of the JOBS Act by amending § 3(b) of the 1933 Act[94] and adds a new class of securities exempt from registration requirements for offerings up to $50 million.[95] Section 4(a)(6), for which the SEC adopted the final rules on October 30, 2015, adds a new class of securities exempt from registration requirements for offerings up to $1 million.[96] Below is a discussion of the benefits and drawbacks of each, in terms of cost-effectiveness and access to potential investors.

89. *See* Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011) ("For the purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not 'make' a statement in its own right.").

90. *Stoneridge Inv. Partners*, 552 U.S. at 159.

91. Parsont, *supra* note 84, at 303.

92. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 401, 126 Stat. 306, 323–25 (2012) (codified at 15 U.S.C. § 77c (2012)). Title 401 of the JOBS Act amends 15 U.S.C. § 77c, the statute underlying Regulation A. *See* 17 C.F.R. §§ 230.251–.263 (2013).

93. Jumpstart Our Business Startups Act, § 302 (codified in scattered sections of 15 U.S.C.).

94. The details of old Regulation A are beyond the scope of this Note, but subpart II(C) briefly discusses the rarity of issuances made pursuant to that exemption.

95. Amendments to Regulation A, *supra* note 16, at 21,806; *see also* Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital (Mar. 25, 2015), https://www.sec.gov/news/pressrelease/2015-49.html [http://perma.cc/P72W-86MY] (announcing that updated rules known as Regulation A+ "will enable smaller companies to offer and sell up to $50 million of securities in a 12-month period").

96. Crowdfunding, 80 Fed. Reg. 71,387, 71,389 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, 274) [hereinafter Crowdfunding]; *see also* Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules to Permit Crowdfunding (Oct. 30, 2015), http://www.sec.gov/news/pressrelease/2015-249.html [http://perma.cc/3RWR-M8Z2].

A. Regulation A+

On April 20, 2015, the SEC introduced the final rules and amendments to Regulation A, known as Regulation A+.[97] The final rules expand old Regulation A into two tiers: (1) Tier 1, for securities offerings up to $20 million; and (2) Tier 2, for securities offerings up to $50 million.[98] There are slightly different requirements and limitations associated with each tier.

The determination of which tier to use is highly dependent on the issuer's specific needs, as each have different benefits and drawbacks in terms of both affordability and access to potential investors. The SEC estimates that issuers opting to use the Tier 1 exemption will be "small companies whose businesses revolve around products, services, and a customer base that will more likely be located within a single state, region, or a small number of geographically dispersed states."[99] Contrastingly, issuers willing to take on the higher costs associated with providing audited financial statements and ongoing reporting requirements under Tier 2 will likely be businesses engaging in offerings "on a larger and more national scale."[100] While issuers seeking to raise less than $20 million are free to choose compliance under either tier, the SEC estimated that "the initial and ongoing costs and limitations associated with complying with Tier 2 will provide for the natural separation of offerings into the respective tiers with issuers in more local offerings electing to comply with the less onerous requirements of Tier 1."[101]

However, unlike Rule 506, Regulation A+ specifically prohibits many issuers from using the exemption, notably among them public and foreign companies.[102] As a practical matter, this means that only a narrow group of issuers—mainly startups and small businesses based in the United States—will be eligible to capitalize pursuant to this exemption.[103]

As the specifics below will show, Regulation A+ stands to meet the needs of both companies like Oculus Rift—which seek to raise a substantial amount of money from a wide array of ordinary investors—and ordinary investors themselves—who want to support a business they believe in with the chance to benefit from that belief if the company succeeds. Had it

97. Amendments to Regulation A, *supra* note 16, at 21,806; U.S. Sec. & Exch. Comm'n, *supra* note 96.

98. Amendments to Regulation A, *supra* note 16, at 21,807.

99. *Id.* at 21,861.

100. *Id.*

101. *Id.* at 21,861–62.

102. *See id.* at 21,811 (restricting the availability of Regulation A+ to "companies organized in and with their principal place of business in the United States or Canada," and prohibiting its use by companies subject to ongoing reporting requirements under § 13 or § 15(d) of the 1934 Securities Exchange Act).

103. *See* Parsont, *supra* note 84, at 302.

existed at the time, Regulation A+ would have easily allowed Oculus Rift to raise the requisite $2.4 million it needed, and the investors—retrospectively dissatisfied with their posters and prototypes—would have realized a “stunning 145x return” on their investment upon the company’s sale to Facebook for $2 billion.[104]

1. To Whom the Securities May Be Sold.—The eligibility of investors varies by tier. Within Tier 1, issuers may sell up to $20 million in securities to all types of investors—accredited or unaccredited.[105] This condition obviates the need for issuers to implement any sort of investor verification measures and thereby saves those associated costs. Furthermore, there are no individual investment limits for purchasers of the securities—a facilitative benefit not enjoyed by individuals investing in issuances under Tier 2 or § 4(6).[106]

Under Tier 2, available for offerings up to $50 million, an issuer may similarly sell to all types of investors—both accredited and unaccredited.[107] However, unaccredited investors can purchase an amount of securities “no more than: (a) 10% of the greater of annual income or net worth (for natural persons); or (b) 10% of the greater of annual revenue or net assets at fiscal year-end (for non-natural persons).”[108] This investment limitation represents an additional hindrance to an issuer’s investor access—one that is not associated with comparable offerings under Rule 506.

For issuers, this is not only a downside in terms of access to potential investors. The disparate application of the rule additionally reintroduces the need for investor verification measures by the issuer when selling to unaccredited investors. However, Regulation A+ allocates that cost differently than does Rule 506. Rather than requiring issuers to take reasonable measures to insure investors’ accredited status, the final rules merely require issuers to notify investors of the investment limitations.[109] Issuers may subsequently rely on a “representation of compliance with the investment limitation from the investor,” absent actual knowledge that the representation is untrue.[110] In adopting this cost allocation balance, the SEC consciously rejected the “reasonable steps to verify . . . compliance” method under Rule 506, deeming the investor-protection mechanism unnecessary “in light of the total package of investor protections included in the final

104. *See* Jeffries, *supra* note 15.

105. *See* Amendments to Regulation A, *supra* note 16, at 21,807.

106. *See id.* at 21,815 (proposing limits to the amount of securities investors can purchase in a Tier 2 offering).

107. *Id.* at 21,807.

108. *Id.*

109. *Id.* at 21,817.

