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Private Inequity: Reform Rule 506 to Safely Accommodate Investment by Nonaccredited Investors

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PRIVATE INEQUITY: REFORM RULE 506 TO SAFELY ACCOMMODATE INVESTMENT BY NONACCREDITED INVESTORS

ALLEN C. PAGE*

ABSTRACT

In 2012, Congress enacted Title III of the Jumpstart Our Business Startups Act (the "JOBS Act"), which it named the Crowdfund Act, to create an exemption from registration under the Securities Act of 1933 that, in the words of President Barack Obama, would allow "ordinary Americans . . . to go online and invest in entrepreneurs that they believe in." While perhaps well-intentioned in principle, Regulation Crowdfunding imposes material limitations and costs on the issuer, leading most issuers to conclude that the inclusion of unaccredited investors in a crowdfunding campaign is not worth the complexity and expense. Furthermore, the most heavily utilized exemptions from registration, contained in Rule 506, either expressly prohibit the inclusion of unaccredited investors or incentivize the exclusion of unaccredited investors due to burdensome disclosure requirements. Therefore, unaccredited investors are largely structurally excluded (whether explicitly or implicitly) from the vast majority of investment opportunities in private companies. Indeed, many counsels actively advise their clients not to raise capital from unaccredited investors for the reasons discussed above. This result makes little sense when unaccredited investors have the ability, from a securities law perspective, to invest unlimited capital into high-risk publicly traded "penny stocks" in the over-the-counter (OTC) markets without restriction, but are then functionally excluded in practice from investing an appropriate amount of funds alongside experienced accredited investors in most private offerings.

* Assistant Professor, Baylor Law School; JD, CPA. A special thanks to my research assistants Tristan Kaisharis, Miles Emery, and Ben Meredith, for providing valuable contributions to this Article and to my family, friends, and mentors who supported me during the writing of this Article.

Furthermore, companies conducting a Regulation Crowdfunding offering often resort to such an offering due to failure to raise sufficient capital under Rule 506. Thus, unaccredited investors are often resigned to the "bottom of the barrel" in the world of private offerings, with issuers being disincentivized to include them in higher-quality private offerings due to increased cost and inconvenience.

This Article explores how the exemptions in Rule 506 could be reformed to remove regulatory barriers and disincentives for the inclusion of unaccredited investors while also including aspects of Regulation Crowdfunding and other exemptions that afford reasonable investor protections for unaccredited investors. Specifically, Part I of this Article reviews Title III and Regulation Crowdfunding, as well as both Rule 506(b) and Rule 506(c), to provide context for analysis. Part II of this Article then reviews recent legislation, rulemaking, and guidance that sought to bolster Regulation Crowdfunding to encourage greater utilization by issuers and investors. Finally, Part III of this Article explores how the Rule 506 exemptions could be reformed to allow unaccredited investors a meaningful opportunity to participate in such offerings without penalizing the issuer while still maintaining reasonable investor protections for such investors. Ultimately, this Article recommends reforms to the Rule 506 exemptions that would allow unlimited participation by unaccredited investors while maintaining adequate protections for unaccredited investors through reasonable investment limits and meaningful co-investment alongside accredited investors, rather than defaulting to costly and complex disclosure requirements or requiring intermediaries, such as funding portals or brokers.

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INTRODUCTION

In most exempt offerings under the Securities Act of 1933 (the "1933 Act"), if an issuer can complete an unregistered offering with accredited investors, it makes little sense to also include unaccredited investors in the offering.[1] In general, unaccredited investors will, on average, make smaller investments than accredited investors, and including such investors in a private offering results in increased offering costs, typically due to increased disclosure requirements.[2] This construct naturally leads issuers to invite only accredited investors to participate in stronger private offerings, typically using the exemptions in Rule 506(b) or Rule 506(c),[3] and only if necessary, resort to including unaccredited investors under an exemption, such as Regulation Crowdfunding, in offerings that could not garner enough interest from accredited investors.[4] The Securities and Exchange Commission (SEC) presumes

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[1] Thomas M. Selman, *Protecting Retail Investors: A New Exemption for Private Securities Offerings*, 14 VA. L. & BUS. REV. 41, 54 (2020).

[2] *Id.* (noting "[a]dditionally, even if Rule 506 did protect non-accredited investors, it hardly encourages access by non-accredited investors to private placements. These investors generally purchase in smaller amounts compared to accredited investors. Therefore, the limited benefit of placing private shares in the hands of the non-accredited investors typically will be exceeded by the cost of preparing the disclosure, limiting the offering to 35 non-accredited investors, and appraising the knowledge and experience of the investor or his purchaser representative."); *see also* 17 C.F.R. § 230.506(b)(1) (2022) and 17 C.F.R. § 230.502 (collectively requiring significant additional disclosures similar to a Regulation A offering if unaccredited investors are included in an offering exempt from registration under Rule 506(b)); 17 C.F.R. §§ 230.252–.257 (2022) (requiring significant filing and ongoing disclosure requirements under Regulation A); 17 C.F.R. §§ 227.201–.202 (2022) (requiring significant filing and ongoing disclosure requirements under Regulation Crowdfunding); 15 U.S.C. § 77d(a)(2); Allen C. Page, *Approaching the Tipping Point For "Public-Private Offerings": The Current Trajectory of Rule 506(c)*, 17 J. BUS. & TECH. L. 26, 26, 49 (2022).

[3] 17 C.F.R § 230.506(b)–(c) (2022).

[4] Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons*, 100 MINN. L. REV. 561, 588–93 (noting that "[s]elling to unaccredited investors involves considerably more risk than selling to accredited investors, even under relaxed rules," and that "[s]tartups have historically preferred to use Rule 506 to raise funds from accredited investors only, and there is unlikely to be a sea change toward seeking out unaccredited investors."). The SEC notes that "[i]ssuers may opt to initially rely on Regulation D rather than

that increased disclosure will protect unaccredited investors, but in practice, the current exemption framework functionally filters out the stronger investment opportunities, primarily leaving weaker opportunities to unaccredited investors.[5] If fully understood, many unaccredited investors would likely not appreciate this type of "protection" from the SEC and would rather prefer more reasonable access to the higher-quality private offerings from which they are currently functionally excluded.[6]

In 2012, the Jumpstart Our Business Startups Act (JOBS Act)[7] seemingly provided a glimmer of hope to unaccredited investors seeking to reap the rewards of private company investments as President Barack Obama announced at its passage that "[f]or the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in."[8] However, this statement assumed that issuers and securities practitioners would actually utilize the new exemptions afforded by the JOBS Act that allow participation of unaccredited investors, such as Regulation Crowdfunding,[9] rather than resort to historical practice and utilize exemptions that are primarily or exclusively used for offerings to accredited investors.[10] It has now been approximately

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Regulation Crowdfunding, to postpone having to provide the disclosures required by Form C." SEC, REP. TO THE COMM'N: REGULATION CROWDFUNDING, at 35 (2019) [hereinafter REGULATION CROWDFUNDING REP.], https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf [https://perma.cc/JY83-8P9T].

[5] *See* Ibrahim, *supra* note 4, at 588, 592.

[6] *See id.*

[7] Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[8] Barack Obama, *Remarks on Signing the Jumpstart Our Business Startups Act*, THE AM. PRESIDENCY PROJECT (Apr. 5, 2012) (transcript available at https://www.presidency.ucsb.edu/documents/remarks-signing-the-jumpstart-our-business-startups-act [https://perma.cc/FG2H-FH6L]) (stating "[a]nd for startups and small businesses, this bill is a potential game changer. Right now you can only turn to a limited group of investors, including banks and wealthy individuals, to get funding. Laws that are nearly eight decades old make it impossible for others to invest. But a lot's changed in 80 years, and it's time our laws did as well. Because of this bill, startups and small business will now have access to a big new pool of potential investors, namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.").

[9] 17 C.F.R. § 227 (2022).

[10] *See* Ibrahim, *supra* note 4.

a decade since the passage of the JOBS Act, and recent data concerning exempt offerings demonstrates continued modest participation by unaccredited investors in private offerings.[11] According to a recent study by the SEC's Division of Economic and Risk Analysis, approximately 92% of private offerings were conducted using Regulation D,[12] and "[n]onaccredited investors were present in only 9% of Regulation D offerings."[13] Furthermore, in terms of the amount of capital raised, the Advocate for Small Business Capital Formation of the Securities and Exchange Commission noted in its 2020 report that from July 1, 2019, to June 30, 2020, that Rule 506(b) accounted for approximately $1.4 trillion in capital raised, while Regulation A, Rule 504 and Regulation Crowdfunding, which more commonly includes unaccredited investors, accounted for $1.3 billion, $171 million, and $88 million, respectively, in capital raised.[14] This means Regulation D offerings accounted for 875 times more in capital raised than in all Regulation A, Rule 504, and Regulation Crowdfunding offerings combined.[15] The above data demonstrate that unaccredited investors participate in only a small percentage of private offerings and make up a low percentage of investments in the private offering landscape.[16] This result makes some intuitive sense generally, given that unaccredited investors typically have less money to invest in opportunities than accredited investors.[17] However, we also see that securities laws structurally exclude or functionally limit unaccredited investors from participation in offerings using the Rule 506 exemptions, which are the most common offering types in which accredited investors regularly invest.[18] This dynamic

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[11] *See, e.g.*, notes 12–14 and accompanying text.

[12] Scott Bauguess et al., *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009–2017*, SEC, at 9 (2018), https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf [https://perma.cc/2QT5-3C5H] (noting that 37,785 of the 41,101 total private offerings in 2017 were conducted using Regulation D).

[13] *Id.* at 2.

[14] *See* OFF. ADVOC. FOR SMALL BUS. CAP. FORMATION, SEC, ANN. REP. FOR FISCAL YEAR 2020, at 17 (2020), https://www.sec.gov/files/2020-oasb-annual-report.pdf [https://perma.cc/U34N-DYFM].

[15] *Id.*

[16] *See supra* notes 13–15.

[17] *See* Selman, *supra* note 1, at 54.

[18] *Id.*

exacerbates the possibility, or even probability, that, in most cases, unaccredited investors only have access to less attractive private offerings than their accredited counterparts.[19]

This Article explores how the exemptions in Rule 506 could be reformed to remove regulatory barriers and disincentives for the inclusion of unaccredited investors while also including aspects of Regulation Crowdfunding and other exemptions that afford reasonable investor protections for unaccredited investors.[20] Specifically, Part I of this Article reviews section 4(a)(6) and Regulation Crowdfunding,[21] as well as both Rule 506(b)[22] and Rule 506(c),[23] to provide context for analysis.[24] Part II of this Article then reviews recent legislation, rulemaking, and guidance that seeks to bolster Regulation Crowdfunding to encourage greater utilization by issuers and investors.[25] Finally, Part III of this Article explores how Rule 506(b) and Rule 506(c) could be reformed to allow unaccredited investors a meaningful opportunity to participate in such offerings without penalizing the issuer while still maintaining reasonable investor protections for such investors.[26] Ultimately, this Article recommends reforms to Rule 506(b) and Rule 506(c) that would allow unlimited participation by unaccredited investors while maintaining adequate protections for unaccredited investors through reasonable investment limits and meaningful co-investment alongside accredited investors, rather than requiring costly and complex disclosure requirements or use of intermediaries, such as funding portals or brokers.[27]

I. Summary of Regulation Crowdfunding and the Rule 506 Exemptions

Nearly all exemptions to registration under the 1933 Act allow for the inclusion of unaccredited investors in the applicable

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[19] *See* Ibrahim, *supra* note 4, at 588–89, 592.
[20] *See infra* Part III.
[21] 15 U.S.C. § 77d(a)(6) (2018); 17 C.F.R. § 227.
[22] 17 C.F.R. § 230.506(b).
[23] 17 C.F.R. § 230.506(c).
[24] *See infra* Part I.
[25] *See infra* Part II.
[26] *See infra* Part III.
[27] *See infra* Conclusion.

offering.[28] Thus, on the surface, it would seem the 1933 Act provides unaccredited investors adequate access to the private markets.[29] However, upon further inspection of the available exemptions and their relative usage by issuers, it becomes clear that unaccredited investors have very limited access to the private markets compared to their accredited counterparts.[30] While part of the rationale for this divide likely relates to unaccredited investors having less capital to deploy than their accredited counterparts, the 1933 Act also structurally discourages issuers from including unaccredited investors in an offering where accredited investors can adequately complete the financing round.[31]

To discuss whether regulatory reforms could and should address this issue, this Article will specifically review Rule 506(b), Rule 506(c), and Regulation Crowdfunding.[32] This Article focuses on Rule 506(b) and Rule 506(c) because they are the most heavily utilized exemptions by issuers in securities offerings.[33] In contrast, this Article then focuses on the rarely utilized Regulation Crowdfunding, as its offerings disproportionately include unaccredited investors[34] and also share fundamental similarities to the Rule 506 exemptions with respect to federal preemption over state law and restrictions on the resale of issued securities.[35] No

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[28] The only issuer exemptions that expressly exclude investment by unaccredited investors are Rule 506(c) and section 4(a)(5). *See* 17 C.F.R. § 230.506(c); 15 U.S.C. § 77d(a)(5). Furthermore, Rule 144A is a private resale exemption often used by issuers in combination with the private placement exemption in section 4(a)(2) and only permits resales to qualified institutional buyers. *See* 15 U.S.C. § 77d(a)(2); 17 C.F.R. § 230.144A (2022).

[29] *See* 17 C.F.R. § 230.506(c).

[30] *See supra* notes 13–15 and accompanying text.

