The New Regulation of Small Business Capital Formation: The Impact—If Any—Of the JOBS Act

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Rutheford B Campbell, Jr.

INTRODUCTION

The Jumpstart Our Business Startups Act (JOBS Act) was—at least apparently—driven by the desire to promote job creation by facilitating small business capital formation. The legislation was premised on the correct assumptions that small businesses create jobs and that an efficient access to capital is essential for small businesses to emerge, compete, and survive in our competitive, market economy.

Titles II, III, and IV of the JOBS Act are seemingly aimed at small businesses and the special challenges faced by small businesses when they

1 Spears-Gilbert Professor of Law, University of Kentucky College of Law. The author thanks Rebecca McKinney and William Middleton for their assistance in the preparation of this Article.


3 Id.


6 Id. tit. III, 126 Stat. at 315-23.

7 Id. tit. IV, 126 Stat. at 323-25.

8 While one may find disagreement regarding a precise definition of small businesses, data collected annually by the Small Business Administration (SBA) provides sensible categories regarding business size. The smallest SBA category includes businesses with less than 20 employees. Earlier, the SBA also provided information regarding businesses with less than 100 employees. Presently, however, SBA reports do not include information regarding that category but, instead, report on businesses with less than 500 employees. See, e.g., Campbell, A Moderate Capital, supra.
attempt to access external capital. Title II, entitled Access to Capital for Job Creators, provides a statutory basis for general solicitations for investors in Rule 506 offerings. Title III, entitled Crowdfunding, provides a statutory basis for unregistered public offerings of up to one million dollars over the Internet. Title IV, entitled Small Company Capital Formation, requires the Securities and Exchange Commission to enact a new regulatory exemption under Section 3(b) of the Securities Act of 1933 (the 1933 Act) for offerings up to fifty million dollars, subject to such terms "as the Commission may determine necessary in the public interest and for the protection of investors." Because this new Section 3(b)(2) is intended to provide a basis for increasing the amount that may be offered under the exemption provided by Regulation A, the Commission's regulations under this statute are sometimes popularly referred to as "Regulation A-Plus."

None of the three titles of the JOBS Act is self-executing. Instead, each title delegates to the Commission the responsibility to enact implementing regulations. Thus, whether the JOBS Act achieves its goal of facilitating a balanced and efficient access to external capital for small businesses depends both on the Act itself and the Commission's regulatory implementation of the legislation.

The efficiency of the JOBS Act and the Commission's regulatory implementations of the JOBS Act can be appropriately measured by reference to the legislative mandate in Section 2(b) of the 1933 Act. That section obligates the Commission, when enacting regulations "in the public interest," to balance investor protection with capital formation. Such regulatory balance is essential for a market economy. Businesses must have access to external capital, but investors may face market failures (inadequate investment information, disinformation, etc.) that make it impossible in some cases to allocate their capital to its highest and best use. In such situations, investors—and indeed our market economy—are unprotected. Investors may, in the worst cases, lose their entire investment, and our market economy may lose an allocation of capital.

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note 4, at 85. The importance of small businesses to our economy is vividly shown through the SBA data regarding the smallest category (businesses with less than 20 employees). See id. at 84–86.


10 Id. §§ 301–305.

11 Id. §§ 401–402.

12 Id. § 401(b)(a).


16 "Whenever . . . the Commission is engaged in rulemaking and is required to consider . . . whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." Id.
to its most productive use. In such cases, notions of fairness and economic efficiency necessitate regulation.

It is certain that the JOBS Act will have an effect on businesses' access to external capital. With regard, however, to the capital formation efforts of small businesses—businesses that may account for more than 25% of our national economy—17—the analysis offered by this Article suggests that the benefits may be modest. Unless the Commission acts under its delegated authority in a rational and in some instances bold manner, the benefits from the JOBS Act to small businesses and their capital formation needs and efforts will be far less than was possible or anticipated.