110. *Id.*

rules for Tier 2 offerings."[111] Further rationalizing the outcome, the SEC cited the desire to avoid the unintended consequence of "dissuading issuers from selling to non-accredited investors in Tier 2 offerings by increasing compliance uncertainties and obligations."[112] Likely, this is an unstated reference to the practical realities under Rule 506[113] and a desire to break with the status quo thereunder.

2. Availability of Advertising or General Solicitation.—As a further benefit in terms providing access to potential investors, issuers taking advantage of a Regulation A+ exemption are permitted to "test the waters" regarding the pending issuance before filing an offering statement, without restriction as to the types of investors solicited.[114] These solicitation materials need not be submitted to the SEC before they are issued—a concession that greatly reduces compliance expenses and allows issuers who decide not to proceed with an issuance to completely avoid filing altogether.[115] Limitations on the substance of the testing-the-waters materials are not overly burdensome,[116] yet all statements made therein are subject to applicable antifraud and civil liability provisions under the 1933 Act.[117]

Within forty-eight hours prior to the first sale, the issuer must file a completed offering statement with the SEC.[118] The filed offering statement must include all previously used solicitation materials, which will be made publically available by the SEC.[119] Associated procedural requirements postfiling are likewise minimal. Any solicitation made after filing must be accompanied by the most current preliminary offering circular, or alternatively, information about how that circular may be obtained.[120] Additionally, any issuer who opts to use solicitation materials postfiling must update and redistribute the new materials in a substantially similar

111. *Id.*; *see also supra* note 70 and accompanying text.

112. Amendments to Regulation A, *supra* note 16, at 21,817.

113. *See supra* section II(D)(1) (noting that, as a practical matter under Rule 506, issuers generally do not sell to unaccredited investors even though such sales are permissible within certain limits).

114. Amendments to Regulation A, *supra* note 16, at 21,842.

115. *Id.* at 21,843.

116. *See id.* at 21,842 (requiring simply a disclaimer that "(1) [n]o money or other consideration is being solicited, and if sent, will not be accepted; (2) no sales will be made or commitments to purchase accepted until the offering statement is qualified; and (3) a prospective purchaser's indication of interest is non-binding").

117. *See* 15 U.S.C. § 77c(b)(2)(D) (2012) (attaching the civil liability provisions of § 77*l*(a)(2) to any person offering or selling securities under Regulation A); 17 C.F.R. § 240.10b–5 (2015) (imposing antifraud liability on any issuer engaging in interstate transactions).

118. Amendments to Regulation A, *supra* note 16, at 21,843.

119. *Id.* at 21,842.

120. *Id.* The requirement is satisfied merely by providing a URL where the requisite offering statement can be found. *Id.*

manner as previously used.[121] These conditions allow issuers to solicit interest in their prospective offerings either at no cost (if the issuer opts to abandon the issuance) or at very little cost (if the issuer ultimately goes forward with the issuance and requisite qualification and filing).

3. Disclosure Requirements.—In addition to certain disclosures and filings associated with testing-the-waters materials, an issuer must also make additional disclosures and filings as prescribed by statute or by the SEC. The mechanics of disclosure under Regulation A+ present no significant cost to the issuer—electronic filing is permitted, and the SEC has adopted an "access equals delivery" system under which issuers may presume investors have access to the Internet and may satisfy the delivery requirement solely by filing the necessary information online.[122] However, issuers hoping to rely on Regulation A+ will be unavoidably subject to costs associated with substantive disclosure that would not be present under a Rule 506 issuance.

Issuers under both Tier 1 and Tier 2 must deliver preliminary offering circulars at least forty-eight hours prior to the first sale.[123] These official offering documents must include information "such as financial statements, a description of the issuer's business operations, financial condition, and use of investor funds."[124] Financial statements associated with Tier 2 issuances must be audited and included in offering circulars—an additional cost not imposed on issuers using the Tier 1 exemption.[125]

In addition to these substantive requirements, and in contrast to the situation under Rule 506, the SEC must qualify all Regulation A+ offering statements before any sales are made.[126] This requirement potentially slows the closing speed of an issuance and constitutes an area of stark departure from the alternative—i.e., no SEC involvement—under Rule 506.[127]

Finally, although issuances under Tier 1 are not subject to ongoing disclosure requirements, issuances under Tier 2 must provide annual, semiannual, and current reports covering periodic happenings and current events, in addition to audited financial statements covering the "financial periods between the most recent period included in a qualified offering

121. *Id.* at 21,842.

122. *Id.* at 21,821–23.

123. *Id.* at 21,808. For exemptions under Tier 2, an issuer can avoid this requirement if the issuer is otherwise subject to, and current in, an ongoing reporting obligation. *Id.* In that case, issuers will only be required to comply with general delivery requirements for offerings. *Id.*

124. *See id.* at 21,825 (citations omitted). For a substantive list of all items of which disclosure in the offerings statement is required, see *id.* at 21,826.

125. *Id.* at 21,835–36.

126. *Id.* at 21,808, 21,841.

127. *See supra* sections II(D)(3), (5) (explaining that, under Rule 506, no SEC or state qualification or approval is required).

statement and the issuer's first required periodic report."[128] These ongoing reporting requirements—which can cost as much as $1.5 million per year for registered securities[129]—pose a substantial additional cost to issuers seeking to rely on a Tier 2 exception.

4. Intermediary Requirements.—Like issuances made pursuant to Rule 506, issuances under Regulation A+ do not require an intermediary in connection with the sale of securities. Although issuers have the option to utilize an intermediary, the SEC cites the limited involvement of intermediaries in current Regulation A offerings[130] and, given that the flexibility is identical to that allowed under Rule 506,[131] this is unlikely to change.

5. State Law Preemption.—For issuances made pursuant to Tier 2, state law is preempted, and resultantly issuers face no additional costs associated with dual compliance.[132] However, Tier 1 offerings are subject to supplementary state law regulations via "coordinated review."[133] The goal of coordinated review—a recently implemented multistate review program for Regulation A+ offerings—is to reduce state law disclosure and compliance obligations and associated costs.[134] In rationalizing this scheme, the SEC cited the "generally more local nature of Tier 1 offerings," and stated that it believed it "appropriate, in this context, for the states to retain oversight over how these offerings are conducted."[135] The details of the program are beyond the scope of this Note, but given that the program is still relatively in its infancy, it is somewhat uncertain what effect coordinated review will have on the cost of securities offerings subjected to it, as compared to the cost associated with traditional subjection to both federal and state securities law. However, the cost is unlikely to be nonexistent given the SEC has acknowledged that the lack of state

128. *See* Amendments to Regulation A, *supra* note 16, at 21,808, 21,847. For a detailed list of the full ongoing reporting requirements for Tier 2 offerings, see *id.* at 21,846–50.