[31] *See supra* note 19 and accompanying text.

[32] The Appendix to this Article provides a chart summarizing an analysis of the availability of exemptions to unaccredited investors.

[33] *See supra* note 14 and accompanying text.

[34] REGULATION CROWDFUNDING REP., *supra* note 4, at 39 (showing that from May 16, 2016, to December 31, 2018, available offering data for 111 crowdfunding offerings revealed participation by an average of 349 unaccredited investors and 67 accredited investors per issuer).

[35] 15 U.S.C. § 77r(b)(3)–(4)(C), (F); 17 C.F.R. § 227.504 (2022) (collectively, providing that both Rule 506 exemptions and Regulation Crowdfunding preempt state securities laws). *Compare* 17 C.F.R. § 230.144(a)(3)(i) (2022) (providing that securities issued pursuant to the Rule 506 exemptions are "restricted securities," which imposes, among other things, a one-year holding period with respect to securities of an issuer that is not a reporting company under

other exemptions from registration used in practice have this same combination of features in a multistate offering.[36] The SEC designed Rule 147A[37] and Rule 504 to foster regional or intrastate offerings pursuant to state registration requirements (or exemptions therefrom), so by their nature, they are not scalable to facilitate large-scale national offerings.[38] The primary attraction of Regulation A, in contrast to other exemptions from registration, is an issuer's ability to issue unrestricted securities, thus affording unlimited resales of such securities without registration, subject to limitations on issuer affiliates under Rule 144.[39] If an issuer desires to issue unrestricted securities to investors, including unaccredited investors, then such issuer must provide heightened disclosure and undertake ongoing reporting requirements in any such offering, whether under Regulation A or in a registered offering under section 5 of the 1933 Act.[40] Because the desire to issue unrestricted securities may logically cause an issuer to comply with Regulation A, it is a less comparable exemption to the heavily-utilized Rule 506 exemptions than Regulation Crowdfunding.[41] Thus, by only focusing on the Rule 506 exemptions in contrast to Regulation Crowdfunding, this analysis can focus solely on the impact of investor protections through required disclosure and offering limitations, rather than factors related to the geographical scope of a raise or the desire of an issuer to deliver unrestricted securities inherent to other exemptions.[42]

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the Securities and Exchange Act of 1934), *with* 17 C.F.R. § 227.501 (2022) (providing that securities issued pursuant to Regulation Crowdfunding are subject to a one-year holding period, other than to the issuer, accredited investors, or other listed exceptions to such restriction).

[36] Technically, the exemption in section 4(a)(5) of the 1933 Act could be added to the list of exemptions with these same features, but Rule 506(b) effectively subsumes the utility of section 4(a)(5) given that these two exemptions are nearly identical, except that section 4(a)(5) has an offering limit of only $5 million and limits the offering to only accredited investors. *Compare* 17 C.F.R. § 230.506(b), *with* 15 U.S.C. § 77d(a)(5).

[37] Note that Rule 147A fully encompasses the benefits of the exemptions in Section 3(a)(11) and Rule 147 and also allows issuers incorporated in another state to conduct an intrastate offering in the state of the issuer's primary place of business. 15 U.S.C. § 77c(a)(11); 17 C.F.R. §§ 230.147–.147A (2022).

[38] *See* 17 C.F.R. § 230.147A; *see also* 17 C.F.R. § 230.504.

[39] 17 C.F.R. § 230.144.

[40] 17 C.F.R. § 230.257.

[41] 17 C.F.R. § 230.251.

[42] *See infra* Section I.A.

A. Rule 506(b)—The Traditional and Most Common Exemption

Rule 506(b) in Regulation D is the hallmark private placement exemption used by issuers in the vast majority of private offerings. Rule 506(b) was enacted as a safe harbor to section 4(a)(2) of the 1933 Act in 1982 to provide better certainty of compliance to issuers desiring to conduct a private offering of securities.[43] Due to its relative ease and certainty of compliance, Rule 506(b) has grown into the most popular exemption under the 1933 Act, both in terms of the number of transactions and aggregate offering amounts.[44] From July 1, 2019, to June 30, 2020, total offerings under Rule 506(b) resulted in an aggregate offering amount of approximately $1.4 trillion, exceeding the combined total of all other exempt offering types.[45] Furthermore, when excluding Rule 144A transactions,[46] offerings under Regulation D in 2017 accounted for approximately 97% of all private offerings, and Rule 506(b) accounted for approximately 93% of all new offerings under Regulation D.[47] Thus, the data clearly shows that Rule 506(b) is the predominant exemption in private offerings.[48]

As expected, based on the above data, Rule 506(b) provides many advantages to issuers desiring to raise capital, particularly from accredited investors.[49] Specifically, this exemption allows an issuer to raise unlimited amounts of capital from an unlimited number of accredited investors with minimal disclosure requirements to such investors,[50] all while preempting state securities registration requirements.[51] This strong combination of material advantages is unique to Rule 506(b) and the more recently enacted

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[43] Page, *supra* note 2, at 32 n.26.

[44] Bauguess et al., *supra* note 12, at 8–10, 16.

[45] *See* SEC *supra* note 14, at 17.

[46] Rule 144A offerings primarily consist of large debt transactions that only afford participation by qualified institutional buyers. Thus, unaccredited investors cannot participate in these offerings. Rule 144A offerings accounted for 2,099 of 41,101 private offerings conducted in 2017 (or 5.1%). Bauguess et al., *supra* note 12, at 9.

[47] Bauguess et al., *supra* note 12, at 9, 16.

[48] *See supra* notes 45–47 and accompanying text.

[49] *See supra* notes 43–48 and accompanying text.

[50] 17 C.F.R. § 230.506(b); 17 C.F.R. § 230.502(b). Note that this is still subject to anti-fraud rules.

[51] 15 U.S.C. § 77r(b)(4)(F).

Rule 506(c) discussed further below.[52] Rule 506(b) also limits the level of due diligence that an issuer must conduct on its accredited investors by requiring only that the issuer "reasonably believes" that the investor meets the definition of "accredited investor" under Rule 501 of Regulation D at the time of sale of the applicable securities to such investor.[53] Issuers customarily meet this "reasonable belief" standard by having an investor certify that it meets one or more definitions of an accredited investor under Rule 501 in a questionnaire that the investor completes and returns prior to the closing of the offering.[54] The only major limitation under a Rule 506(b) offering to accredited investors, as compared to other exemptions, is that the issuer is prohibited from engaging in general solicitation in the offering.[55] While the prohibition of general solicitation does create some compliance risk, its adverse impact on the issuer's ability to raise capital was recently significantly mitigated in the SEC's November 2020 amendments, where Rule 152 and Rule 502(a) were amended to minimize the application of the integration doctrine on offerings conducted under Regulation D.[56] Because of these amendments, issuers may now rely on an integration safe harbor that allows an issuer to conduct a private placement under Rule 506(b), which prohibits general solicitation, and then conduct an offering that affords general solicitation, such as Rule 506(c), immediately following the completion or termination of such offering.[57] For context, the

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[52] *See* Page, *supra* note 2, at 29.

[53] Rule 501(a) defines "accredited investor" as any person that the issuer "reasonably believes" comes within any of the categories listed in the definition. 17 C.F.R. § 501(a). As discussed below, Rule 506(c)(2)(ii) requires additional verification of accredited investors that are not included in Rule 506(b). 17 C.F.R. § 230.506(c).

[54] Note that while accredited investor forms may help establish a "reasonable belief" that an investor meets the definition in Rule 501(a), the SEC has warned that "checking a box" may not be sufficient to form a substantive relationship with such an investor (and thus avoid the prohibition against general solicitation under Rule 506(b)) absent other factors. *See* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3,496, 3,505 (Jan. 14, 2021) [hereinafter November 2020 Amendments].

[55] *See* 17 C.F.R. § 230.506(b); *see also* 17 C.F.R. § 230.502(c).

[56] *See* November 2020 Amendments, *supra* note 54, at 3,499–517.

[57] 17 C.F.R. § 230.152(b)(4) (2022). Note that the revised integration rules also afford an issuer to rely on an integration safe harbor when initially conducting

prior integration rules only provided a six-month safe harbor in both of the foregoing cases, thus preventing an issuer from efficiently sequencing these offering types without a material risk of integration.[58] Thus, with these recent amendments in place, Rule 506(b) has become an even more compelling exemption for issuers, with the SEC lessening the impact of its most significant limitation without changing the exemption's overwhelming benefits.[59]

However, the benefits of this exemption change dramatically when unaccredited investors are included in a Rule 506(b) offering.[60] As an initial matter, Rule 506(b) limits the number of unaccredited investors that may participate in the offering to thirty-five investors within a ninety-day period, thus creating some additional compliance risk in an offering with a large number of investors.[61] Furthermore, the issuer must reasonably believe that the unaccredited investor "has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment" prior to making a sale to such an investor.[62] While an investor questionnaire may help form a reasonable belief that an unaccredited investor meets this sophistication requirement, this standard is certainly less objective than the bright-line definition of "accredited investor," thus increasing the risk of non-compliance.[63] Finally, and most importantly, an issuer must furnish substantial

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an offering that affords general solicitation, such as Rule 506(c), and then conducting a Rule 506(b) offering, without general solicitation, by waiting thirty days after the completion or termination of the initial offering affording general solicitation, but the issuer must also comply with the general integration requirements for offerings prohibiting general solicitation under Rule 152(a)(1) in the Rule 506(b) offering, which partly undermines the certainty of compliance with this safe harbor. *See* 17 C.F.R. § 230.152(b)(1) (2022); *see also* 17 C.F.R. § 230.152(a)(1) (2022). Therefore, when practical, issuers would be well advised to sequence a Rule 506(b) offering prior to a Rule 506(c) offering to reduce compliance risks. 17 C.F.R. § 230.506(b)–(c).

[58] 17 C.F.R. § 230.502(a) (2013) *amended by* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3,598 (Jan. 14, 2021) (to be codified at 17 C.F.R. Pt. 230)).

[59] *Id.*

[60] *See infra* notes 61–64 and accompanying text.

[61] 17 C.F.R. § 230.506(b)(2)(i).

[62] 17 C.F.R. § 230.506(b)(2)(ii).

[63] *Compare* 17 C.F.R. § 230.501(a), *with* 17 C.F.R. § 230.506(b)(2)(ii).

disclosures under Rule 502(b) that are similar to a Regulation A offering to unaccredited investors participating in the Rule 506(b) offering and should also provide such disclosures to accredited investors in the offering to promote compliance with federal anti-fraud rules, such as section 17 of the 1933 Act or Rule 10b-5 of the Securities and Exchange Act of 1934 (1934 Act).[64]

This last requirement, in particular, significantly increases both the compliance risk and cost of a Rule 506(b) offering.[65] The compliance risk increases materially for a couple of reasons. First, the issuer must now meet the technical disclosure requirements of Rule 502(b)(2), which in recent rule amendments have incorporated similar disclosure requirements as required by Regulation A on Form 1-A.[66] These disclosures include financial statements[67] and other significant nonfinancial disclosures, such as a description of the offering, a description of the issuer's business, management's discussion and analysis of the issuer's financial condition, and results of operations and executive compensation.[68] Secondly, even if an issuer manages to complete the disclosure requirements of Rule 502(b)(2), the issuer now has

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[64] 17 C.F.R. § 230.502(b)(1); *see supra* note 50. Section 17 of the 1933 Act allows the SEC to bring an enforcement action against an issuer for intentional fraud (with scienter) or negligent material misrepresentations or omissions. 15 U.S.C. § 77q (2018). Rule 10b-5 of the 1934 Act provides a cause of action to both the SEC and private plaintiffs if an issuer, with scienter, commits fraud or makes material misrepresentations or omissions in connection with the purchase or sale of securities. 17 C.F.R. § 240.10b-5 (2022). Providing disclosure only to unaccredited investors and not accredited investors in an offering, though technically allowed by Rule 502(b)(1), creates a notable risk that accredited investors or the SEC could later claim that the issuer omitted material facts from disclosures to accredited investors that were provided to unaccredited investors, which made the partial disclosures to accredited investors misleading. Even if scienter could not be established under Rule 10b-5, the SEC could still pursue the issuer for negligently omitting such information in disclosures to accredited investors. Practically, given that the information is already available when disclosing to unaccredited investors, issuers are well-advised to provide the same disclosure to both accredited and unaccredited investors in a Rule 506(b) offering.

[65] *See supra* note 64 and accompanying text.

[66] 17 C.F.R. § 230.502(b); 17 C.F.R. § 230.252.

[67] Similar to Regulation A, financial statements required by Rule 502(b)(ii) may be unaudited if the aggregate offering amount is below $20 million and must be audited if the aggregate offering amount is more than $20 million.

[68] 17 C.F.R. § 230.502(b)(ii); 17 C.F.R. § 239.90 (2022).

heightened risk under Rule 10b-5 of the 1934 Act due to the substantially increased number of disclosures made concerning the company and the offering.[69] Not only must these disclosures be free of material misstatements, but the disclosures must also provide sufficient context to avoid omitting a material fact that makes any included disclosure misleading, even if technically accurate.[70] In short, these additional disclosure requirements lay a heavy compliance burden upon issuers and create significantly more fodder for future securities litigation.[71] Because of the increased compliance risk, attendant increases in cost naturally coincide with these disclosures in the form of professional fees and heightened management attention to help ensure that the issuer meets its notable compliance burden without material misstatements or omissions.[72] For these reasons, a number of practitioners rightly advise their clients not to include unaccredited investors in a Rule 506(b) offering.[73] Recent data shows the impact of these factors, with the SEC estimating that, during 2019, only between 4.45% and 9% of offerings under Rule 506(b) included unaccredited investors.[74] Thus, while the SEC has technically afforded the inclusion of unaccredited investors in a Rule 506(b) offering, they have functionally excluded such investors from these offerings in the vast majority of cases by strongly disincentivizing issuers from including them.[75]

B. Rule 506(c)—Accredited Crowdfunding

Rule 506(c) is a relatively new exemption promulgated by the SEC in response to Title II of the JOBS Act in 2012.[76] Similar to

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[69] *See supra* note 64.