I. Rules and Reality of Capital Formation at the Time the JOBS Act Became Law

To understand the difficulties that small businesses had in accessing external capital prior to the JOBS Act, it is helpful first to consider the structural and economic disadvantages that small businesses inevitably face in the capital markets. The disadvantages are largely due to high relative transaction costs that small businesses encounter when they attempt to raise capital and to the fact that financial intermediation is rarely available for small businesses that are searching for external capital.

Small businesses typically face very high relative transaction costs when they attempt to secure external capital. This is due to the fact that small businesses usually require only small amounts of external capital. "Relative" transaction costs are offering expenses relative to the total proceeds from an offering.

It is relative, not absolute, transaction costs that impede and in some cases foreclose access to external capital. To use a simple, extreme example, legal and accounting expenses of $100,000 are essentially irrelevant in a $100 million offering (amounting in that case to only 0.1% of the total offering). But $100,000 in expenses will preclude an offering with total proceeds of $100,000 (amounting to 100% of the offering in that case).

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17 Historically, firms with fewer than 20 employees have accounted for slightly less than 20% of all United States employment, and firms with fewer than 100 employees have accounted for slightly more than 35% of all United States employment. See Campbell, A Moderate Capital, supra note 4, at 85.
18 Id. at 88–89.
19 Id.
20 If a company spends $10 to raise a total of $100 in external capital, the relative offering costs are 10%. Id. at 90.
21 See Rutheford B Campbell, Jr., Blue Sky Laws and the Recent Congressional Preemption Failure, 22 J. CORP. L. 175, 181 (1997) [hereinafter Campbell, Blue Sky Laws] ("[A]s offerings get larger, the offerings can stand larger absolute offering costs without collapsing from their own weight.").
The small capital requirements of small businesses, therefore, drive up relative transaction (or offering) costs and make it difficult for small businesses to raise external capital.\textsuperscript{22}

The other, obviously related structural or economic disadvantage of small firms trying to find external capital is that financial intermediation is rarely available to them.\textsuperscript{23} The problem is that small businesses in search of external capital are usually unseasoned and, as described above, need relatively small amounts of capital. Due diligence costs generated by the need for underwriters or brokers to gather and analyze information regarding unseasoned issuers are high.\textsuperscript{24} Small offerings do not generate the proceeds sufficiently large to pay underwriters or brokers the costs that they encounter in learning and selling the deal and in assuming the residual risk of liability.\textsuperscript{25} As a result, small businesses are generally on their own in selling their securities, and that is a significant disadvantage.

Consider, for example, Table I below. The information in the table is based on a sample of 1000 Form Ds filed in connection with Regulation D offerings. The Table shows that of the 308 Regulation D offerings of less than $1 million from that sample, only 5.8\% of those very small offerings involved financial intermediation.\textsuperscript{26}

\begin{table}[h]
\centering
\begin{tabular}{ll}
\hline
\textbf{Regulation D Offerings of $1 Million or Less} & \textbf{Regulation D Offerings of $1 Million to $5 Million} \\
\textbf{with Financial Intermediation} & \textbf{with Financial Intermediation} \\
\hline
\textbf{Percentage} & 5.8\% & 12.7\% \\
\textbf{Number} & 18/308 & 31/244 \\
\hline
\end{tabular}
\caption{Table I}
\end{table}

Before the JOBS Act was passed and signed into law, these structural and economic disadvantages that small businesses encountered in capital formation were significantly exacerbated by two related legal obstacles. The two legal impediments were the result of the combined effects of state and federal statutes and regulations requiring the registration of securities.