129. IPO TASK FORCE, *supra* note 14, at 9.

130. Amendments to Regulation A, *supra* note 16, at 21,872.

131. *See supra* section II(D)(4) (detailing the identical Rule 506 intermediary situation and the implications associated thereunder).

132. *See* Amendments to Regulation A, *supra* note 16, at 21,858 (providing for the preemption of state securities law for securities offered or sold to "qualified purchasers" and defining qualified purchaser to include "any person to whom securities are offered or sold in a Tier 2 offering").

133. *Id.* at 21,860–61.

134. *Id.* at 21,860. For a full description of the coordinated review program, see *Regulation A Offerings*, N. AM. SEC. ADM'RS ASS'N, http://www.nasaa.org/industry-resources/corporation-finance/coordinated-review/regulation-a-offerings/ [http://perma.cc/MS7S-J6UK].

135. Amendments to Regulation A, *supra* note 16, at 21,858.

preemption for Tier 1 offerings could potentially inhibit the use of solicitation materials for smaller, more localized offerings.[136]

As a final note, it is important to distinguish that, with respect to all offerings, states retain the power to investigate and bring enforcement actions against fraudulent securities transactions and to enforce compliance under applicable federal law.[137]

6. Liability.—In addition to liability for fraud under Rule 10b-5,[138] issuers relying on a Regulation A+ exemption will also be subject to liability under § 12(a)(2) of the Securities Act of 1933.[139] Much less friendly to issuers than SEC Rule 10b-5, § 12(a)(2) does not require plaintiffs to prove either scienter or reliance.[140] As long as the plaintiff had no actual knowledge of the untruth or omission, the issuer is liable absent: (1) proof that the plaintiff's loss was not caused by the issuer's untruth or omission,[141] or (2) the establishment of a "reasonable care" defense, wherein the defendant proves that, even in the exercise of reasonable care, he or she could not have known of the misinformation.[142] In establishing this affirmative reasonable care defense, the defendant must defeat a presumption in favor of the plaintiff and is not entitled to assert any "graduated scale of duty depending upon the sophistication and access to information of the consumer."[143]

136. *See id.*

137. 15 U.S.C. § 77r(c)(1) (2012).

138. 17 C.F.R. § 240.10b-5 (2015). See also *supra* section II(D)(6) for a discussion of the liability exposure under Rule 10b-5 and the implications and costs associated therewith.

139. Amendments to Regulation A, *supra* note 16, at 21,814; *see also* 15 U.S.C. § 77c(b)(2)(D) (2012) ("The civil liability provision in section 77*l*(a)(2) of this title shall apply to any person offering or selling such securities.").

140. *See* 15 U.S.C. § 77*l*(a) (prescribing liability, without mention of scienter or reliance, to anyone who "offers or sells a security in violation of section 77e . . . or . . . offers or sells a security . . . by means of a prospectus or oral communication, which includes [or omits] an untrue statement of material fact"). Although there is no explicit requirement that the plaintiff show reliance on the alleged misinformation, the "by means of" language in § 12(a)(2) suggests that there should be some causal connection between the misleading untruth or omission and the purchase of the security. Sanders v. John Nuveen & Co., 619 F.2d 1222, 1225 (7th Cir. 1980). However, this requirement is hardly substantial given that the purchaser need not have even seen the misleading prospectus. *See id.*

141. *See* 15 U.S.C. § 77*l*(b) (providing that the amount recoverable by the plaintiff "represents other than the depreciation in value . . . resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable").

142. *See Sanders*, 619 F.2d at 1227–28 (declining to recognize defendant's reasonable care defense).

143. *See id.* at 1229 (presuming plaintiff's lack of knowledge and denying the defendant's use of a graduated scale).

Finally, unlike the narrow scope of potentially liable parties under Rule 10b-5,[144] a broad range of parties may be liable under § 12(a)(2), including the business's owners, directors, and executives—that is, "any person who . . . offers or sells a security in violation of section 77e."[145]

B. *Section 4(a)(6) Crowdfunding*

In response to the growing popularity of crowdfunding and the demand to shift from a donation or rewards model to a true investment model, the JOBS Act made crowdfunding available to nonreporting companies seeking to raise up to $1 million in securities offerings, primarily over the Internet.[146] Section 302 of the JOBS Act amended § 4 of the Securities Act of 1933 by adding § 4(a)(6), which created a new class of crowdfunded securities exempt from registration with the SEC.[147] Like Regulation A+, § 4(a)(6) specifically prohibits many issuers from using the exemption, essentially leaving only U.S.-based private companies as potentially eligible issuers.[148]

The SEC promulgated the final rules for the exemption on October 30, 2015.[149] However, the publication of the rules in early 2015 associated with Regulation A+ led many commentators at the time to suggest Regulation A+ may make recently finalized Title III crowdfunding "a relic."[150] While this prophecy was unrealized in the sense that the SEC went forward to adopt final rules implementing § 4(a)(6), a bevy of further conditions and requirements attendant to the capitalization method may yet make the method inferior to alternative Rule 506 and Regulation A+ options. Given the comparatively restrictive $1 million issuance limit under § 4(a)(6) (less than half of the $2.4 million that Oculus Rift required)[151] and the alternate

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144. *See* Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011) (explaining the exclusive applicability of Rule 10b-5 to the "maker" of the statement).

145. 15 U.S.C. § 77*l*(a).

146. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306, 315–21 (2012) (codified in scattered sections of 15 U.S.C.); *see also* Palmiter, *supra* note 29, at 397–99.

147. *See* Jumpstart Our Business Startups Act § 302(a)(6)(A) (creating an exception for "transactions involving the offer or sale of securities by an issuer" less than $1 million).

148. To qualify for the JOBS Act crowdfunding exemption, an entity must meet the requirements of § 4A. *See id.* § 302(b). Section 4A makes certain issuers ineligible, including foreign companies. 15 U.S.C. § 77d-1(f). See also *supra* subpart III(A) for a discussion of the similar exclusions under Regulation A+.