[70] 17 C.F.R. § 240.10b-5.

[71] *See supra* notes 64, 70 and accompanying text.

[72] *See* Selman, *supra* note 1, at 54.

[73] *See, e.g.*, Derek Colla, *Can You Raise Money from Investors Who Are Not "Accredited Investors"?*, COOLEYGO (Mar. 10, 2021), https://www.cooleygo.com/can-you-raise-money-from-unaccredited-investors/ [https://perma.cc/GVN3-AKHG].

[74] November 2020 Amendments, *supra* note 54, at 3,509 n.127 ("Based on the analysis of Form D data on initial Form D filings, we estimate that, in 2019 among all Rule 506(b) offerings by issuers other than pooled investment funds, between approximately 4.45[%] and 9[%] of offerings included non-accredited purchasers."); *see also* Bauguess et al., *supra* note 12, at 2 ("Non-accredited investors were present in only 9[%] of Regulation D offerings.").

[75] *See id.*

[76] JOBS Act, 126 Stat. 306, at 313; 17 C.F.R. § 230.506(c).

its historical counterpart, Rule 506(b), this exemption allows issuers to raise unlimited amounts of capital from an unlimited number of accredited investors with minimal required disclosures, subject to the anti-fraud provisions of the 1933 Act and 1934 Act.[77] Another significant benefit that mirrors Rule 506(b) is that an offering under Rule 506(c) preempts state registration requirements, which might otherwise require additional disclosures and fees that would make such an offering increasingly complex and expensive.[78] Unlike Rule 506(b), Rule 506(c) expressly prohibits the participation of unaccredited investors[79] but allows the issuer to utilize general solicitation in the capital raise process to solicit accredited investors with whom the issuer has no prior substantive relationship.[80] While this exemption was intended to substantially increase access to capital in connection with the JOBS Act by allowing for general solicitation,[81] which is strictly prohibited by the widely utilized Rule 506(b),[82] a number of factors ultimately stifle the use of this exemption by issuers, including the requirement that issuers must take reasonable steps to verify that investors in the offering are indeed accredited investors.[83]

Some scholars have referred to this exemption as "accredited crowdfunding," given the ability of the issuer to use general solicitation in the offering process.[84] Indeed, it was passed at the same time as Regulation Crowdfunding, discussed further below, which allows for general solicitation of both accredited and unaccredited investors, subject to several conditions.[85] From an

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[77] 17 C.F.R. § 230.506(c). Note that Rule 506(c)(1) does not require compliance with Rule 502(b), which otherwise requires disclosures for offerings under Regulation D, similar to a Regulation A offering. *See* 17 C.F.R. § 230.502(b)(ii); 17 C.F.R. § 239.90 (2022).

[78] 15 U.S.C. § 77r(b)(4)(F).

[79] 17 C.F.R. § 230.506(c)(2)(i).

[80] 17 C.F.R. § 230.506(c)(1) (providing that availability of Rule 506(c) does not require compliance with Rule 502(c), which otherwise prohibits the use of general solicitation in an offering under Regulation D.); *see* 17 C.F.R. § 230.502(c).

[81] JOBS Act, 126 Stat. 306, at 316–17.

[82] 17 C.F.R. § 230.506(b)(1) (requiring compliance with general solicitation restrictions in Rule 502(c)).

[83] 17 C.F.R. § 230.506(c); Page, *supra* note 2, at 33.

[84] Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. 281, 323 (2014).

[85] *See infra* Section I.C.

analysis of offering data from the SEC's Division of Economic and Risk Analysis, we see that Rule 506(c) is used much more extensively than Regulation Crowdfunding, suggesting that when an issuer decides to embark upon these unregistered "private-public offerings," unaccredited investors will not have the opportunity to participate in most cases.[86] The rationale for an issuer's use of Rule 506(c) rather than Regulation Crowdfunding is discussed further below.[87]

C. Regulation Crowdfunding—The Unaccredited Crowdfunding Experiment

On October 30, 2015, the SEC adopted final rules for Regulation Crowdfunding to give life to section 4(a)(6) of the 1933 Act, enacted by Title III of the JOBS Act on April 5, 2012.[88] These rules became effective on May 16, 2016.[89] From inception, this exemption contained significant limitations that would limit its widespread use by well-developed private companies.[90] Section 4(a)(6) and Regulation Crowdfunding initially limited the total offering size to $1 million in a twelve-month period,[91] which the SEC recently raised to $5 million under Regulation Crowdfunding.[92] Furthermore, this exemption requires that the issuer use a funding portal or broker-dealer, meaning that the issuer must pay an intermediary in order to comply with this exemption.[93] Finally, the issuer must provide material disclosures to complete the offering and on an annual basis, including certified, reviewed, or audited financial statements in accordance with generally accepted accounting principles.[94] Predictably,

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[86] *See* SEC *supra* note 14, at 11 (providing that from July 1, 2019, to June 30, 2020, U.S. businesses raised approximately $69 billion under Rule 506(c) and only approximately $88 million under Regulation Crowdfunding).

[87] *See infra* Section I.C.

[88] 17 C.F.R. § 227 (2022).

[89] *Id.*

[90] JOBS Act, 126 Stat. 306, at 316–17.

[91] 15 U.S.C. § 77d(a)(6).

[92] November 2020 Amendments, *supra* note 54, at 3,499.

[93] 15 U.S.C. § 77d-1 (2018); 17 C.F.R. §§ 227.303–.400 (2022).

[94] *See* 17 C.F.R. § 227.201 (2022). In connection with an offering under Regulation Crowdfunding, Rule 201(t) requires disclosure of financial statements with varying levels of assurance based upon the offering amount. For

most private companies avoid using this exemption,[95] given that other exemptions, such as Rule 506(b), require little disclosure and have much fewer restrictions when raising funds from accredited investors.[96] There is also some evidence that issuers utilizing Regulation Crowdfunding are relegated to crowdfunding from unaccredited investors after not completing their capital raise objectives under Rule 506.[97] Recent data also shows that Regulation Crowdfunding primarily attracts very early-stage companies with a higher risk profile than more established private companies.[98] In fact, one scholar summed it up nicely when calling Title III of the JOBS Act a "market for lemons."[99] Considering the additional time and expense of conducting a Regulation Crowdfunding offering, it seems that a logical issuer would not use Regulation Crowdfunding unless it has no ability to raise sufficient capital from accredited investors under Rule 506(b) or Rule 506(c).[100] Thus, in most cases, investors should perhaps see an offering under Regulation Crowdfunding as a "red flag" for investment, and the SEC should be concerned that the riskiest (if not unadvisable) opportunities are being filtered

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any offering in excess of $535,000, the issuer's financial statements must be audited in most cases and at least reviewed by external auditors. Furthermore, pursuant to Rule 202(a) of Regulation Crowdfunding, the issuer must disclose its financial statements on an annual basis with its annual report, and such financial statements must be certified by its principal executive officer, or if available, the issuer must submit audited or reviewed financial statements.

[95] *See supra* note 86 and accompanying text.

[96] *See supra* Section I.A.

[97] REGULATION CROWDFUNDING REP., *supra* note 4, at 35–36 (revealing that 73% of issuers using Regulation Crowdfunding in the study previously conducted an offering under Rule 506(b)). This report further notes that

> [c]rowdfunding issuers may rely on Regulation D for various reasons, such as to ensure that the Regulation Crowdfunding offering remains within the required limit, to draw a different investor pool (such as accredited investors), or to avoid investment limits. Issuers may opt to initially rely on Regulation D rather than Regulation Crowdfunding, to postpone having to provide the disclosures required by Form C.

[98] *See generally* Bauguess et al., *supra* note 12.

[99] *See generally* Ibrahim, *supra* note 4.

[100] Bauguess et al., *supra* note 12 ("Compared to Regulation Crowdfunding offerings, Regulation D offerings for up to $1 million are more numerous and raise significantly more capital.").

down to an exemption largely tailored to include less financially capable, and arguably less sophisticated, investors.[101]

Perhaps one factor that alleviates some concern about Regulation Crowdfunding is that it is not heavily utilized in practice.[102] From July 1, 2019, to June 30, 2020, approximately $88 million was raised through Regulation Crowdfunding, representing approximately 0.0063% of amounts raised through Rule 506(b) offerings during the same period.[103] Furthermore, since the inception of Regulation Crowdfunding in 2016 to September of 2020, there have been only approximately 3,000 Regulation Crowdfunding offerings in total, while there were 24,636 Rule 506(b) offerings during 2019 alone.[104] Thus, as demonstrated above, both issuers and investors should rightly be wary of a Regulation Crowdfunding offering, and the offering data appears to confirm their collective wisdom in this regard.[105]

II. Recent Reforms to Regulation Crowdfunding

In November 2020, the SEC released final rules that became effective on March 15, 2021 (November 2020 Amendments) that sought to improve access to capital in private markets.[106] These rule amendments include changes to Regulation Crowdfunding that seek to increase its utilization by issuers, such as by increasing the annual offering cap to $5 million from $1 million and removing limitations on the amount that an accredited investor may invest under this exemption.[107] These rule changes also allow investors to aggregate capital in a "crowdfunding vehicle" that serves merely as an investment conduit to organize

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[101] Regulation Crowdfunding Rep., *supra* note 4, at 39 (explaining that only 9% of investors in the crowdfunding offerings were accredited investors). *Compare id.*, *with* Bauguess et al., *supra* note 12 (showing Rule 506(b) to have only 9% of offerings including unaccredited investors).

[102] *See* SEC, *supra* note 14, at 11.

[103] *See id.* (reporting approximately $1.4 trillion raised under Rule 506(b) and only approximately $88 million raised under Regulation Crowdfunding from July 1, 2019, to June 30, 2020).

[104] November 2020 Amendments, *supra* note 54, at 3,554.

[105] *Id.*

[106] *Id.* at 3,590.

[107] 17 C.F.R. § 227.100(a)(1)–(2) (2022).

capital placed by crowdfunding investors in the issuer.[108] For the reasons discussed below, these reforms will likely result in immaterial changes to the utilization of Regulation Crowdfunding when compared to the Rule 506 exemptions.[109] Furthermore, the SEC's purported expansion of section 4(a)(6) of the 1933 Act under Regulation Crowdfunding suffers from technical drafting errors that raise notable concerns over the effectiveness of the expanded rules, which, if asserted, could expose issuers to potential recission claims under section 12(a)(1) of the 1933 Act.[110]

A. Increased Offering Limit to $5 Million

In 2012, section 4(a)(6) of the 1933 Act originally imposed the $1 million twelve-month offering limit statutorily,[111] and in 2015, Regulation Crowdfunding mirrored this requirement, with appropriate numerical adjustments afforded by section 4A(h) of the 1933 Act that increased the limit to $1.07 million.[112] In the November 2020 Amendments, the SEC amended Rule 100(a)(1) of Regulation Crowdfunding to increase the twelve-month offering limit from $1.07 million to $5 million.[113] In doing this, the SEC expected these changes to facilitate more efficient capital formation for smaller issuers, thus leading to higher utilization of the exemption in exempt offerings.[114]

Indeed, the SEC is likely correct that this change will result in some increase in the number and size of exempt offerings that rely on Regulation Crowdfunding.[115] However, because

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[108] 17 C.F.R. § 227.100(d) (2022); 17 C.F.R. § 270.3a-9 (2022).

[109] *See infra* Sections II.A–C.

[110] *See infra* Section II.D.

[111] 15 U.S.C. § 77d(a)(6)(A).

[112] 17 C.F.R. § 100(a)(1) (2015) (*amended by* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3,598 (Jan. 14, 2021) (to be codified at 17 C.F.R. pt. 230)); 15 U.S.C. § 77d-1(h)(1).

[113] 17 C.F.R. § 227.100(a)(1).

[114] November 2020 Amendments, *supra* note 54, at 3,538 ("We believe that permitting larger offerings under Regulation Crowdfunding may encourage more issuers to use the exemption and could lower the offering costs per dollar raised, which would make the exemption a more efficient capital raising option for smaller issuers.").

[115] *Id.*

Regulation Crowdfunding still has a number of disadvantages when compared to raising capital from accredited investors under the Rule 506 exemptions,[116] the growth of Regulation Crowdfunding will probably result primarily from attrition, or decreased relative growth, of other offering types that typically include unaccredited investors, such as Rule 504 offerings.[117] When comparing Regulation Crowdfunding and Rule 504 prior to the November 2020 Amendments, Rule 504's most notable advantage over Regulation Crowdfunding was the ability to raise up to $5 million in a twelve-month period under Rule 504 versus Regulation Crowdfunding's twelve-month offering cap of $1.07 million.[118] So when raising capital primarily from unaccredited investors,[119] it is conceivable that issuers would pursue a Rule 504 offering in hopes of raising more than $1.07 million and would not desire to conduct two separate offerings to meet their capital requirements.[120] In the November 2020 Amendments, the Regulation Crowdfunding offering limit was increased to $5 million, while Rule 504's offering limit increased to $10 million.[121] It could be argued that Rule 504 will have a sustained advantage over Regulation Crowdfunding due to its elevated offering cap. However, both offerings had a median offering size of only $100,000 from July 1, 2019, to June 30, 2020,[122] perhaps indicating that Regulation Crowdfunding's $5 million limit would sufficiently

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[116] *See supra* Part I.