The first legal problem faced by small businesses was that the combined state and federal registration regimes effectively foreclosed any broad solicitation for

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\textsuperscript{22} Campbell, \textit{A Moderate Capital}, supra note 4, at 81.
\textsuperscript{23} Id. at 88.
\textsuperscript{24} Id. at 89.
\textsuperscript{25} See id.
\textsuperscript{26} A sample of 1000 Regulation D filings was obtained from SEC filings during the period from September 15, 2010, to October 12, 2010. This data was first reported in Rutheford B Campbell, Jr., \textit{The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC’s Crown Jewel Exemptions}, 66 Bus. Law. 919, 931 tbl.IX (2011) [hereinafter Campbell, \textit{The Wreck of Regulation D}].
external capital.\textsuperscript{27} A second, related legal problem was that the capital raising efforts of small businesses were subject to multiple, separate state and federal regulatory regimes requiring the registration of securities that were offered and sold in connection with capital raising efforts.\textsuperscript{28}

Regarding the legal impediments to a broad solicitation of capital by small businesses, consider the fact that before the JOBS Act, there were four broadly available federal exemptions from the registration obligations imposed by the 1933 Act.\textsuperscript{29} They were: Section 4(a)(2) of the 1933 Act,\textsuperscript{30} as that statute was interpreted by the courts\textsuperscript{31} and the Commission; Regulation D;\textsuperscript{32} Regulation A;\textsuperscript{33} and the intrastate exemption as provided by Rule 147.\textsuperscript{34} Issuers offering under any of these exemptions were legally foreclosed from any broad solicitation for capital.\textsuperscript{35}

The exemption provided by Section 4(a)(2) was limited to "transactions by an issuer not involving any public offering."\textsuperscript{36} Predicating that exemption from registration on the absence of any "public offering" foreclosed an issuer's broad solicitation for external capital.\textsuperscript{37}

With regard to Regulation D, all three of its exemptions—Rule 504, Rule 505 and Rule 506—were conditioned on the absence of any "general solicitation or general advertising."\textsuperscript{38} This requirement prohibited any broad solicitation for investors.

\textsuperscript{27} Campbell, \textit{A Moderate Capital}, supra note 4, at 91–92; Rutheford B Campbell, Jr., \textit{Regulation A and the JOBS Act: A Failure to Resuscitate}, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 317, 322–23 (2012) [hereinafter Campbell, \textit{Failure to Resuscitate}].

\textsuperscript{28} Campbell, \textit{A Moderate Capital}, supra note 4, at 91.

\textsuperscript{29} Section 4(a)(6)—now renumbered as section 4(a)(5)—is a fifth exemption from registration for offerings to "accredited" investors. Securities Act of 1933 § 4(a)(6), 15 U.S.C. § 77d(a)(5) (2012). Section 4(a)(6) had a modest usage, principally because Regulation D offered issuers a more attractive alternative. Indeed, from the period between January 1, 2005, and October 16, 2012, only 3,188 of 107,018 (3.1%) exempt offerings reported on Form D were offered under what is now section 4(a)(6). \textit{See Disclosure and Transactions, KNOWLEDGE MOSAIC, www.knowledgemosaic.com} (last visited Apr. 1, 2012) (follow “Exempt Offerings” hyperlink; then search “Securities Act Section 4(a)(6)” (KNOWLEDGE MOSAIC has yet to update their search criteria to the renumbered section)).


\textsuperscript{31} In its broadest sense, the limit on the breadth of the issuer’s solicitation in a section 4(a)(2) offering was set by the Supreme Court in \textit{SEC v. Ralston Purina Co.}, 346 U.S. 119 (1953), when the Court limited offerings to persons who can "fend for themselves." \textit{Id.} at 124–25.


\textsuperscript{33} Regulation A, 17 C.F.R. §§ 230.251–263 (2014) (enacted by the Securities and Exchange Commission under the authority of section 3(b) of the Securities Act of 1933, 15 U.S.C. § 77c(b) (2012)).

\textsuperscript{34} Rule 147, 17 C.F.R. § 230.147 (2014).

\textsuperscript{35} See Campbell, \textit{The Wreck of Regulation D}, supra note 26, at 933–935.