149. Crowdfunding, *supra* note 96, at 71,387.

150. Seedinvest, *The Reg A+ Bombshell: $50M Equity Crowdfunding Under Regulation A*, SEEDINVEST (Mar. 25, 2015), http://www.seedinvest.com/blog/regulation-a-equity-crowdfunding-rules/ [https://perma.cc/89DW-HJTS].

151. *See Oculus Rift: Step into the Game*, KICKSTARTER, https://www.kickstarter.com/projects/1523379957/oculus-rift-step-into-the-game/description [http://perma.cc/W5S4-3JAT] (showing that Oculus Rift's original funding goal was $250,000 and that Oculus Rift eventually raised $2,437,429). Under Rule 506, issuers may sell an unlimited amount of securities, and

funding sources available to startups and small businesses, issuers' use of this crowdfunding exemption is dubious.

1. To Whom the Securities May Be Sold.—Under Title III Crowdfunding, securities may be sold to all types of investors—accredited and unaccredited alike.[152] However, there are strict individual investment limits across the board: the total amount sold to any investor may not exceed (1) "the greater of . . . $2,000 or 5 percent of [the investor's] annual income or net worth" (for those investors whose annual income or net worth is less than $100,000), or (2) "10 percent of [the investor's] annual income or net worth" (for those investors whose annual income or net worth equals or exceeds $100,000).[153] And regardless of income, there are no circumstances under which any individual may invest more than $100,000 in a twelve-month period.[154]

Although there is no accredited versus unaccredited distinction, there is still a potential cost associated with verification of each investor's net worth to ascertain how much he or she is allowed to contribute, as well as a cost associated with insuring that no individual investor goes over that investor's respective investment limit. The SEC's final rules place the initial cost of verification on an intermediary broker or funding portal, but there is still potential for this cost to be ultimately passed on to the issuer—a cost that may be significant due to sheer volume given that § 4(a)(6) specifically contemplates raising small amounts of money from a large number of investors.[155]

For the intermediary to ensure that no investor exceeds his or her investment limit, the SEC requires there be "a reasonable basis for believing that the investor satisfies the investment limits" before accepting any investment commitment.[156] In establishing this reasonable basis for belief, the intermediary may rely on the investor's representations concerning his or her annual income, net worth, and amount of securities he or she purchased elsewhere within the past twelve months.[157] In this

under Regulation A+, issuers may sell up to $50 million of securities. Accordingly, the issuers opting to use § 4(a)(6) crowdfunding will have a very specific low-capitalization requirement.

152. *See* 15 U.S.C. § 77d(a)(5)–(6).

153. Crowdfunding, *supra* note 96, at 71,393.

154. *Id.*

155. *Id.* at 71,442. See *infra* section III(B)(4) for more information about the intermediary requirement associated with § 4(a)(6) crowdfunding.

156. Crowdfunding, *supra* note 96, at 71,442.

157. *Id.* at 71,442–43. Additionally, the SEC has noted that an intermediary can, in its discretion, establish a "centralized database," which can require verification of income or net worth electronically by uploading financial documents. *Id.* at 71,444.

respect, § 4(a)(6) crowdfunding is similar to Regulation A+ and will be less costly in terms of direct costs of investor verification than Rule 506.[158]

But a novel "investor education requirement" as a condition to investment constitutes a final cost associated with the sale of § 4(a)(6) securities. Title III requires crowdfunding intermediaries to provide potential investors with "disclosures related to risks and other investor education materials" as specified by the SEC.[159] These educational materials, to be given to investors in plain English, must include information on the purchase process, the risks associated with investing, the types of securities offered on the platform, the restrictions on securities' resale, the individual investment limits, the circumstances under which an issuer may cancel an investment commitment, the circumstances under which an issuer may cease to publish annual reports, the need for an investor to consider whether investing is appropriate for him or her, and any other type of information that an issuer is typically required to provide in an annual report.[160] The SEC estimates that hiring a third party to produce these materials may cost as much as $10,000 to $30,000 initially, with ongoing costs of $5,000 to $15,000 per year.[161]

Not only must the investor be provided with the material, but also he or she must *understand* that material; to that effect, intermediaries must ensure each investor (1) reviews the materials, (2) affirms he or she understands the risk of losing the entire investment, and (3) answers questions demonstrating an understanding of the level of risk generally involved in investing in small businesses.[162] The SEC does not proscribe any model format for this "questionnaire"—rather, the questions need only be developed in a format "reasonably designed to demonstrate the investor's receipt of the information."[163] Although the cost is prima facie born by intermediaries,[164] it will undeniably be passed on to issuers engaging their services. Accordingly, this new condition poses both a monetary cost and a potential barrier to easy investor access.

158. *See supra* section II(D)(1) (explaining an issuer's mandate to take "reasonable steps" to verify accredited status).

159. 15 U.S.C. § 77d-1(a)(3) (2012).

160. Crowdfunding, *supra* note 96, at 71,438. Aside from these basic informational requirements, the intermediary is free to determine the format of the material or include any additional information deemed pertinent. *Id.* at 71,439–40.

161. *Id.* at 71,511.

162. 15 U.S.C. § 77d-1(a)(4)(A)–(C); Crowdfunding, *supra* note 96, at 71,444–45.

163. Crowdfunding, *supra* note 96, at 71,445.

164. *See* Thomas V. Powers, *SEC Regulation of Crowdfunding Intermediaries Under Title III of the JOBS Act*, BANKING & FIN. SERVICES. POL'Y REP., Oct. 2012, at 1, 3 (explaining that requiring intermediaries to create investor-education materials could potentially be expensive).