[117] 17 C.F.R. § 230.504; 17 C.F.R. § 230.506(b)–(c).

[118] *Compare* 17 C.F.R. § 230.504(b)(2) (2015) (*amended by* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3,598 (Jan. 14, 2021) (to be codified at 17 C.F.R. pt. 230)), *with* 17 C.F.R. § 227.100(a)(1) (2015) (*amended by* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3,598 (Jan. 14, 2021) (to be codified at 17 C.F.R. pt. 230)).

[119] *See supra* note 101 and accompanying text.

[120] November 2020 Amendments, *supra* note 54, at 3,538 ("Commenters further suggested that start-ups and small businesses seeking to raise between $1 million and $5 million need to spend 'additional time and expense pursuing other exempt offering types' in addition to Regulation Crowdfunding in order to meet their funding needs, as the existing offering limits in Regulation Crowdfunding are insufficient to meet those needs.")

[121] 17 C.F.R. § 230.504(b)(2); 17 C.F.R. § 227.100(a)(1); November 2020 Amendments, *supra* note 54, at 3,535, 3,538.

[122] *See* SEC, *supra* note 14, at 11.

encompass even the aspirational issuers that sought to raise more than $1.07 million in a Rule 504 offering.[123] If the $5 million offering limit is sufficient for the issuer's capital raise, the issuer would logically balance the cost and inconvenience of complying with one or more state securities laws under Rule 504[124] and the federal requirements of Regulation Crowdfunding, which preempt state securities laws.[125] A similar argument could also be made that Rule 504's $10 million offering limit will cause some issuers to abandon Regulation A, Tier I offerings with a $20 million cap[126] since both exemptions require compliance with state law[127] and Tier 1, Regulation A offerings also require additional federal filings and disclosures.[128] Thus, subsequent offering data may ultimately show an increase in both Regulation Crowdfunding and Rule 504 offerings and a decrease in the already near-extinct Regulation A, Tier 1 offering.[129]

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[123] *See supra* note 112.

[124] Unlike Rule 506(b) under Regulation D, Rule 504 does not require compliance with Rule 502(b) disclosure requirements when raising capital from unaccredited investors. *Compare* 17 C.F.R. § 230.506(b)(1), *with* 17 C.F.R. § 230.504(b)(1). However, section 18 of the 1933 Act does not provide Rule 504 federal preemption over state law, meaning that an issuer must comply with state registration requirements or a state exemption in each state where it offers and sells securities. *See* 15 U.S.C. § 77r(b)(3), (4)(C).

[125] *See* 15 U.S.C. § 77r(b)(3), (4)(C); 17 C.F.R. § 227.504 (2022).

[126] *Compare* 17 C.F.R. § 230.504(b)(2), *with* 17 C.F.R. § 230.251(a)(1).

[127] Neither Rule 504 nor A Tier 1 Regulation A offering is afforded federal preemption under section 18 of the 1933 Act. *See* 15 U.S.C. § 77r(b).

[128] *See* 17 C.F.R. §§ 230.251–53, .257. Note that Rule 504 also allows for delivery of unrestricted securities, a benefit of Regulation A, if the issuer complies with state registration requirements that require the public filing and delivery to investors of a substantive disclosure document before sale, Rule 504(b)(1)(i). Given that most Regulation A investments also require state registration. *See* SEC, *Regulation A Lookback Study and Offering Limit Review Analysis*, at 36 (2021).

[129] Since the inception of Tier 1, Regulation A offerings in 2015, an aggregate of only $230.4 million has been raised under such exemption. *Regulation A Lookback Study and Offering Limit Review Analysis*, SEC, at 8 (2021), https://www.sec.gov/files/regulationa-2020.pdf [https://perma.cc/X2DN-Z9TL]. Furthermore, the average amount sought in all Tier 1, Regulation A offerings was only $7.6 million, with an average of $5.9 million raised in such offerings, which is less than Rule 504's revised offering cap of $10 million per the November 2020 Amendments. *Id.* at 8–9; Rule 504(b)(2). Thus, with the updated offering cap of $10 million under Rule 504 and Regulation A data revealing

Even with an increased offering limit of $5 million,[130] Regulation Crowdfunding offerings will still pale in comparison to offerings under Rule 506.[131] Both exemptions in Rule 506 have no offering cap at all[132] and do not suffer from the current and ongoing reporting requirements and intermediary requirement of Regulation Crowdfunding.[133] Because issuers can more easily raise capital from accredited investors under the Rule 506 exemptions, issuers will only logically resort to Regulation Crowdfunding when it needs to undertake the inconvenient and costly process of raising capital from unaccredited investors.[134] As discussed above, this dynamic will perpetuate a filtering of suboptimal opportunities to Regulation Crowdfunding offerings (and Rule 504 offerings).[135] Thus, the SEC has really done nothing more when raising the offering cap of Regulation Crowdfunding than to either (i) shift capital formation transaction volume from Rule 504 offerings to Regulation Crowdfunding[136] or (ii) open the aperture of a structurally flawed exemption that systemically aggregates subpar opportunities for investment to be funded primarily by the most financially vulnerable investors.[137]

B. Unlimited Participation of Accredited Investors

The SEC also amended Rule 100(a)(2) of Regulation Crowdfunding to remove all investment limits on accredited investors participating in an offering under this exemption.[138] The investment limitation originated statutorily upon promulgation of the JOBS Act in section 4(a)(6) of the 1933 Act, which required that

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that many issuers opted for Tier 2, Regulation A offerings when raising less than the Tier 1 offering cap of $20 million (due to the benefit of federal preemption of state law), it is reasonable to assume Tier 1 offerings will largely disappear from the exempt offering landscape. *Id.*

[130] 17 C.F.R. § 227.100(a)(1).

[131] *See supra* note 100 and accompanying text.

[132] *Compare* 17 C.F.R. § 230.506(b)–(c), *with* 17 C.F.R. § 227.100(a)(1).

[133] *Compare* 17 C.F.R. § 230.502(b)(1) (providing that accredited investors need not receive disclosures otherwise required by Rule 502(b)), *with* 17 C.F.R. §§ 227.100–.404.

[134] *See supra* note 100 and accompanying text.

[135] *See supra* note 100 and accompanying text.

[136] *See supra* note 117 and accompanying text.

[137] *See supra* notes 100–01 and accompanying text.

[138] 17 C.F.R. § 227.100(a)(2).

"the aggregate amount sold to *any investor* by an issuer . . . during the twelve-month period preceding the date of such transaction" not exceed a prescribed formula that could not exceed $100,000.[139] In 2015, Regulation Crowdfunding originally mirrored this requirement, with appropriate numerical adjustments afforded by section 4A(h) of the 1933 Act that increased the cap to $107,000.[140] Thus, prior to the enactment of the November 2020 Amendments, no investor under this exemption, whether accredited or unaccredited, could invest more than $107,000 in an offering under Regulation Crowdfunding.[141] However, the November 2020 Amendments to Rule 100(a)(2) of Regulation Crowdfunding cause this investment limitation to apply only when "the purchaser is not an accredited investor," meaning that accredited investors can now invest unlimited amounts of capital under a Regulation Crowdfunding offering, subject to the updated offering cap of $5 million.[142]

While this change hypothetically helps issuers conducting an offering under Regulation Crowdfunding to raise more capital from accredited investors, this advantage of uncapped participation by accredited investors was already provided to issuers under both of the Rule 506 exemptions.[143] That said, Regulation Crowdfunding has a distinct advantage over Rule 506(b) in that it allows general solicitation to source accredited investors in its offering.[144] Furthermore, Regulation Crowdfunding also has a distinct advantage over Rule 506(c) in that an issuer (or intermediary) is not required to "take reasonable steps to verify" that purchasers in the offering are accredited investors in a Regulation Crowdfunding offering, which is a significant limitation to broader utilization of Rule 506(c).[145] However, again, these advantages

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[139] 15 U.S.C. § 77d(a)(6) (2012) (*amended by* Pub. L. 114-94) (2015) (emphasis added).

[140] 17 C.F.R. § 227.100(a)(2) (2015) (*amended by* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3,598 (Jan. 14, 2021) (to be codified at 17 C.F.R. pt. 230)); 15 U.S.C. § 77d-1(h).

[141] *Supra* note 139 and accompanying text.

[142] 17 C.F.R. § 227.100(a)(2) (2022).

[143] 17 C.F.R. § 230.506(b)–(c).

[144] *Compare* 17 C.F.R. § 227.100, *with* 17 C.F.R. § 230.502(c), .506(b).

[145] 17 C.F.R. § 230.506(c)(2)(ii); 17 C.F.R. § 227.303(b)(1) (2022); *see* Manning G. Warren III, *The False Promise of Publicly Offered Private Placements*, 68

over the Rule 506 exemptions come with the inconvenience of increased current and ongoing disclosure requirements, required use of a funding portal or other intermediary in the offering, and a $5 million annual offering cap.[146] Accordingly, uncapping participation by accredited investors is unlikely to increase the utilization of Regulation Crowdfunding in offerings in which an issuer is able to raise sufficient capital from accredited investors under the more flexible Rule 506 exemptions that currently dominate the exempt offering landscape.[147] Therefore, this change does little to remedy the issue discussed further above that Regulation Crowdfunding will continue to filter suboptimal or higher risk opportunities for investment, leaving unaccredited investors with an asymmetry of opportunity compared to accredited investors with unfettered regulatory access to Rule 506 offerings.[148] While the SEC has indeed eliminated a material barrier to widespread usage of Regulation Crowdfunding by allowing uncapped investment by accredited investors, subject to the annual offering cap,[149] many other barriers persist within Regulation Crowdfunding that render this change immaterial to this exemption's impact on the exempt offering landscape without further reform.[150]

C. Allowing for Investment Through Crowdfunding Vehicles

In one of its more complex rulemaking changes, the SEC afforded investors in a Regulation Crowdfunding offering the ability to aggregate their investments into a "crowdfunding vehicle," rather than individually invest in securities of the issuer.[151]

SMU L. REV. 899, 908 (2015) (In a survey of attorneys concerning use of the exemption in Rule 506(c), "[a]pproximately 65% of respondents indicated concerns over compliance with the verification requirement."); *see also*, Page, *supra* note 2, at Section I.B.

[146] *See supra* note 133 and accompanying text.

[147] *See supra* Part I.

[148] *See supra* notes 100–01 and accompanying text.

[149] *See supra* note 142 and accompanying text.

[150] *See supra* Section I.C.

[151] *See* 17 C.F.R. § 227.100(b)(3) (providing that that Regulation Crowdfunding does not apply to the offer and sale of securities by an issuer that is an "investment company" under the Investment Company Act of 1940 (the "Company Act"), or a company excluded from such definition under section 3(b) or 3(c) of the Company Act, which includes 3(c)(1) and 3(c)(7) funds often

Conceptually, allowing the use of a special purpose vehicle (SPV) under Regulation Crowdfunding is a welcome improvement to this exemption, given that these offerings may consist of a high number of investors that invest relatively small amounts, otherwise precipitating administrative inconvenience with respect to capitalization table maintenance and governance challenges with respect to stockholder voting.[152] However, creating an SPV to facilitate investment in an issuer also creates additional administrative and tax burdens, given that a new entity is formed with its own governing documents, capitalization table, and tax filing requirements.[153] For the SEC's regulations affording crowdfunding vehicles to be effective in practice, the advantages of the crowdfunding vehicle must outweigh the burdens imposed by creating the SPV.[154] Unfortunately, the SEC's rulemaking stripped most of the benefits of an SPV to an issuer out of the afforded crowdfunding vehicle, resulting in rulemaking that will not likely be heavily utilized and will not achieve the SEC's stated objective of "reducing the administrative complexities associated with a large and diffuse shareholder base" and "encourag[ing] crowdfunding issuers to offer voting rights, or other terms not currently offered as frequently to investors."[155]

Rule 100(b)(3) of Regulation Crowdfunding continues to provide that the crowdfunding exemption under Regulation Crowdfunding shall not apply to investment companies under the Investment Company Act of 1940 (Investment Company Act) or certain companies excluded from the definition of "investment company," such as 3(c)(1) and 3(c)(7) funds regularly used in

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utilized for venture capital and private equity funds.); Rule 3a-9 of the 1934 Act (17 C.F.R. § 270.3a-9) (providing that a "crowdfunding vehicle," as defined therein, will be deemed not to be an "investment company," thus excepting such vehicles from the exclusion in Rule 100(b)(3) of Regulation Crowdfunding).

[152] November 2020 Amendments, *supra* note 54, at 3544 n.525 ("In particular, the crowdfunding vehicle may be able to appear as a single entry on the crowdfunding issuer's capitalization table.").

[153] *See* November 2020 Amendments, *supra* note 54, at 3542 n.486 (citing a comment from the Crowdwise Letter "stating that the proposed approach would create a Schedule K-1 burden for issuers with respect to SPVs organized as limited liability companies, and disadvantage investors by disqualifying them from certain preferential tax treatment.").