\textsuperscript{38} 17 C.F.R. § 230.502(a). All three rules, Rule 504, 17 C.F.R. § 230.504, Rule 505, 17 C.F.R. § 230.505, and Rule 506, 17 C.F.R. § 230.506, conditioned exemptions from registration on the
Although the federal exemptions from registration provided by Regulation A and Rule 147 were not dependent on the absence of any “public offering” or “general solicitation,” state regulatory regimes effectively throttled any broad search for external capital by small businesses relying on those federal exemptions. Significant in that regard was the fact that National Securities Markets Improvement Act (NSMIA) enacted by Congress in 1996 failed to preempt state registration authority over offerings made under Regulation A or Rule 147. As a result, offerings under those exemptions were subject to state regulatory regimes. Typically, issuers attempting to coordinate a state exemption with offerings exempt under Regulation A or Rule 147 were forced to rely on a state’s small offering exemption or, in more recent times, on a state’s accredited investor exemption. Both of those state exemptions from registration prohibited a broad solicitation for capital. States’ absence of any general solicitation or advertising based on general conditions found in 17 C.F.R. § 230.502(c).


40 In fact, the Securities and Exchange Commission’s rules regarding a valid Regulation A or Rule 147 offering facilitate a general solicitation in offerings under those exemptions. For example, the Commission enacted its “test the waters” rule, which permits an issuer in a Regulation A offering to solicit broadly for indications of interest in the offering even before the issuer files an offering statement with the Commission. 17 C.F.R. § 230.254 (2014). State regulators strongly opposed the adoption of the “test the waters” rule. See Mark A. Sargent, A Future for Blue Sky Law, 62 U. CIN. L. REV. 471, 477-79 (1993); Marc I. Steinberg, The Emergence of State Securities Laws: Partly Sunny Skies for Investors, 62 U. CIN. L. REV. 395, 408-11 (1993). With regard to offerings under the intrastate exemption provided by Rule 147, the Commission takes the position, for example, that an issuer in an intrastate offering may advertise interstate for investors (i.e., engage in conduct that would otherwise be considered an interstate offer), so long as the solicitation makes clear that the offer is limited to intrastate investors only. See Exemption for Local Offerings From Registration, Securities Act Release No. 4434, 26 Fed. Reg. 11,896, 11,897 (Dec. 13, 1961) (to be codified at 17 C.F.R. Pt. 23) (offers under the intrastate exemption “may be made the subject of general newspaper advertisement (provided the advertisement is appropriately limited to indicate that offers to purchase are solicited only from, and sales will be made only to, residents of the particular State involved”).


42 An interesting historical fact is that, as originally introduced, the legislation that became NSMIA did preempt state authority over the registration of securities offered under section 3(b) of the 1933 Securities Act. However, this provision was dropped from the final version of NSMIA, resulting in only Rule 506 preempting state authority for offerings; thus, Rule 506 became the only meaningful preemption for small issuers attempting to access external capital. See Rutheford B Campbell, Jr., The Impact of NSMIA on Small Issuers, 53 BUS. LAW. 575, 582-83 (1998).

43 15 U.S.C. § 77r(b) (2012) (defining “covered securities,” which are the securities offered by an issuer with regard to which state registration authority over offerings is preempted).

44 State registration of offerings under Rule 147 or Regulation A was always possible, and, over time, states have attempted to provide efficient registration options for offerings exempt from federal registration. Not surprisingly, coordinating a federal exemption with a state registration has never worked. Expenses generated by state registration—especially when multiple states are involved—are prohibitively high. See Campbell, A Moderate Capital, supra note 4, at 107-10.
small offering exemptions imposed very harsh limits on the number of offerees or purchasers.\textsuperscript{45} Accredited investor exemptions normally imposed wealth or insider requirements on purchasers that limited the issuer's search for external capital to a very small percentage of the total population.\textsuperscript{46}