2. Availability of Advertising or General Solicitation.—A further potential constraint on access to potential investors is that the only permissible advertising of issuances pursuant to § 4(a)(6) must direct investors to the registered funding portal or broker handling the offering.[165] Rationalizing this scheme, the SEC noted that this limited "notice of offering" approach would "allow issuers to generate interest in offerings and to leverage the power of social media to attract potential investors," while maintaining protection for potential investors by "limiting the ability of issuers to provide certain advertising materials without also providing the disclosures, available on the intermediary's platform, that are required for an offering made in reliance on Section 4(a)(6)."[166] But, as the SEC subsequently noted, while this inability to advertise terms of the offering imposes no *monetary* costs on issuers, it may reduce the accessibility of potential investors who may not be sufficiently enticed by the notice to click onwards to learn about the full opportunity.[167]

The SEC purportedly met these concerns by giving issuers flexibility in terms of information included in the notices and in the manner of their distribution. For example, although the range of permissible information is narrow,[168] issuers may opt to *exclude* certain information so that the notice acts as a form of "teaser," enticing potential investors to continue on to the intermediary site for more information.[169] Once the potential investor has chosen to visit the intermediary's website, an issuer may use communication channels provided by the intermediary to communicate with investors about the terms of the offering, so long as the issuer identifies itself as such in all communications.[170]

165. Crowdfunding Proposed Rules, *supra* note 21, at 66,454 (noting that § 4A(b)(2) provides that "an issuer shall 'not advertise the terms of the offering, *except for notices which direct investors to the funding portal or broker*'" (emphasis added)); *see also* Crowdfunding, *supra* note 96, at 71,425 (adopting the proposed rules, but clarifying that an advertising notice may include no more than (1) a statement that the issuer is conducting the offering and the name of and link to the intermediary's platform; (2) the terms of the offering; and (3) factual information about the legal identity and business location of the issuer).

166. Crowdfunding Proposed Rules, *supra* note 21, at 66,525.

167. *See id.* (alleging that "this proposed requirement that limits the issuer's ability to advertise the terms of the offering, while directing investors to the intermediary's platform for more offering-specific information, would not impose costs to market participants").

168. See *supra* note 165 for a list of the information that may be included in a notice.

169. *See* Crowdfunding, *supra* note 96, at 71,425 (noting that an issuer's flexibility *not* to include each of the enumerated matters in the notice may "facilitate certain types of social media communications").

170. *Id.*

3. Disclosure Requirements.—In addition to possible difficulty reaching potential investors, the Title III crowdfunding exemption is conditioned on providing investors and the SEC with substantial disclosures, despite its goal to minimize costs associated therewith.[171] Required disclosures fall into three main categories: (1) business and ownership information;[172] (2) company finances and the offerings themselves;[173] and (3) updates and ongoing reporting.[174] With respect to each category, the SEC specifically intended to balance consumer protection policies of promoting full and fair disclosure with the equally important goal of easing the burden and cost for small businesses to meet these requirements.[175] Accordingly, although the burden associated with these disclosures—both substantively and procedurally—will be sizable, it will not approach the cost associated with a traditional registered offering.[176]

However, juxtaposed with the complete absence of disclosure and filing requirements under Rule 506, compliance under § 4(a)(6) is undeniably more costly. Vis-à-vis Regulation A+, disclosure costs under § 4(a)(6) may be somewhat less sizable, but that is largely dependent on the size of the issuance. Given that the substance of required disclosures largely mirrors that information required in Regulation A+ offering statements, the costs are likely to be similar in that respect.[177] For issuances between $100,000 and $500,000, financial statements must be reviewed by an independent public accountant (similar to the requirement for Tier 1 offerings under Regulation A+).[178] For issuances above $500,000, financial

171. 15 U.S.C. § 77d-1(b)(1) (2012); Crowdfunding, *supra* note 96, at 71,398–99.

172. For a substantive description of the final rules for disclosure of business and ownership information, see Crowdfunding, *supra* note 96, at 71,399–402. Although the details are beyond the scope of this Note, this category of disclosures includes information relating to the officers, beneficial owners, and the company or business itself. *Id.*

173. For a substantive description of the final rules for disclosure of company finances and the offering itself, see *id.* at 71,401–03. This category of disclosures includes information about the use of proceeds, the target offerings amount, the offering price, the ownership and capital structure of the business, and financial statements. *Id.*

174. For a substantive description of the final rules regarding updates and ongoing reporting, see *id.* at 71,407–21. This requirement mandates issuers file an amended offering statement whenever there is "any material change in the offer terms or disclosure," in addition to filing annual reports on operations and financial statements with the SEC. *Id.* at 71,418.

175. *Id.* at 71,500–01.

176. *See id.* at 71,501 (recognizing that the disclosure requirements for offerings made pursuant to § 4(a)(6) are "more extensive, in terms of breadth and frequency, than those for other [private] offerings," but ultimately deciding that although lower disclosure requirements would decrease compliance costs, "the disclosure requirements . . . appropriately consider the need to enhance the ability of issuers relying on Section 4(a)(6) to raise capital while enabling investors to make informed investment decisions").

177. See *supra* section III(A)(3) for a summary of information to be included in offering statements.

178. 15 U.S.C. § 77d-1(b)(1)(D)(ii) (2012).

statements must be audited (similar to the requirement for Tier 2 offerings under Regulation A+).[179] Only those issuances below $100,000 require no review or auditing—rather, they must merely be certified by the principal executive officer of the issuing company as "true and complete in all material respects."[180] Accordingly, unless the issuance is less than $100,000, the cost of financial statement compliance for § 4(a)(6) offerings for issuances below $500,000 and above $500,000 mirror the cost under Tier 1 and Tier 2 of Regulation A+, respectively. Finally, the cost of ongoing reporting under § 4(a)(6) is likely to be similar to that under Tier 2 of Regulation A+—both require the provision of annual reports and financial statements to the SEC and investors, although issuances pursuant to § 4(a)(6) may not be subject to semiannual or current event reports.[181]

4. Intermediary Requirements.—In addition to disclosure costs, an issuer relying on § 4(a)(6)—unlike Rule 506 and Regulation A+—will also incur costs associated with the requirement to use an intermediary broker or funding portal to facilitate each transaction.[182] At the most fundamental level, these crowdfunding portals must make money—an economic reality that translates inevitably into costs associated with their use. In addition to these foundational costs, there will also be costs associated with the affirmative duties imposed on crowdfunding intermediaries by § 4(a)(6).[183] Among these duties is registration with the SEC and a self-regulatory organization,[184] disclosure of risk-related information and investor-education materials,[185] assurance that each investor has reviewed and understood those disclosures,[186] adoption of fraud-prevention measures,[187] and enactment of investor-verification procedures.[188] Additionally, the intermediary portal must "take such steps to protect the privacy of information collected from investors,"[189] and may not have financial ties to

179. *Id.* § 77d-1(b)(1)(D)(iii).

180. *Id.* § 77d-1(b)(1)(D)(i)(II).

181. *Id.* § 77d-1(b)(4); *cf.* Amendments to Regulation A, *supra* note 16, at 21,836–38 (discussing the associated compliance costs with various SEC accounting and filings requirements based on entity type).