[154] *Id.*

[155] *Id.* at 3541.

venture capital and private equity investment vehicles.[156] This means, for example, that a venture capital firm cannot rely on Regulation Crowdfunding to aggregate unaccredited investors into a traditional fund or SPV for further investment into an issuer selling its securities under Regulation Crowdfunding.[157] The inability to aggregate small investors into an SPV has been a historical criticism of Regulation Crowdfunding.[158] Issuers often prefer that multiple investors that invest relatively small individual amounts aggregate into an SPV to (i) allow the issuer to coordinate with a single point of contact (or small group of governing persons) that is authorized to act on behalf of the investor group for voting and notification purposes[159] and (ii) if the issuer is a partnership structure for tax purposes, whether structured under state law as a limited partnership or limited liability company, simplify the issuer's tax filing requirements due to a fewer number of partners in the issuer's capitalization structure.[160]

In response to these concerns, the SEC enacted Rule 3a-9 under the Investment Company Act, providing that a "crowdfunding vehicle" will not be an investment company if the vehicle

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[156] 17 C.F.R. § 227.100(a)(3).

[157] *Id.*

[158] REGULATION CROWDFUNDING REP., *supra* note 4, at 57 ("Another issue frequently raised by market participants is the prohibition against conducting a crowdfunding offering through a special purpose vehicle or fund organized to invest in, or lend money to, a single company.").

[159] *Id.* at 58 ("Similarly, some intermediaries report that crowdfunding issuers are hesitant to offer voting rights to crowdfunding investors because the logistical challenges of seeking any required shareholder vote are too high a risk in the event of later financing and governance of the issuer.").

[160] *See* 26 C.F.R. § 1.6031(b)-1T(a)(3)(i). The Internal Revenue Code requires that entities structured as a partnership for tax purposes must provide a statement to each of the entity's partners on Schedule K-1 that includes such partner's "distributive share of partnership income, gain, loss, deduction, or credit required to be shown on the partnership return." 26 C.F.R. § 1.6031(b)-1T; *see* 26 C.F.R § 1.6031(a)-1; *see also* Schedule K-1, IRS, https://www.irs.gov/pub/irs-pdf/f1065sk1.pdf [https://perma.cc/JX3F-J3PF]; *Partner's Instructions for Schedule K-1*, IRS, https://www.irs.gov/pub/irs-pdf/i1065sk1.pdf [https://perma.cc/7HG9-TDZE]. For an investor structured as a traditional SPV structure (not a crowdfunding vehicle), the issuer would only need to issue a single Schedule K-1 to the SPV, and the manager or general partner of the SPV, as applicable, would provide a Schedule K-1 to each of its members or partners, as applicable. *Id.*

meets a number of requirements.[161] The purpose of such requirements is to make such a vehicle a "mere conduit" in support of a Regulation Crowdfunding offering that gives all investors in the crowdfunding vehicle the same rights that it would have if the investor were a direct investor in the issuer.[162] Furthermore, the crowdfunding vehicle must require the issuer to fund or reimburse all expenses associated with the formation, operation, and winding up of the crowdfunding vehicle, including any amounts paid to any person operating the crowdfunding vehicle.[163] So instead of "reducing the administrative complexities associated with a large and diffuse shareholder base,"[164] the new rules actually require the issuer to manage (or pay someone to manage) two entities, including their respective governing documents, capitalization tables, and tax filings.[165] The SEC rationalizes in the November 2020 Amendments that crowdfunding vehicles help solve the "messy cap table" issue faced by issuers.[166] Unfortunately, this is a complete misunderstanding of the problems faced by issuers in this regard.[167] It would be much simpler administratively for an issuer to "simplify its cap table" from a presentation standpoint by adding a simple Excel tab to its cap table spreadsheet that includes all crowdfunding investors and

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[161] November 2020 Amendments, *supra* note 54, at 3541.

[162] *Id.*

> In proposing this exclusion, the Commission expressed its belief that proposed Rule 3a-9 would be consistent with the intent of section 4(a)(6) because it would not be aimed at allowing investment companies or similar issuers to raise capital, but rather, solely at facilitating crowdfunding offerings by eligible issuers, and under the proposed rule, a crowdfunding vehicle would serve merely as a conduit for investors to invest in a single underlying issuer and would not have a separate business purpose. The proposed crowdfunding vehicle was intended to allow investors in the vehicle to achieve the same economic exposure, voting power, and ability to assert State and Federal law rights and receive the same disclosures under Regulation Crowdfunding as if they had invested directly in the underlying issuer in an offering made under Regulation Crowdfunding.

Id.

[163] 17 C.F.R. § 270.3a-9(a)(4) (2022).

[164] November 2020 Amendments, *supra* note 54, at 3541.

[165] *See* 17 C.F.R. § 270.3a-9(a)(7)(i).

[166] November 2020 Amendments, *supra* note 54, at 3544 n.525.

[167] *Id.*

ties into a master summary cap table tab than to add an entirely new entity with a separate cap table, governance structure, and tax filing requirements.[168] As described above, the real "cap table problem" that an SPV could solve for issuers pertains to simplified administration in voting and tax matters,.[169] Issuers might reasonably bear the added complexity and cost of a separate entity (including tax administration) to achieve efficiencies in voting and communications within its stockholder base but not simply to cause its capitalization table to have fewer shareholders.[170] Because the crowdfunding vehicle must provide its investors the same rights that such an investor would have if the investor had invested directly in the issuer,[171] the issuer receives no relative advantage when working to obtain stockholder votes to approve a corporate action.[172] Thus, issuers will remain quite wary of issuing securities in a crowdfunding offering with voting rights to a diffusive stockholder base, much less issuing preferred stock with customary protective provisions relating to key corporate actions, as is customary in many early-stage financings.[173]

To further add to the complexity and impracticality of the new crowdfunding vehicles, the mandate to provide investors in a crowdfunding vehicle the same rights that such investors would have if the investor had invested directly in the issuer is fundamentally different from the default governance structures of most (if not all) entities under state law, thus likely requiring material attorneys' fees to concoct an entity structure that complies with the unique requirements of a crowdfunding vehicle.[174] For example, stockholders in a traditional corporation typically elect directors who then take action for the corporation as a whole.[175] There is no natural mechanism to allow stockholders of a corporation to direct the voting of their pro rata number of shares in the corporation with respect to their beneficial interest

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[168] *Id.*

[169] *See supra* note 160 and accompanying text.

[170] *See supra* notes 159–60 and accompanying text.

[171] *See* 17 C.F.R. § 270.3a-9(a)(7)(i).

[172] *See infra* notes 181–82 and accompanying text.

[173] *Certificate of Incorporation*, NVCA, at 15NVCA-2020-Certificate-of-Incorporation-September-1-2020.docx (live.com) [https://perma.cc/7JPV-U59A] (section 3.3).

[174] 86 Fed. Reg. at 3,542 (Jan. 14, 2021).

[175] *See, e.g.*, 8 Del. C. §§ 141(a), 211(b) (2020).

in a partially owned subsidiary (i.e., the issuer).[176] By its nature, a corporation is a separate legal person that takes unitary action, not a "conduit" that affords disparate action based upon the vote of its stockholders.[177] Even in the more flexible limited liability company (LLC) structure, the likely choice of entity for a crowdfunding vehicle, the company agreement would need to be quite unique to afford each member the ability to direct the voting of its beneficial ownership in the issuer, as opposed to the LLC simply voting its entire interest in the crowdfunding vehicle based on the governance structure in the LLC's company agreement.[178] Again, like the corporation,[179] an LLC is a separate legal person and does not traditionally vote part of its interests in one direction and another part of its interests in an opposite direction, based on the vote of its membership.[180] Typically, an operating agreement of a member-managed LLC will act with respect to shares or membership interests held by the LLC based upon the direction of a managing member or a majority-in-interest of the members (or another threshold).[181] However, a crowdfunding vehicle expressly disallows either of these common governance constructs because the member must have the same rights as it would if directly holding an interest in the issuer.[182]

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[176] *Id.*

[177] *Id.* Case law for well over a century has established the doctrine of corporate personhood in the United States. *See, e.g.*, Citizens United v. Federal Election Comm'n, 558 U.S. 310, 311–16 (2010); Sorrell v. IMS Health Inc., 564 U.S. 552, 552–56 (2011); Tr. of Dartmouth C. v. Woodward, 17 U.S. 518, 518 (1819).

[178] *See, e.g.*, 6 Del. C. § 18-302 (providing a default voting structure for members in a limited liability company, but also deferring to the LLC's company agreement to define the members' relative rights, powers, and duties).

[179] *See supra* note 177 and accompanying text.

[180] 6 Del. C. § 18-302(a)–(c); *see, e.g.*, ELIZABETH MILLER, RECENT CASES INVOLVING LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS, at 33 (2011) (citing Bos. Sci. Corp. v. Wall Cardiovascular Tech., 647 F. Supp. 2d 358 (D. Del. 2009)) ("recognizing separate legal existence of LLC and its members under Texas law and rejecting argument that personal jurisdiction over LLC is proper in any forum in which LLC's members are subject to jurisdiction").

[181] *See* 6 Del. C. § 18-302(a); 6 Del. C. § 18-402(a) (2016).

[182] 17 C.F.R. § 270.3a-9(a)(7)(i). *See* November 2020 Amendments, *supra* note 54, at 3,541 and accompanying text; *supra* note 162 and accompanying text.

> The proposed crowdfunding vehicle was intended to allow investors in the vehicle to achieve the same economic exposure, voting power, and ability to assert State and Federal law rights and receive the same disclosures under Regulation Crowdfunding

Again, this would likely require an LLC to vote part of its shares or interests in the issuer in opposite or different directions, essentially creating a legal person with multiple personalities.[183] In short, the SEC's crowdfunding vehicle is an unusual fictitious legal person with no natural existence in state law, thus increasing attorneys' fees and compliance risk for issuers to birth its existence.[184]

In summary, a crowdfunding vehicle under the SEC's new rules (i) *increases* administrative complexity and cost for the issuer; (ii) provides no material incentive to an issuer to give voting rights to investors in a crowdfunding offering; and (iii) prescribes a new creature of state law that increases both attorneys' fees and compliance risks.[185] Therefore, the SEC's rulemaking concerning crowdfunding vehicles undermined the very objectives it sought to accommodate by actually disincentivizing issuers to use these very limited-use SPVs.[186]

D. Potential Issuer Exposure to Recission Under Expanded Regulations

One final potential issue with the November 2020 Amendments relates to whether the SEC technically had proper agency authority to enact the updated rules under Regulation Crowdfunding, as drafted.[187] In general, the SEC has very broad exemptive authority under section 28 of the 1933 Act to "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions" from the requirements of the 1933 Act or rules or regulations issued thereunder.[188] The SEC has utilized section 28 multiple times since the legislature granted the SEC this authority, including with respect to the enactment of Rule 147A[189] and the

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> as if they had invested directly in the underlying issuer in an offering made under Regulation Crowdfunding.

Id.

[183] *See supra* note 145 and accompanying text.

[184] *See supra* notes 174, 182 and accompanying text.

[185] *See supra* notes 134–48 and accompanying text.

[186] *See supra* note 128 and accompanying text.

[187] *See infra* Section II.D.

[188] 15 U.S.C. § 77z-3.

[189] Exemptions to Facilitate Intrastate and Regional Securities Offerings, 81 Fed. Reg. 83,494, 83,495 (Nov. 21, 2016) (to be codified at 17 C.F.R. pts. 200, 230, 239, 240, 249, 270, and 275).

latest iterations of Regulation A and Rule 504.[190] However, the SEC sought to utilize section 28 differently when enacting the Regulation Crowdfunding rules in the November 2020 Amendments.[191] Instead of stating that "[o]ffers and sales . . . made in accordance with this rule are exempt from section 5 of the [1933] Act," as it did in Rule 147A, Rule 100(a) of Regulation Crowdfunding provides that "[a]n issuer may offer or sell securities *in reliance on section 4(a)(6)* of the Securities Act of 1933" if it complies with the updated rules.[192] The problem with this latter approach is that section 4(a)(6) of the 1933 Act is more restrictive than the newly enacted Rule 100 of Regulation Crowdfunding, such that these new rules cannot fully derive exemptive authority under section 4(a)(6).[193] Thus, as written, Regulation Crowdfunding seems to say that an issuer must comply with *both* section 4(a)(6) and Regulation Crowdfunding to rely on the updated exemption in Rule 100(a).[194] Reliance upon section 4(a)(6) is further specifically reiterated in the expanded Rules 100(a)(1) and 100(a)(2), neither of which by their terms fully fall within the exemptive language in section 4(a)(6).[195] For example, if an issuer relies on updated Rule 100(a)(1) of Regulation Crowdfunding

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[190] November 2020 Amendments, *supra* note 54, at 3,534 n.379, 3,535.

[191] *See infra* notes 192–94 and accompanying text.

[192] 17 C.F.R. § 230.147A(a); 17 C.F.R. § 227.100(a).

[193] *Id.*; *see*, *e.g.*, 15 U.S.C. § 77d(a)(6)(A) (providing for only a $1 million offering cap within a twelve-month period, while Rule 100(a)(1) of Regulation Crowdfunding provides for a $5 million offering cap within twelve months).

[194] *Compare* 15 U.S.C. § 77d(a)(6)(A)–(B) (providing for an offering cap of only $1 million within a twelve-month period and requiring that *all* investors in the offering comply with the prescribed investment limits), *with* 17 C.F.R. § 227.100(a)(1)–(2) (providing for an offering cap of $5 million within a twelve-month period and exempting accredited investors from the prescribed investment limits).