The second, related legal problem before the passage of the JOBS Act for small issuers in search of external capital was the result of the multiple, separate registration regimes imposed by state blue sky laws. Not only did these state blue sky laws effectively prohibit small businesses' wide solicitation for investors, as described above, but also, more generally, complying with multiple registration regimes drove up legal (and other) expenses to levels that rendered small businesses unable to compete in the market for external capital. An offering in a single state meant that the issuer must underwrite the costs of compliance with two separate registration regimes. An offering in fifty states meant that the issuer encountered the costs of meeting the requirements of fifty-one separate registration regimes.\textsuperscript{47}

The stifling expense generated by the obligation to meet multiple, independent registration regimes was the most pernicious of the legal impediments to external capital faced by small businesses before the enactment of the JOBS Act. For example, multiple, independent state registration regimes governing small business capital formation activities practically eliminated small businesses' use of more efficient exemptions from federal registration.

Consider first Regulation A. Before the JOBS Act, Regulation A offered small businesses an exemption from registration that appeared to be both sound as a matter of policy and attractive for small businesses.\textsuperscript{48} Broadly, Regulation A offered an exemption for the offer and sale of securities by non-reporting companies. The offerings were limited to $5 million and required issuers to provide investors with closely tailored investment information. The disclosure obligations were sensitive to the preclusive effects of high, relative transaction costs and thus required significantly less disclosures than were required in registered offerings. Regulation A also permitted broad public offerings and


\textsuperscript{46} See, e.g., 808 Ky. ADMIN. REGS. 10:340 § 1 (2014) (incorporating by reference the federal "accredited investor" definition from Regulation D into Kentucky's regulatory exemption from registration for offers limited to accredited investors); see also Justin Bryan, \textit{High-Income Tax Returns for 2007}, SOI Bull. (Internal Revenue Serv., Wash., D.C.), Spring 2010, at 3, 4 fig. A, available at http://www.irs.gov/pub/irs-soi/totprbul.pdf (demonstrating that 3.172% of tax returns according to Internal Revenue Service data for 2007 reported income of $200,000 or more).

\textsuperscript{47} Attempts over the years at achieving uniformity among state blue sky laws have proven fruitless. See, e.g., Therese H. Maynard, \textit{The Uniform Limited Offering Exemption: How "Uniform" is "Uniform"—An Evaluation and Critique of the ULOE}, 36 Emory L. J. 357, 509 (1987) (describing the lack of uniformity among states adopting the Uniform Limited Offering Exemption); see also Campbell, \textit{A Moderate Capital}, supra note 4, 107–08 (describing the failed attempt by states to develop a uniform registration statement for offerings by small issuers).

\textsuperscript{48} See Campbell, \textit{A Moderate Capital}, supra note 4, at 77, 79–81, 99–105 (describing Regulation A and its attractiveness to small businesses).
even permitted small businesses the opportunity to “test the waters” by soliciting indications of interest before constructing and filing the required disclosure documents. 49

At the time the JOBS Act was signed into law, however, this apparently attractive exemption was essentially unused by small businesses.

Table II provides information regarding the use of Regulation A during two time periods before the JOBS Act.

<table>
<thead>
<tr>
<th>Time Periods</th>
<th>Total Number of Regulation A Offerings During the Period</th>
<th>Average Annual Number of Regulation A Offerings During the Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/95 – 12/31/04</td>
<td>78</td>
<td>7.8</td>
</tr>
<tr>
<td>1/1/05 – 1/1/11</td>
<td>162</td>
<td>23.1</td>
</tr>
</tbody>
</table>

The data show that the millions of small businesses that needed external capital to compete and survive in their respective product markets were not utilizing this apparently attractive federal exemption from registration.

The principal reason for the non-use of Regulation A was the legal obligation to comply with the multiple, separate registration requirements imposed by state blue sky laws. A broad solicitation for investors in a Regulation A offering may require compliance with fifty-one different registration regimes—fifty state regimes and one federal regime—and this drove offering costs to a level that destroyed the attractiveness of the exemption.