182. *See* 15 U.S.C. § 77d(a)(6)(C) (requiring the use of an intermediary broker or funding portal for each transaction).

183. *See id.* § 77d-1(a) (prescribing affirmative duties for both brokers and funding portals).

184. *Id.* § 77d-1(a)(1)–(2).

185. *Id.* § 77d-1(a)(3).

186. *Id.* § 77d-1(a)(4).

187. *Id.* § 77d-1(a)(5).

188. *Id.* § 77d-1(a)(7)–(8).

189. *Id.* § 77d-1(a)(9).

any issuer using its services.[190] Finally, the portals must be prepared to meet any other requirements that the SEC may prescribe "for the protection of investors and in the public interest."[191]

All affirmative requirements considered, the SEC estimates the cost on intermediaries to be between $417,000 and $770,000 the first year, with an ongoing yearly cost ranging from $90,000 to $270,000.[192] Subtracting a flat $250,000—the one-time cost estimated by the SEC to develop the platform itself—registration and regulatory compliance are estimated between $520,000 and $167,000 initially, and between $130,000 and $50,000 yearly thereinafter.[193] While these costs would be born initially by the intermediaries rather than the issuers themselves, the SEC estimates that the resulting transaction costs imposed on issuers could be anywhere from 5% to 15% of the offering under the § 4(a)(6) exemption.[194] Thus, even an issuance of $100,000 would incur an average of $5,000 to $15,000 in costs merely to facilitate the transaction in the first place, before even considering costs associated with other aspects of compliance with the exemption.

5. State Law Preemption.—Although issuances in reliance on § 4(a)(6) may incur additional intermediary costs, state law is preempted and thus issuers face no supplementary costs associated with state law registration requirements.[195] Nonetheless, this preemption does not extend to state enforcement authority; accordingly, like under Rule 506 and Regulation A+, states retain authority "to take enforcement action with regard to an issuer, funding portal, or any other person or entity using the exemption."[196]

6. Liability.—Although § 4(a)(6) exemptions incur no additional cost associated with state law compliance, they incur more costs associated with liability exposure than any other exemption. In addition to liability under

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190. *See id.* § 77d-1(a)(11) (prohibiting a portal's "directors, officers, or partners (or any person occupying a similar status or performing a similar function) from having any financial interest in an issuer using its services").

191. *Id.* § 77d-1(a)(12).

192. Crowdfunding Proposed Rules, *supra* note 21, at 66,528. The higher estimate is the cost of registration and operation as an intermediary broker, whereas the lower estimate is the cost of registration and operation as a funding portal. *Id.* The practical difference between the two is beyond the scope of this Note.

193. *See id.* at 66,528.

194. *Id.* at 66,529. Note that these estimations depend on the specific intermediary used and the fees charged for those services. *Id.* Furthermore, "competition among potential crowdfunding venues and the potential development of new products and services could have a significant impact on these estimates over time." *Id.*

195. 15 U.S.C. § 77r-1(c).

196. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 305(b)(1), 126 Stat. 306, 322 (2012) (noted at 15 U.S.C. § 77r (2012)).

Rule 10b-5—a relatively low liability risk for issuers and the exclusive source of liability for Rule 506 offerings—§ 4(a)(6) imposes significant attendant costs on both portals and issuers (who may ultimately bear the cost of portals' liability risk in addition to their own). Title III imposes liability on "issuers" akin to § 12(a)(2) liability for any untrue statement or omission of material fact in the offering or sale of the securities.[197] Included in the definition of "issuer" is "any person who offers or sells the security in such an offering"—a catchall provision that would not only encompass the issuers themselves but also intermediary brokers and funding portals engaged in sale.[198] However, while the SEC specifically declined to exempt intermediaries from statutory liability, it recognized in the final rules that treating intermediaries as issuers "may adversely affect funding portals."[199] To remedy this "untenable" framework of strict intermediary liability, the SEC determined that intermediary liability would "turn on the facts and circumstances of the particular matter in question."[200] And as further protection, intermediaries will be allowed to exercise discretion to restrict the offerings or issuers allowed on their platforms.[201]

However, the SEC did recognize that intermediaries should take certain steps to exercise reasonable care in light of their potential liability, and those measures taken to reduce the risk of fraud will not come without a cost.[202] These steps include establishing preventative policies and procedures designed to ensure compliance with the crowdfunding rules as a whole, reviewing the issuers' offering documents for false or misleading information before posting them to their platform, and conducting background and securities-history checks on each issuer, officer, director, or "20 Percent Beneficial Owner" of an issuer to ascertain qualification.[203]

197. *See supra* notes 126–31 and accompanying text (describing § 12(a)(2) liability).

198. 15 U.S.C. § 77d-1(c)(3).

199. Crowdfunding, *supra* note 98, at 71,478.

200. *Id.*

201. *Id.*

202. *Id.* at 71,478–79. The SEC specifically estimates that these measures taken to reduce the risk of fraud will claim an initial 740 hours in intermediaries' time, with an ongoing time requirement of three hundred hours per year. *Id.* at 71,528. Monetarily, intermediaries can expect to spend approximately $13,818 to $34,546 a year using a third party to fulfill the required background and regulatory-history checks. *Id.* at 71,528.

203. *Id.* at 71,528.

IV. Summary of Cost and Access to Potential Investors

As previously mentioned, the economic baseline against which all capitalization options are invariably measured is the availability of the option and comparative benefits and drawbacks of alternatives. In other words, whether an issuer opts to rely on one method as opposed to another depends on the costs and benefits of other capital raising methods available. The preeminent use of Rule 506 in the past[204] illustrates the point that a superior compilation of conditions and allowances built into one method can result in the use of that method largely to the exclusion of others. Below is a comparison of the methods either amended or created by the JOBS Act (i.e., Rule 506, Title IV Regulation A+, and Title III crowdfunding) in terms of cost-effectiveness and access to potential investors. The implications suggest that, in the face of superior offering allowances under Rule 506 and Regulation A+, crowdfunding via § 4(a)(6) will be substantially underemployed.