[195] 17 C.F.R. § 227.100(a)(1) ("The aggregate amount of securities sold to all investors by the issuer *in reliance on section 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)(6))* during the twelve-month period preceding the date of such offer or sale, including the securities offered in such transaction, shall not exceed $5,000,000 . . . .") (emphasis added); 17 C.F.R. § 227.100(a)(2) ("Where the purchaser is not an accredited investor (as defined in Rule 501 (§ 230.501 of this chapter)), the aggregate amount of securities sold to such an investor across all *issuers in reliance on section 4(a)(6) of the Securities Act (15 U.S.C. § 77d(a)(6))* during the twelve-month period preceding the date of such transaction, including the securities sold to such investor in such transaction, shall not exceed [the investment limits set forth in Rule 100(a)(2)]." (emphasis added).

rules and issues $5 million of securities within a twelve-month period, such issuer fails to comply with section 4(a)(6) because section 4(a)(6)(A) only affords sales of up to $1 million within a twelve-month period.[196] Furthermore, this issuance arguably fails to comply with Rule 100(a)(1) of Regulation Crowdfunding because such provision requires that sales under this section must be "in reliance on section 4(a)(6)."[197] The same issue arises in Rule 100(a)(2), which was revised to afford unlimited investment by accredited investors, while section 4(a)(6) continues to impose investment limits on all investors.[198] Indeed, the SEC even notes when releasing its final rules for Regulation Crowdfunding that it is relying on section 28 of the 1933 Act when promulgating these expanded rules,[199] so it is quite strange that the language of the rules themselves provides for reliance upon section 4(a)(6).[200]

During the comment period of the rulemaking process for these rules, one letter provided by Better Markets generally raised the issue as to the SEC's authority to expand section 4(a)(6) utilizing section 28, stating that the SEC does not have the "authority to rewrite a standing provision of a law," though this letter more generally challenged the scope of the SEC's authority under section 28, rather than noting the specific technical deficiencies of the rules noted above.[201] The SEC responded to the Better Markets letter by stating that it has broad general exemptive authority under section 28 of the 1933 Act.[202] Based

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[196] *See supra* note 156 and accompanying text.

[197] 17 C.F.R. § 227.100(a)(3); *see supra* note 157 and accompanying text.

[198] *See supra* note 156 and accompanying text.

[199] November 2020 Amendments, *supra* note 54, at 3,521 n.245 ("Section 28 of the Securities Act gives the commission broad authority to conditionally or unconditionally exempt any person . . . from any provision or provisions of the Securities Act[.]").

[200] November 2020 Amendments, *supra* note 54, at 3,538 ("We are raising the offering limit in Regulation Crowdfunding from $1.07 million to $5 million and are adjusting the investment limits in reliance on the general exemptive authority under Securities Act section 28.").

[201] Letter from Lev Bagramian, Better Mkts., on Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, to Vanessa A. Countryman, Secretary, SEC, 13 (June 1, 2020), https://www.sec.gov/comments/s7-05-20/s70520-7261530-217652.pdf [https://perma.cc/N3Q6-KZND].

[202] November 2020 Amendments, *supra* note 54, at 3,537 n.429.

upon the plain language of section 28, the SEC is indeed correct that it has the requisite exemptive authority under section 28 of the 1933 Act to enact rules that give effect to an increased offering cap of $5 million and removal of investment limits from accredited investors under Regulation Crowdfunding.[203] However, the Better Markets letter is correct when stating that the SEC does not have the "authority to rewrite a standing provision of a law," which the text of Rule 100(a) unfortunately purports to accomplish by invoking statutory authority under section 4(a)(6) rather than section 28.[204] In other words, Rule 100(a) of Regulation Crowdfunding does not suffer from a lack of available authority but rather from improper drafting that fails to invoke such authority properly.[205]

Because of the technical nature of the above discrepancy, some may dismiss the importance of the issues noted above.[206] After all, the SEC would likely be highly reticent to bring an enforcement action against issuers that fail to comply with section 4(a)(6) yet do comply with Rule 100(a) of Regulation Crowdfunding.[207] However, private litigants have the opportunity to seek rescission under section 12(a)(1) of the 1933 Act for violations of section 5 of the 1933 Act,[208] which would very likely result if an issuer conducts a crowdfunding offering involving unaccredited investors without a valid exemption.[209] Here, the SEC would have no prosecutorial discretion to prevent such action, and federal courts would likely interpret the interplay between sections 4(a)(6), section 28, and the language of Rule 100 under Regulation

[203] 15 U.S.C. § 77z-3 ("The Commission, by rule or regulation, *may conditionally or unconditionally exempt any person, security, or transaction*, or any class or classes of persons, securities, or transactions, *from any provision or provisions of this subchapter* or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.") (emphasis added).

[204] *See* Letter from Lev Bagramian, Better Mkts., *supra* note 201, at 13 and accompanying text; *supra* note 154 and accompanying text.

[205] *See* 17 C.F.R. § 227.100(a).

[206] *See supra* Section II.D.

[207] *Id.*

[208] *See* 15 U.S.C. § 77l(a).

[209] *Id.* The registration requirements under section 5 of the 1933 Act are much more extensive than the filing and disclosure requirements under Regulation Crowdfunding. *Compare* 15 U.S.C. §§ 77f(b), 77j (2018), *with* 17 C.F.R. § 227.201; 15 U.S.C. § 771(a)(1) (2018).

Crowdfunding under principals of administrative law, such as the *Chevron* doctrine.[210] Under the *Chevron* doctrine, the court would first ask "(1) whether the statute is clear or ambiguous; and (2) if the statute is ambiguous, whether the agencies' construction 'is a reasonable policy choice for the agency to make.'"[211] Under this analysis, there is an argument that section 4(a)(6) is clear and unambiguous, leaving no room for the SEC's interpretation that Regulation Crowdfunding, as amended, may derive exemptive authority therefrom in its amended rules.[212] Section 4(a)(6)(A) has a very clear limit of $1 million on sales within a twelve-month period and section 4(a)(6)(B) clearly applies investment limits to "any investor," not just unaccredited investors.[213] Rule 100(a) of Regulation Crowdfunding then clearly invokes section 4(a)(6) as its statutory basis and then clearly surpasses the statutory limits of section 4(a)(6) by increasing the limit on sales within twelve months to $5 million and excluding accredited investors from the investment limits imposed on "any investor" under section 4(a)(6).[214] Conversely, a court could ultimately decide to resolve this issue in favor of the SEC's interpretation of Rule 100 of Regulation Crowdfunding by citing the SEC's mention of section 28 as its source of regulatory authority for Regulation Crowdfunding in its release of the November 2020 Amendments,[215] but this result is uncertain given that the text of Regulation Crowdfunding itself never mentions section 28 and specifically invokes section 4(a)(6).[216]

Similar issues arise under Rule 501 of Regulation Crowdfunding which permits resales of securities issued thereunder to the issuer of the securities, to accredited investors, or certain family members (or related trusts), in each case, without registration under section 5 of the 1933 Act.[217] However, because Rule 501 specifically pertains to "[s]ecurities issued in a transaction exempt

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[210] *See* Jessica L. Asbridge, *Be Reasonable: The Applicability of Chevron to Agency Interpretations of Split-Authority Statutes,* 104 MARQ. L. REV. 813, 828 n.80 (2021).

[211] *Id.*

[212] *See id.*

[213] 15 U.S.C. § 77d(a)(6)(A)–(B).

[214] 17 C.F.R. § 227.100.

[215] *See* November 2020 Amendments, *supra* note 54, at 3,537 n.429.

[216] *See supra* note 166 and accompanying text.

[217] 17 C.F.R. § 227.501 (2022).

from registration pursuant to section 4(a)(6) of the Securities Act . . . *and* in accordance with section 4A of the Securities Act" *and* Regulation Crowdfunding, conjunctively, and the one-year period begins when the securities were issued in a transaction under section 4(a)(6) (not mentioning Regulation Crowdfunding), ambiguity now persists within Rule 501.[218] While the SEC very likely intends for this resale restriction to apply to all offerings under the expanded version of Regulation Crowdfunding,[219] Rule 501 could logically be interpreted to say that either (i) *the restriction* of Rule 501 does not apply to securities that are issued under Regulation Crowdfunding beyond the scope of section 4(a)(6) because the one-year restriction in Rule 501 only applies if the securities are issued under section 4(a)(6); or, conversely, (ii) if exclusions from Rule 501 are read as a resale exemption, *permitted resales* within the one-year period under Rule 501 do not apply to securities that are issued under Regulation Crowdfunding beyond the scope of section 4(a)(6) because the securities are not within the scope of Rule 501 or its similar provision in section 4A(e) of the 1933 Act that permits these resales.[220] To further complicate matters of resale, securities issued pursuant to section 4(a)(6) or Regulation Crowdfunding are not within the definition of "restricted securities" under Rule 144 (a safe harbor to the general resale exemption in section 4(a)(1) of the 1933 Act),[221] causing practitioners to reasonably wonder whether such securities may be resold safely in compliance with section 4(a)(1) of the 1933 Act.[222] Furthermore, it may not be advisable to resell such securities privately under section 4(a)(7) or the case-law-derived exemption 4(a)(1½), as such securities would then arguably become "restricted securities" in accordance with those resale exemptions when no such restriction seems to exist under Regulation Crowdfunding or Rule 144.[223] Indeed, any resale of securities issued pursuant to Regulation Crowdfunding currently treads in murky waters.[224]

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[218] *Id.* (emphasis added).

[219] November 2020 Amendments, *supra* note 54, at 3,498.

[220] 15 U.S.C. § 77d(a)(6); 15 U.S.C. § 77d-1(e); 17 C.F.R. § 227.501.

[221] *See* 17 C.F.R. § 230.144, preliminary note.

[222] *See* 15 U.S.C. § 77d(a)(1).

[223] *Supra* notes 220–21 and accompanying text.

[224] *See id.*

Finally, the use of the SEC's newly minted "crowdfunding vehicles" from the November 2020 Amendments raises similar concerns.[225] The term "crowdfunding vehicle" defined in Rule 3a-9 of the Investment Companies Act of 1940 only applies to offerings "under section 4(a)(6) of the Securities Act" and does not mention Regulation Crowdfunding.[226] Meanwhile, a "crowdfunding issuer" under the same rule must comply with *both* section 4(a)(6) *and* Regulation Crowdfunding.[227] Thus, if an offering complies with Regulation Crowdfunding but not section 4(a)(6), the use of crowdfunding vehicles could be interpreted to fall outside of section 4(a)(6) as seemingly required by Rule 3a-9, thereby creating additional risk for issuers seeking to use such vehicles.[228]

Interestingly, in the November 2020 Amendments, the SEC addressed a similar issue concerning the interplay between section 4(a)(6) and Regulation Crowdfunding in the context of federal preemption.[229] One commenter expressed concern that federal preemption under section 18 of the 1933 Act did not apply to Regulation Crowdfunding in the proposed rules because section 18 only exempted section 4(a)(6), and not Regulation Crowdfunding, from state regulation under section 18(b)(4).[230] In response, the SEC added Rule 504 to Regulation Crowdfunding to exempt offers and sales under Regulation Crowdfunding from state regulation pursuant to section 18(b)(3) of the 1933 Act.[231] Accordingly, the SEC's response indicates their acknowledgment (or at least acquiescence) that section 4(a)(6) is not broad enough to provide a statutory basis for Regulation Crowdfunding and that section 28 does not enable the SEC to modify the scope of section 4(a)(6).[232] Historically, the SEC has only used section 28 to create a new and expanded exemption, such as when the SEC used Section 28 to expand exempt intrastate offerings under section 3(a)(11) by promulgating Rule 147A, which does not reference

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[225] *See supra* Section II.C for a discussion of crowdfunding vehicles.

[226] 17 C.F.R. § 270.3a-9(b)(2) (2022).

[227] 17 C.F.R. § 270.3a-9(b)(1).

[228] *See supra* notes 226–27 and accompanying text.

[229] *See infra* note 296.

[230] November 2020 Amendments, *supra* note 54, at 3,537 n.430.

[231] *See* 17 C.F.R. § 227.504; *see also* 15 U.S.C. § 77r(b)(3); November 2020 Amendments, *supra* note 54, at 3,538.