One finds similar data regarding the use (or non-use) of the exemptions from federal registration provided by Regulation D. The data show small issuers migrating from cost efficient ways of meeting federal registration requirements to more expensive paths with many fewer potential investors, this due to the impact of state registration requirements.

Regulation D 52 represents a rational attempt by the Commission to balance capital formation with investor protection. The exemptions in Regulation D are based on an understanding (as described above) that relative offering

49 Id. at 100–06.
51 Regulation A data were obtained from the subscription only Knowledge Mosaic website. See Form A Data, KNOWLEDGE MOSAIC, supra note 29 (follow “SEC Filings” hyperlink; then search “Form 1-A”).
expenses can make it difficult or even impossible for small businesses to access external capital. A related premise for Regulation D is that investor protection provisions—offeree/purchaser qualification requirements and mandated disclosures—are expensive for issuers.

Thus, one finds a stepped approach to requirements for investor protection provisions in Regulation D, an approach that requires more investor protection as the offering size increases.

Under the provisions of Regulation D, offerings up to $1 million can be made under Rule 504 without any disclosure obligations or offeree/purchaser qualification requirements; offerings of up to $5 million under Rule 505, however, may require disclosures; and offerings of unlimited size under Rule 506 may require additional disclosures and investor qualification.

The point here is that Regulation D, specifically Rule 504 and Rule 505, were designed to provide relatively low cost access to external capital for small issuers. Data demonstrate, however, that Regulation D has not worked the way the Commission intended.

Although issuers with small external capital needs were certainly using Regulation D prior to the JOBS Act, data also show that issuers offering small amounts of securities overwhelmingly abandoned Rule 504 and Rule 505, making their small offerings, instead, under the more complicated and expensive terms of Rule 506.

Table III, immediately below, shows the extent to which Regulation D offerings of $1 million or less relied on Rule 504, the Regulation D exemption specifically designed for such small offerings.

<table>
<thead>
<tr>
<th>Regulation D Offerings of $1 Million or Less Offered Under Rule 504</th>
<th>Regulation D Offerings of $1 Million of Less Offered Under Rule 506</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>14.3%</td>
</tr>
<tr>
<td>Number</td>
<td>1,125/7,889</td>
</tr>
</tbody>
</table>

53 17 C.F.R. § 230.504.
54 17 C.F.R. § 230.505.
55 17 C.F.R. § 230.506.
56 Data show, for example, that in one twenty-six month period more than 27,000 Form Ds were filed in connection with Regulation D offerings. Campbell, The Wreck of Regulation D, supra note 26, at 926 tbl.I. Regulation D data were obtained from the Knowledge Mosaic website. See Form D Data, KNOWLEDGE MOSAIC, supra note 29 (follow “Form D” hyperlink; then search “Form D”). The data are for Form D filings from September 15, 2008 to October 18, 2010. Form D filings claiming multiple Regulation D exemptions were not included in the data used in my Business Lawyer article, see Campbell, The Wreck of Regulation D, supra note 26, or in this paper.
57 Campbell, The Wreck of Regulation D, supra note 26, at 928 tbl.III.
Table IV, immediately below, shows the extent to which Regulation D offerings of $1 million to $5 million relied on Rule 505, the Regulation D exemption specifically designed for such offerings.\(^{38}\)

<table>
<thead>
<tr>
<th>Regulation D Offerings of $1 to $5 Million Offered Under Rule 505</th>
<th>Regulation D Offerings of $1 to $5 Million Offered Under Rule 506</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>3.9%</td>
</tr>
<tr>
<td></td>
<td>91.6%</td>
</tr>
<tr>
<td>Number</td>
<td>276/7,059</td>
</tr>
<tr>
<td></td>
<td>6,487/7,059</td>
</tr>
</tbody>
</table>

The data from Table III and Table IV show that issuers prior to the JOBS Act overwhelmingly abandoned the attractive, balanced and closely tailored Regulation D exemptions provided by Rule 504 and Rule 505 and relied instead on Rule 506, with its disclosure obligations and its requirements regarding the qualification of investors.