A. Cost-Effectiveness

Given this past predominance of Rule 506, it is likely that issuers will continue to take advantage of it. Familiarity with the rule's use makes it certain and efficient. And not only is it naturally easiest to maintain the status quo, using Rule 506 is also the least expensive, most flexible, and least restrictive method.[205] Under Rule 506, many costs indigenous to capitalization via Tier 2 and § 4(a)(6) will not apply.[206] For example, the absence of mandatory disclosure requirements to accredited investors, lack of intermediation requirement, state law preemption, and limited liability exposure all amount to a relatively economical way to capitalize.[207] The only potential monetary drawback is the requirement to verify investors' accredited status in order to prevent sales to nonaccredited investors.[208] However, the nonexclusive list of safe-harbor methods helps make this requirement as manageable and certain as possible.

Comparatively, the cost-effectiveness of a Regulation A+ exemption is highly dependent on the amount of capital sought in connection with the issuance and, consequently, whether the issuance will be made pursuant to

204. *See* VLADIMIR IVANOV & SCOTT BAUGUESS, DIV. OF ECON. & RISK ANALYSIS, U.S. SEC. & EXCH. COMM'N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009–2012, at 9 tbl.2 (2013) (reporting that in 2012, 31,471 offerings were made under Regulation D, compared to only 1,473 financed by debt and 518 financed through other exemptions under § 4(a)(2)).

205. *See* Parsont, *supra* note 84, at 317 (explaining why issuers may generally prefer "accredited crowdfunding" instead of crowdfunding under § 4(a)(6)).

206. See *supra* sections II(D)(1)–(6) for a full discussion on the various costs associated with Rule 506.

207. *See supra* sections II(D)(1)–(6).

208. *See supra* section II(D)(1).

Tier 1 or Tier 2.[209] Tier 1 operates as a relatively affordable capitalization method, requiring no investor verification, audited financial statements, or ongoing reporting.[210] However, there will be an additional cost associated with dual compliance with both federal and state securities laws.[211] The ultimate cost of that compliance—given the recentness of the coordinated review program—is not yet certain. But assuming some attendant monetary drawback—a reality suggested by the fact that the SEC acknowledged this aspect of the exemption may inhibit its use[212]—the fallout is that funding through Rule 506 is slightly less expensive in absolute terms. This facially marginal expense may be made even more significant in relative terms, given the unlimited offering limit under Rule 506 and the $20 million cap under Tier 1.[213]

Tier 2 is more costly; an exemption thereunder requires the provision of audited financials and ongoing reporting but does not require compliance with both state and federal law.[214] The costs associated with investor self-verification in Tier 2 are minimal but are an additional consideration nonetheless.[215] Finally, both Tiers are subject to significant liability exposure, which translates into higher insurance costs, higher auditing costs, and higher underwriting fees (if an intermediary is used).[216] Accordingly, the impetus for capitalization under a Regulation A+ exemption, as opposed to a Rule 506 exemption, will not be cost related.

Finally, the affordability of an offering under § 4(a)(6) is comparatively poor vis-à-vis the other exemptions available.[217] In fact, this cost is so high in proportion to the relative benefits that crowdfunding under § 4(a)(6) may be superfluous.[218] Even though it is unlikely there will be any significant costs associated with investor verification, there will undoubtedly be costs passed from intermediaries to issuers in connection

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209. See *supra* sections III(A)(1)–(6) for a full discussion on the various costs associated with Tier 1 and Tier 2 funding under Regulation A+.

210. *See supra* sections III(A)(1), (3).

211. *See supra* section III(A)(5).

212. Amendments to Regulation A, *supra* note 16, at 21,861.

213. *See supra* subparts II(D), III(A). For example, the difference between compliance costs of $1 million and $1.5 million under Rule 506 and Tier 1, respectively, is relatively insignificant. However, expressed as a percentage of $75 million offerings (1%) versus $20 million offerings (7.5%), the cost differential is more pronounced.

214. *See supra* sections III(A)(1), (5).

215. *See supra* section III(A)(1).

216. *See* Parsont, *supra* note 84, at 302–03 (listing the fixed costs associated with heightened liability exposure in the public-company context); *supra* section II(A)(6).

217. See *supra* sections III(B)(1)–(6) for a full discussion on the various costs associated with § 4(a)(6) crowdfunding.

218. *See* Parsont, *supra* note 84, at 317–18 (arguing that the benefits relative to costs associated with Rule 506 "accredited crowdfunding" outweigh those associated with "retail crowdfunding"); Seedinvest, *supra* note 150 (summarizing commentators' assertions that Title III crowdfunding may now be a "relic").

with investor-education requirements—a cost not incurred under any other exemption.[219] And providing information and assuring investor understanding is not cheap.[220] Furthermore, although the disclosure requirements largely mirror those under Regulation A+ in terms of substance and absolute cost, expressed as a percentage of the relatively low offering maximum, these requirements are likely to be incredibly expensive for issuances pursuant to § 4(a)(6).[221] Additionally, issuers relying on § 4(a)(6) would bear an estimated absolute minimum of $5,000 to $15,000 in intermediary fees—a cost entirely absent from compliance with other exemptions.[222] Finally, the expense associated with liability exposure mirrors that under Regulation A+ but is potentially extended to a broader range of parties—not only will issuers bear the costs associated with their own exposure to liability, they may also incur costs passed on by intermediaries seeking to limit their own potential exposure to liability.[223]

B. Access to Potential Investors

In conclusion and assuming all other things being equal—that is, there are no factors beyond cost bearing on an issuer's choice of capitalization method—Rule 506 is the compelling choice for issuers seeking to access capital markets. However, access to potential investors is another key concern when evaluating capital-formation methods. A wide pool of potential investors provides easier access to capital, yet requires both a practical way to reach those investors and a substantive way to obtain their investments—preferably large amounts thereof.

The prohibition of sales to nonaccredited investors is theoretically the primary drawback to making an offering pursuant to Rule 506. Although the recently lifted ban on general solicitation and advertising improves access to potential investors and makes it easier to solicit institutional and accredited investors, the exclusion of over 92% of U.S. households from that pool may be a significant reason to choose another capitalization method.[224] However, while smaller, the accredited pool controls over 70% of available capital.[225] This suggests that what was previously considered

219. *See supra* section III(A)(1).

220. Crowdfunding, *supra* note 96, at 71,511 (estimating an initial cost of $10,000 to $30,000, with an additional ongoing yearly cost of $5,000 to $15,000); *see supra* section III(B)(1).

221. *See supra* section III(A)(3). For example, a disclosure cost expressed as an absolute $150,000 under both § 4(a)(6) and Tier 1 is seemingly equal. However, expressed as a percentage of $1 million offerings (15%) vs. $20 million offerings (.75%), the cost differential is significant.