[232] *Id.*

section 3(a)(11) as its basis of statutory authority.[233] Because the SEC did not correctly wield section 28 when crafting its rule amendments to Regulation Crowdfunding, there is an increased risk of recessionary damages in private litigation under section 12(a)(1) for issuers who rely upon Regulation Crowdfunding's purported expansion of section 4(a)(6) of the 1933 Act.[234]

III. Reforming Crowdfunding

Despite the prior efforts of Congress and the SEC, the unaccredited crowdfunding experiment of Title III has largely failed to afford unaccredited investors meaningful access to private investment opportunities with appropriate protections and provide issuers meaningful access to additional capital, as contemplated by Title III.[235] Instead, Regulation Crowdfunding has largely created a notable divide between "accredited deals" under Rule 506 and "unaccredited deals" under Regulation Crowdfunding and disincentivized issuers to pursue an "unaccredited deal" when they can complete an "accredited deal."[236] Furthermore, imprecise drafting in the rulemaking process has arguably created additional regulatory risks for issuers, providing a further disincentive to utilize this exemption.[237] Reforms to Regulation Crowdfunding can help correct this unfortunate situation if the SEC will, (i) at a minimum, correct its drafting errors within Regulation Crowdfunding discussed above to provide more certainty to issuers seeking to comply with the expanded exemption in the November 2020 Amendments; and (ii) ideally, propose rulemaking that affords unaccredited investors reasonable participation in Rule 506 offerings without imposing punitive disclosure requirements on issuers.[238]

A. Correcting the November 2020 Amendments

Beginning with the simpler reform, the SEC should correct the language of new rules promulgated in the November 2020

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[233] 17 C.F.R. § 230.147A.
[234] *See supra* note 209.
[235] *See supra* Section I.C.
[236] *See supra* note 100 and accompanying text.
[237] *See supra* Section II.D.
[238] *Id.*

Amendments to clarify that the expanded version of Regulation Crowdfunding relies solely on section 28 of the 1933 Act rather than invoking authority from section 4(a)(6) or claiming that the SEC somehow used section 28 to change the scope of statutory authority within section 4(a)(6).[239] The legislature did not (and could not) bestow legislative authority upon the SEC to amend statutes, but the legislature did provide the SEC broad authority to create exemptions from section 5 of the 1933 Act "by rule or regulation" under section 28 of the 1933 Act.[240] Thus, the SEC has the requisite authority from the legislature to enact an exemption beyond the scope of section 4(a)(6); it simply needs to clarify that it is acting within such authority correctly.[241] Specifically, an efficient approach to resolve this issue would be for the SEC to add a savings clause within Regulation Crowdfunding to clarify that Regulation Crowdfunding, as amended, is an exemption promulgated pursuant to the SEC's exemptive authority provided by the legislature in section 28 of the 1933 Act,[242] and to the extent that the provisions of Regulation Crowdfunding conflict with the terms of section 4(a)(6) or section 4A of the 1933 Act, compliance with Regulation Crowdfunding shall nonetheless be deemed to satisfy the requirements of section 4(a)(6) and section 4A of the 1933 Act with respect to any references or cross references to section 4(a)(6) or section 4A of the 1933 Act contained in all rules promulgated by the SEC.[243] This type of savings clause would still leave intact any nonconflicting reference that Regulation Crowdfunding seeks to import into its rules from section 4(a)(6) or section 4A while also (i) eliminating any confusion concerning the source of Regulation Crowdfunding's current exemptive authority and (ii) resolving any conflicts between section 4(a)(6) or section 4A and Regulation Crowdfunding, in each case, in favor of Regulation Crowdfunding.[244] This change will cause all problematic conjunctive or singular references to

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[239] *See supra* Section II.D.

[240] 15 U.S.C. § 77z-3.

[241] *See supra* note 203.

[242] *See* 15 U.S.C. § 77z-3.

[243] *See supra* Section II.D; *see also* 15 U.S.C. § 77z-3; 15 U.S.C. § 77d(a)(6); 15 U.S.C. § 77d-1.

[244] *See supra* Section II.D; *see also* 15 U.S.C. § 77z-3; 15 U.S.C. § 77d(a)(6); 15 U.S.C. § 77d-1.

section 4(a)(6), section 4A, and Regulation Crowdfunding noted in Section II.D of this Article to function correctly[245] and could likely be enacted without complying with the notice and comment requirements under the Administrative Procedure Act due to such procedures being unnecessary for a technical amendment under the "good cause" exception to such procedures.[246] Of course, another option would be for the SEC to surgically revise each conflicting reference within the regulations noted in Section II.D of this Article and make it clear that the revised Regulation Crowdfunding rules derive exemptive authority from section 28 of the 1933 Act to the extent that they conflict with section 4(a)(6) and section 4A.[247] However, this exercise could prove quite difficult given that Regulation Crowdfunding was promulgated pursuant to a directive of Congress to correspond with certain provisions of section 4(a)(6) and section 4A, such that Regulation Crowdfunding supports but does not necessarily fully encompass section 4(a)(6) and section 4A.[248] This dynamic is different from a situation like the enactment of Rule 147A pursuant to section 28, which provided an independently intrastate exemption with no ties to the statutory intrastate exemption in section 3(a)(11).[249] In either case, the SEC might also consider

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[245] *See supra* Section II.D; *see also* 15 U.S.C. § 77z-3; 15 U.S.C. § 77d(a)(6); 15 U.S.C. § 77d-1.

[246] *See* 5 U.S.C. § 553(b)(3)(B) (providing that the notice and comment requirements of the APA do not apply "when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest."); *see also* Kyle Schneider, *Judicial Review of Good Cause Determinations Under the Administrative Procedure Act*, 73 STAN L. REV. 237, 244 (2021) (citing the legislative history of the APA, providing that the term "'unnecessary' referred to instances such as those involving a 'minor or merely technical amendment.'").

[247] *See supra* note 243.

[248] *See, e.g.*, 15 U.S.C. § 77d-1(a)(3) (requiring that an intermediary "provide such disclosures . . . as the Commission shall, by rule, determine appropriate.").

[249] *See* 15 U.S.C. § 77z-3; *see also* 17 C.F.R. § 230.147A; 15 U.S.C. § 77c(a)(11); Exemptions to Facilitate Intrastate and Regional Securities Offerings, *supra* note 189, at 83,546 (providing that "the final rules retain Rule 147 as a safe harbor under section 3(a)(11), while adopting a substantially similar new exemption pursuant to the Commission's general exemptive authority under section 28 as an alternative to the section 3(a)(11) exemption for companies that are conducting an intrastate offering.").

attempting to enact these new rules with retroactive effect to avoid hypothetical violations of Regulation Crowdfunding prior to the enactment of the proposed savings clause, though potential legal hurdles exist when attempting to enact rules retroactively.[250]

B. Afford Reasonable Participation of Unaccredited Investors Under Rule 506

To break down the regulatory wall between "accredited deals" under Rule 506, making up the vast majority of private investments, and "unaccredited deals" under Regulation Crowdfunding, a relatively immaterial sector of private investments,[251] the SEC should afford reasonable participation of unaccredited investors by revising Rule 506 to eliminate protections and restrictions that exclude unaccredited investors or disincentivize issuers from including unaccredited investors in an offering.[252] More specifically, costly disclosure requirements are likely the most impactful factor causing opportunity asymmetry between accredited and unaccredited investors in private investments.[253] As consistently noted when analyzing transactional exemptions, if unaccredited investors are included in an offering, more disclosure and, thus, more expense will be required in the offering.[254] As a result, we clearly see in statistical data that the exemptions from registration requiring the least disclosure predominate over exemptions requiring disclosure.[255]

As discussed above, Rule 506(b) affords participation of up to thirty-five unaccredited investors if the issuer provides investors disclosure under Rule 502(b), similar to an offering under

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[250] *See* Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 204 (1988) (providing that agencies do not have retroactive rulemaking authority unless such authority is "conveyed by express terms."). *But see* William V. Luneburg, *Retroactive and Administrative Rulemaking*, 1991 DUKE L. J. 106, 110 (1991) (discussing weaknesses of the *Bowen* case and situations where retroactive rulemaking may be appropriate, even in the absence of express legislation, such as when there is no undue "surprise" or "reasonable reliance" caused by the prior rule).

[251] *See* 17 C.F.R. § 230.506(c); 17 C.F.R. § 230.100.

[252] *See* 17 C.F.R. § 230.506(c).

[253] *See supra* Section I.A.

[254] *See supra* note 64 and accompanying text.

[255] *See* Bauguess et al., *supra* note 12, at 9, 16.

Regulation A.[256] As a preliminary matter, the thirty-five-person limit makes little sense in terms of investor protection, particularly when the disclosure requirements are now nearly identical to an offering under Regulation A, which allows unlimited unaccredited investors to participate.[257] Furthermore, the additional disclosure requirement under Rule 502(b) incentivizes issuers to limit Rule 506(b) offerings to accredited investors so that the issuer can reduce the costs of the offering and avoid added risks of non-compliance.[258] Indeed, less than 10% of Rule 506(b) offerings include unaccredited investors.[259] While Rule 502(b)'s disclosure requirement could be viewed as protective to unaccredited investors, it has a significant exclusionary effect that undermines the purpose of the protection itself, promoting stark inequality between accredited and unaccredited investors.[260]

Furthermore, this disclosure requirement does little to promote rational diversification of investments held by unaccredited investors.[261] Indeed, an unaccredited investor could invest its entire life savings in a single Rule 506(b) offering without restriction, so long as the issuer "reasonably believes" that the purchaser "has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."[262] In short, Rule 506(b)'s disclosure requirement and thirty-five-person limit on unaccredited investors has become outdated and stifles meaningful participation of unaccredited investors in those offerings.[263]

However, if the SEC decides to remove the disclosure requirement from Rule 506(b) to afford the inclusion of unaccredited investors, additional reasonable and non-exclusionary protections should be added to provide counterbalancing protections to unaccredited investors in these offerings.[264] Analyzing the SEC's rationale for the current disclosure construct in Rule 506(b) in

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[256] 17 C.F.R. §§ 230.502(b), .506(b).

[257] 17 C.F.R. § 230.502(b); 17 C.F.R. § 230.506(b)(2)(i); 17 C.F.R. § 230.251.

[258] *See supra* Section I.A.

[259] *See* November 2020 Amendments, *supra* note 54, at 3,509 n.127.

[260] *See supra* Section I.A.

[261] 17 C.F.R. § 230.502(b).

[262] 17 C.F.R. § 230.506(b)(2)(ii).

[263] 17 C.F.R. § 230.506(b)(2).

[264] *Id.*

parallel with other mechanisms the SEC has used in other exemptions proves instructive.[265] The SEC justifies minimal required disclosure to accredited investors under 506(b) and 506(c) due to (i) their ability to bear the risk of loss in the investment; and (ii) an implied heightened level of sophistication of such investors.[266] However, in other exemptions, the SEC has used other protections for unaccredited investors to account for these factors.[267]

With regard to an unaccredited investor's ability to bear the loss of an investment, the SEC has used investment limits for unaccredited investors in Regulation Crowdfunding and Regulation A.[268] This type of protection helps ensure that unaccredited investors invest reasonable amounts in an offering based on their individualized assets and income, thus promoting a diversified investment strategy tailored to the particular investor.[269]

Furthermore, concerning sophistication requirements, the SEC and the courts have long afforded the use of a purchaser representative to allow unaccredited investors to obtain the needed sophistication to participate in an offering.[270] Because the use of a purchaser representative has notable flaws, as discussed above,[271] the SEC should consider a new type of protection that would afford the participation of unaccredited investors if accredited investors participate in an offering at prescribed levels.[272] This type of protection would allow unaccredited investors to benefit from the collective wisdom of accredited investors

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[265] *Id.*

[266] *See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, SEC, at 53 (2012), https://www.sec.gov/rules/proposed/2012/33-9354.pdf [https://perma.cc/8QRH-J6KG]; *see also* 78 Fed. Reg. 44,771 (July 24, 2013) (to be codified at 17 C.F.R. pt. 230, 239, 242) ("The risks to investors of fraudulent offerings conducted under Rule 506(c) may be mitigated to some extent by the requirement that issuers sell only to accredited investors (and take reasonable steps to verify such status), who, by virtue of meeting the requirements of the definition, may be better able to assess their ability to take financial risks and bear the risk of loss than investors who are not accredited investors.").

[267] *See supra* notes 28–31 and accompanying text.

[268] *See* 17 C.F.R. § 230.251(d)(2)(c); *see also* 17 C.F.R. § 227.100(a)(2).

[269] *See* November 2020 Amendments, *supra* note 54, at 3,579 (discussing the impact of investment limits on investor diversification).

[270] *See* 17 C.F.R. § 230.506(b)(2)(ii).

[271] *See supra* note 208.

[272] *See supra* note 270.

who have traditionally been afforded the opportunity to participate more fully in private investments.[273] This dynamic would better simulate the public markets, which, from a regulatory perspective, affords unaccredited and accredited investors equal opportunity to invest in companies with the same access to information.[274] Furthermore, allowing increased co-investment among accredited and unaccredited investors provides some inherent protection to unaccredited investors, given that, per the SEC's Division of Economic Risk Analysis, unaccredited or vulnerable investor types were targeted in a disproportionate number of fraud and misconduct cases.[275] Accredited investors, on average, have more experience in private placements than unaccredited investors and, by their nature, have more funds available to perform due diligence and hire legal counsel, from which unaccredited investors could vicariously benefit.[276]

Interestingly, a similar concept was considered and ultimately rejected long ago when Regulation D was first adopted in 1982.[277] Under this prior proposal, disclosures under prior Rule 502(b) would not be mandatory for unaccredited investors if 60%

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[273] *See* Darian M. Ibrahim, *Crowdfunding Without the Crowd,* 95 N.C. L. REV. 1481, at 1502–03 (2017) (discussing the benefits of investment clubs and angel networks consisting of experienced accredited investors).

[274] Ibrahim, *supra* note 4, at 595 n.174.

[275] Rachita Gullapalli, *Misconduct and Fraud in Unregistered Offerings: An Empirical Analysis of Select SEC Enforcement Actions*, SEC, at 27–28 (Aug. 2020), https://www.sec.gov/files/Misconduct%20And%20Fraud%20In%20Unregistered%20Offerings.pdf [https://perma.cc/PWP8-6M6R] (noting that in a study of ninety-two enforcement cases where investor information was disclosed, sixty-seven of such cases involved financially unsophisticated and susceptible investors).

[276] *See supra* Sections I.A–B (discussing, among other things, statistics concerning participation of accredited investors and unaccredited investors in private offerings).