222. *See supra* section III(B)(4).

223. *See supra* section III(B)(6).

224. *See* Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, *supra* note 67, at 3980 (noting that in 2010 only 7.4% of all U.S. households qualified as accredited investors).

225. Parsont, *supra* note 84, at 284.

the primary advantage of crowdfunding under the JOBS Act—a larger pool of potential investors—might be meaningless as a practical matter.[226]

However, assuming an issuer specifically desires investment from a range of both accredited and unaccredited investors for reasons beyond unmitigated access to capital, that issuer will be unable to rely on Rule 506. In terms of access to investors under the next logical option—Regulation A+—Tier 1 performs very well. Issuances up to $20 million may be sold to an unlimited number of accredited or unaccredited investors, and these individuals may be solicited via testing-the-waters materials subject to minimal procedural regulations.[227] Tier 2 issuances can similarly enjoy testing-the-waters solicitation but are subject to an individual-investment limit when sold to unaccredited investors.[228] This disparate treatment of investors operates as a requirement to sell to accredited investors or to otherwise limit the amount of securities sold, thereby preventing unfettered access to capital. The crux of the decision will ultimately rest on the amount of capital the issuer hopes to raise and an analysis of relative costs implicit in that choice.

Finally, under § 4(a)(6), which was most specifically contemplated for monetization by a broad array of individual investors,[229] issuers may only direct interested individuals to crowdfunding portals—a concession that generally means issuers will only be allowed to distribute a "short teaser."[230] This road to access is undoubtedly narrower than both the broad allowance to solicit investors via testing-the-waters materials under Regulation A+ and the recent accommodation of general solicitation to accredited investors under Rule 506.[231] Although issuers relying on § 4(a)(6) have access to a broader range of investors than do issuers relying on Rule 506—i.e., access to unaccredited and accredited alike—the significant individual investment limitations imposed only serves to increase the cost of raising the desired amount of capital by requiring more work for less return on an individual basis.[232] In comparison to

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226. *See id.* at 317 (suggesting that given these economic realities, Rule 506 offerings "will generally be the logical choice for issuers seeking to crowdfund").

227. *See supra* sections III(B)(1)–(2).

228. *See supra* section III(B)(1).

229. *See* Crowdfunding, *supra* note 96, at 71,388–89 (dubbing § 4(a)(6) crowdfunding as the "new and evolving method of using the Internet to raise capital," and noting that an issuer's principal purpose in using this mechanism will typically be to raise funds in the form of "small individual contributions from a large number of people").

230. *See supra* section III(B)(2).

231. *See* Crowdfunding, *supra* note 96, at 71,484 (illustrating that the manner of offering permitted in Regulation A is "testing the waters" before filing Form 1–A); Parsont, *supra* note 84, at 315 (noting that in accredited crowdfunding, issuers can generally solicit and advertise without any content restrictions like those in § 4(a)(6)).

232. *See supra* sections II(D)(2), III(B)(2). For example, if it costs $50 to reach one investor under both § 4(a)(6) notice advertising and Rule 506 general solicitation, the gross cost to obtain the desired amount of capital can be as disparate as $25,000 and $50, respectively. The estimation

Regulation A+ offerings, § 4(a)(6) offerings are almost obsolete in terms of access to potential investors. Tier 1 allows an issuer to raise an additional $19 million from the same pool of investors, with no individual-investment limits. Even Tier 2 allows issuers to obtain potentially 5% more from a Regulation A+ investor than a comparable unaccredited investor under § 4(a)(6).[233]

Resultantly, an issuer specifically desiring investment from an array of investors made impossible under Rule 506 should rely on Regulation A+, given its superiority to § 4(a)(6) in almost every other consideration.

V. Conclusion and Implications

Taking into consideration all benefits and drawbacks of each exemption, Rule 506 is likely to maintain its status as a highly desirable route to capitalization for businesses not specifically seeking investment from a broader array of investors. While this is the logical and most favorable choice to issuers—and a natural result of efficient economic theory—the consequence is that individual investors will be deprived of the intended benefits of the new exemptions under the JOBS Act—namely, they will still be excluded from meaningful participation in the investment market.[234]

Alternatively, issuers who hope to benefit from access to a more diffuse investor base will find a relatively flexible and affordable solution under Regulation A+, which largely obviates the need for § 4(a)(6). When measured solely against Rule 506, § 4(a)(6) provided a meaningful new way to increase access to capital and spur business growth, but the recent introduction of the final Regulation A+ rules makes the headlines proclaiming the death of Title III crowdfunding ring true.[235]

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under § 4(a)(6) is reached by assuming an issuer seeking the maximum $1 million manages to raise the maximum $2,000 from 500 investors whose net worth or annual income is less than $100,000 ($1 million raised = $2,000 investment × 500 investors). Contrastingly, an issuer seeking to raise an unlimited amount of capital under Rule 506 may, theoretically, raise the entire amount from one accredited investor at a cost of only $50.

233. *See supra* sections III(A)(1), (B)(1). The ability under Tier 1 to raise $20 million as opposed to $1 million from an identical pool of accredited and unaccredited investors is a clear advantage over § 4(a)(6). A less absolute but still distinct advantage exists under Tier 2, whereby an issuer may raise up to $50 million as opposed to $1 million from an identical pool of unaccredited investors, with individual investment limits as much as 10% as opposed to 5% for lesser earning individuals under § 4(a)(6).

234. See *supra* Part I for a discussion of individual investors' role in the impetus behind the JOBS Act.

235. *E.g.*, Victoria Silchenko, *Equity Crowdfunding Is Dead—Long Live Equity Crowdfunding*, HUFFINGTON POST (Mar. 6, 2015, 2:59 PM), http://www.huffingtonpost.com/victoria-silchenko/equity-crowdfunding-is-de_b_6813872.html [http://perma.cc/ZJF4-XUPM].

Even a company seeking to raise a relatively small amount of capital—like Oculus Rift's $2.4 million—will find that Title III's low capital ceiling renders it useless. With the advent of Regulation A+, such companies specifically seeking to capitalize through a widespread fan base can raise at least twenty times the amount of capital that would be possible under Title III. And for those companies unlike Oculus Rift, whose goal is to raise capital irrespective of who it comes from, Rule 506 will still be the simplest and most cost-effective method available.

—Paige M. Lager