[277] *See* Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251, 11,256 (Mar. 16, 1982) (to be codified at 17 C.F.R. pts. 230, 239). As proposed, rule 502(b)(l)(ii) contained a special rule for disclosure when certain institutional accredited investors purchased 60% or more of the total offering. Under the 60% test, an issuer was not required to furnish disclosure documents unless specifically asked by an investor that was not accredited. The concept of the test was that the accredited investors, negotiating in their own interest, could be relied upon to assure the fairness of the transaction to remaining investors and that, for this reason, a disclosure document need not be mandated. *Id.*

of the participating investors were institutional accredited investors.[278] Ultimately, this 60% rule was not adopted, largely due to comments surrounding the uncertainty of whether the 60% test would be met in the offering, thus prompting issuers to preemptively prepare disclosures to avoid a last-minute disclosure obligation.[279] However, many of these early concerns would now be mitigated due to increased efficiency in drafting due to technological advancement in the last forty years and the more regular use of cutback provisions,[280] which could easily be included in a purchase agreement to reduce participation of unaccredited investors on a pro rata basis to ensure that the offering meets the requisite accredited investor threshold.[281] In short, perhaps this concept is now ripe for the SEC to reconsider.

The meaningful presence of accredited investors in an offering will also likely provide stronger protection to unaccredited investors than a prescribed intermediary, such as a funding portal in Regulation Crowdfunding or a purchaser representative in private placements.[282] Intermediaries and purchaser representatives often have fee structures, such as commissions and transaction-based compensation, that are payable upon the closing of a transaction or increase when more funds are invested in an opportunity.[283] Thus, these representatives often have incentives

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[278] *Id.*

[279] *Id.*

[280] *See, e.g.*, *Right of First Refusal and Co-Sale Agreement*, NVCA, https://view.officeapps.live.com/op/view.aspx?src=https%3A%2F%2Fnvca.org%2Fwp-content%2Fuploads%2F2020%2F09%2FNVCA-2020-Right-of-First-Refusal-Agreement-September-1-2020.docx&wdOrigin=BROWSELINK [https://perma.cc/Y9UQ-45FX] (Section 2.1(c) of this agreement contains a customary cutback provision in connection with an oversubscription by fully exercising purchasers in a primary right of first refusal to purchase additional initially unsubscribed shares not purchased by other investors in the primary right of first refusal).

[281] Note that the proposed rule also allowed for an unaccredited investor to request the disclosures pertaining to an offering. *Id.* If the SEC desired to revive this aspect of the prior proposal, an issuer could hypothetically refuse to allow the requesting unaccredited investor to participate and thereby avoid the disclosure requirement.

[282] *See* 15 U.S.C. § 77d-1; 17 C.F.R. § 230.506(b)(2)(ii).

[283] *See* Jerry W. Markham, *Regulating Broker-Dealer Investment Recommendations—Laying the Groundwork for the Next Financial Crisis*, 13 DREXEL L. REV. 377, 396–406 (2021). Broker-dealers commonly serve as purchaser representatives

that run opposite to those of an unaccredited investor when an investment opportunity is or becomes unsuitable to the investor.[284] Certain honest intermediaries and purchaser representatives may still rightly advise their clients to walk away from a particular investment opportunity in spite of that decision reducing their personal gain, but a conflict of interest nonetheless exists in the relationship.[285] On the contrary, accredited investors are very much aligned with their unaccredited investor counterparts in a private placement, as accredited investors are putting their money at risk alongside these unaccredited investors, even though perhaps at different dollar amounts.[286] Put differently, accredited investors are incentivized to walk away from a bad deal and invest in a good deal and often have the resources, relationships, and (sometimes) investment experience to discern the difference.[287] Intermediaries, such as brokers, at best, have no "skin in the game" and, at worst, are incentivized to push a deal to close, even if ill-advised, so long as they are not violating securities laws.[288] Indeed, perhaps these perverse incentives help explain why intermediaries are much more prevalent in fraud cases than in total cases.[289] In summary, intermediaries do not

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and receive transaction-based compensation in connection with the purchase and sale of securities. *See* 17 C.F.R. § 230.501 n.1 (providing the purchaser representatives need to consider the applicability of regulations pertaining to brokers and dealers); *see also* In the Matter of Neovest, Inc., Release No. 34-92285 (June 29, 2021) (indicating that receipt of transaction-based compensation is a strong indication of conducting effecting transactions in securities for the account of others requiring registration as a broker-dealer under section 15a of the 1934 Act; *SEC Frequently Asked Questions Regarding Regulation Crowdfunding and Intermediary Requirements*, SEC, Question 402.3 (Sept. 25, 2018), https://www.sec.gov/divisions/marketreg/tmcompliance/cfportal-faqs.htm#:~:text=Funding%20portals%20are%20brokers%2C%20as,4(a)(6) [https://perma.cc/BD9X-MYVX] (noting that funding portals are brokers and may receive commissions or transaction-based compensation in connection with the purchase and sale of securities and that a broker is any person "effecting transactions in securities for the account of others.").

[284] *See* Markham, *supra* note 283, at 396–406.

[285] *Id.*

[286] *See* Selman, *supra* note 1, at 54.

[287] *See* Markham, *supra* note 283, at 413 n.235.

[288] *See supra* note 283.

[289] *See* Gullapalli, *supra* note 275, at 24: "An intermediary was reported to be used in 154 of the 210 cases (73%). This is much higher than in the total

generally provide reasonable protection to investors; they simply add transaction costs and arguably heighten the risk of fraud.[290]

CONCLUSION

Regulation Crowdfunding has marginal utility in practice and presents notable risks to investors and issuers.[291] The market clearly prefers the exemptions in Rule 506, but current regulations largely exclude unaccredited investors from participating in those offerings.[292] Unfortunately, recent reforms to Regulation Crowdfunding do little to address this issue and arguably create additional risks to investors and issuers.[293] Based on the foregoing analysis, the SEC should consider expanding both Rule 506(b) and Rule 506(c) to allow participation by unlimited nonaccredited investors without the additional disclosure requirements set forth in Rule 502(b) if the following requirements are met: (i) unaccredited investors must purchase securities of the same class and with the same terms, conditions and rights as the securities purchased by accredited investors in the offering;[294] (ii) unaccredited investors must receive the same information as provided to accredited investors in the offering;[295] (iii) accredited investors that are unaffiliated with the issuer and receive no commission or other transaction-based compensation in connection with the offering must purchase the lesser of (A) at least 50% of the total offering or (B) a reasonably material investment amount, such as $5 million;[296] and (iv) investments by nonaccredited investors in the offering are subject to the investment

population of Regulation D offerings where, based on Form D filings, we find that fewer than 20% of issuers, on average, reported using an intermediary."

[290] *See id.*

[291] *See supra* Part I.

[292] *Id.*

[293] *See supra* Part II.

[294] Note that this same requirement exists for compensation to funding portals. *See* 17 C.F.R. § 227.300(b)(2) (2022).

[295] This requirement is similar to the current practice under Rule 506(b) when unaccredited investors participate in such an offering, due to anti-fraud rules. *See* Note following 17 C.F.R. § 230.502(b).

[296] Note that a similar concept was actually considered but ultimately rejected when Regulation D was first adopted in 1982. *See supra* notes 213–17 and accompanying text.

limitations described in section 100(a)(2) of Regulation Crowdfunding.[297] If the SEC were to change Rule 506(c) to afford a new method of unaccredited crowdfunding with general solicitation, it would likely also extend heightened verification requirements to unaccredited investors under Rule 506(c), though that construct notably limits its use by issuers.[298] While the foregoing construct does not utilize a purchaser representative, as traditionally afforded by Rule 506(b), unaccredited investors arguably gain greater protection than a purchaser representative by investing alongside a material investment by accredited investors who have greater incentives than a purchaser representative to perform due diligence, without charging fees to the nonaccredited investor or the issuer.[299] Thus, this construct places unaccredited and accredited investors on equal footing with respect to private investment opportunities yet provides meaningful protections to unaccredited investors in a similar manner as other exemptions that regularly include unaccredited investors.[300]

[297] 17 C.F.R. § 227.100(a)(2).
[298] *See* Section I.B.
[299] *See supra* notes 279–82 and accompanying text.
[300] *See* Section III.B.

Appendix - Exemption Analysis for Unaccredited Investors

	Section 4(a)(2) (Private Placement)	Regulation D (Private Placement Safe Harbors)			Regulation Crowdfunding	Regulation A ("Mini IPO")		Intrastate Offerings
	4(a)(2)	Rule 506(b)	Rule 506(c)	Rule 504	Section 4(a)(6); Reg CF	Tier 1	Tier 2	Rule 147A
Exemption Allows Unaccredited Investors?	Yes, unlimited.	Yes, up to 35 unaccredited investors.	No. Accredited only.	Yes, unlimited.	Yes, unlimited.	Yes, unlimited.	Yes, unlimited.	Yes, unlimited.
Existence and Impact of Unaccredited Investors on Offering	All offerees must be "sophisticated" (based on common law factors) with either access to information or full disclosure. Ability to bear economic risk may help meet the "sophistication" requirement and unaccredited investor generally have less ability to bear risk than accredited investors. Exemption requires significant disclosure requirements, arguably similar to a registered offering. Disclosure requirements are arguably less for an accredited investor, given that the Reg D safe harbors require less disclosure for accredited investors.	Unaccredited investors are typically excluded from participation due to heightened investor qualification and disclosure requirements. Unaccredited investors must meet sophistication requirements (similar to 4(a)(2) requirements). Accredited investors need not meet specific sophistication requirements. Significant disclosure required for unaccredited investors, similar to a Reg A offering. (Rule 506(b)(2); Rule 502(b)). No specific disclosure requirements for accredited investors.	Investors must be accredited to comply with this exemption.	Generally, will include unaccredited investors. Must comply with state blue sky laws. These laws vary from state to state and often impose material investor qualification and disclosure requirements, particularly with respect to unaccredited investors. Some state blue sky laws provide for reduced disclosure requirements for an offering consisting solely of accredited investors. As a practical matter, most issuers use Rule 506(b) or Rule 506(c) when raising capital solely from accredited investors.	Generally, will include unaccredited investors. <u>Unaccredited Investment Limits</u> * If annual income or net worth less than $107K: greater of (i) $2,200 or (ii) 5% of greater of annual income or net worth. * If annual income AND net worth greater than $107K: 10% of greater of annual income or net worth, not to exceed $107K. (See Reg CF Rule 100(a)(2)). No investment limits for accredited investors, but no reason to exclude unaccredited investors.	Generally, will include unaccredited investors. Must comply with state blue sky laws, which typically requires state registration process to generally solicit unaccredited investors (as is typically contemplated in a Reg A offering).	Generally, will include unaccredited investors. If securities not on a national exchange, unaccredited investor cannot invest more than: (i) if a natural person, 10% of greater of annual income or net worth or (ii) if a non-natural person, 10% of greater of revenue or net assets as of most recently completed fiscal year. Otherwise, no limit (subject to offering limit). (See Rule 251(d)(2)(i)(C)). No investment limits for accredited investors, but no reason to exclude unaccredited investors.	Must comply with state blue sky laws. These laws vary from state to state and often impose material investor qualification and disclosure requirements, particularly with respect to unaccredited investors. Some state blue sky laws provide for reduced disclosure requirements for an offering consisting solely of accredited investors. As a practical matter, most issuers use Rule 506(b) or Rule 506(c) when raising capital solely from accredited investors.
Other Material Limitations for Use of the Exemption Generally	In most cases, the use of section 4(a)(2) without a safe harbor is considered risky due to amorphous investor sophistication and disclosure requirements under common law. The Reg D safe harbors were created to address these concerns. Also, must comply with state blue sky laws. These laws vary from state to state and often impose material investor qualification and disclosure requirements, particularly with respect to unaccredited investors.	This exemption does not allow for the general solicitation of investors. Despite this limitation, Rule 506(b) is the most heavily utilized exemption by far in practice.	While this exemption allows for general solicitation of accredited investors (and Rule 506(b) does not), heightened investor verification requirements often limit the use of this exemption in practice. (Rule 506(c)(2)(ii)). Thus, Rule 506(b) is the predominant exemption in practice.	$10 million offering limit within a twelve-month period. No general solicitation except in limited circumstances under Rule 504(b).	$5 million offering limit within a twelve-month period. Must conduct the transaction through broker, or funding portal complying with Section 4A(a). SEC disclosure requirement on Form C, including two years of financial statements that are certified, reviewed or audited, as required. (Rule 201 and Form C). Ongoing reporting requirements, including annual reports with financial statements certified by an executive officer, or must provide reviewed or audited if available. (Rule 202(a)).	$20 million offering limit within a twelve-month period. Substantial disclosure requirements on Form 1-A, including two years of financial statements. (Rule 252(a); Form 1-A). Must file Exit Report upon completion of offering (Form 1-Z; Rule 257(a)).	$75 million offering limit within a 12-month period. Substantial disclosure requirements on Form 1-A, including two years of **<u>audited</u>** financial statements. (Rule 252(a); Form 1-A). Ongoing reporting under the Exchange Act, or else must file: Annual report on Form 1-K (audited financial statements required); Semi-annual report on Form 1-SA (unaudited financial statements required); Current reports on Form 1-U (Rule 257(b)) and exit reports.	Offering allowed within the state only. Issuer must have primary place of business within date (though may be incorporated elsewhere). Offerees must be in-state residents.
Use in Practice	Difficult to track usage due to a lack of filing requirements, but some data indicates limited usage compared to Rule 506(b). Commonly utilized to conduct the initial sale of securities to an intermediary in a Rule 144A resale to qualified institutional buyers or institutional accredited investors. May be useful when Regulation D is unavailable due to the existence of "bad actor" disqualifications.	Most heavily utilized exemption.	Utilized when general solicitation is desirable or necessary to complete an offering. Modest use compared to Rule 506(b), but heavily utilized in comparison to other exemptions.	Very limited use.	Very limited use.	Very limited use.	Limited use.	Very limited use.