Data in Table V, immediately below, also show that small offerings repositioned under Rule 506 were overwhelmingly limited to accredited investors.\(^{39}\)

<table>
<thead>
<tr>
<th>Offerings of $1 Million or Less Made Under Rule 506 and Limited to Accredited Investors</th>
<th>Offerings of $1 Million to $5 Million Made Under Rule 506 and Limited to Accredited Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>88.3%</td>
</tr>
<tr>
<td>Number</td>
<td>203/230</td>
</tr>
<tr>
<td></td>
<td>91.8%</td>
</tr>
<tr>
<td></td>
<td>191/208</td>
</tr>
</tbody>
</table>

The discussion and the data in this Part I support the conclusion that in the pre-JOBS Act period small businesses were significantly, unfairly, and inefficiently disadvantaged in regard to their access to vital external capital. The size and nature of small issuers meant that financial intermediation was unavailable and their relative offering expenses were typically very high.

\(^{38}\) Id. at 928 tbl.IV.

\(^{39}\) The data in Table V first appeared in Campbell, The Wreck of Regulation D, supra note 26, at 930 tbl.VII. Table V is based on a sample of 1000 Regulation D filings that were obtained from SEC filings between September 15 and October 12 of 2010. See Form D Data, KNOWLEDGE MOSAIC, supra note 29 (follow "Form D" hyperlink; then search "Form D" for Filing Date Range beginning on 9/15/2010 and ending on 10/12/2010). The manner in which Mosaic collected and grouped the Form D data regarding accredited investors made it practically impossible to use the approximately 27,000 samples used in Tables III and IV.
State and federal registration requirements on small business capital formation activities also throttled a wide search for investors and imposed on small businesses multiple (expensive) registration regimes. Those legal obstacles exacerbated small businesses' structural and economic disadvantages. As a result of state and federal securities laws, small businesses, struggling under the burden of high relative transaction costs and the absence of financial intermediation, were effectively prohibited from engaging in a wide search for external capital and subjected to stifling expense of multiple, independent regulatory regimes.

Part II of this Article discusses the extent to which the JOBS Act addresses the special circumstances of small businesses and ameliorates their disadvantages in the capital markets.

II. THE IMPACT OF THE JOBS ACT ON SMALL BUSINESSES

There is little doubt that the JOBS Act will have an impact on capital formation activities and strategies. The question for this Article, however, is the extent to which the JOBS Act facilitates efficient capital formation by small businesses and whether any such benefit is greater than any loss in investor protection as a result of the Act.

A. Title II of the JOBS Act: Access to Capital for Job Creators

Section 201 of the JOBS Act directs the Commission to amend Regulation D to permit general solicitation or general advertising for Rule 506 offerings, provided that all purchasers in such offerings are "accredited investors." Although this legislation is not self-executing—it requires SEC action to


61 JOBS Act, Pub. L. No. 112-106, tit. II, § 201(a)(1), 126 Stat. 306, 313-14 (2012) (codified as amended at 15 U.S.C. § 77d (2012)). The same section also directs the Commission in its rules to "require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors," and further states that Rule 506 shall "continue to be treated as a regulation issued under section 4(2) of the Securities Act of 1933." Id. § 201(a)(1).

Section 201(a)(2) of the JOBS Act requires the Commission to enact regulations that permit securities sold in Rule 144A transactions to be "offered to persons other than qualified institutional buyers, including by means of general solicitation or general advertising, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer." Id. § 201(a)(2) (emphasis added).

Section 201(b)(1) of the JOBS Act provides that the Rule 506 offerings using permissible general solicitations or general advertising shall "not be deemed public offerings" and that persons involved in running essentially passive, match-making platforms for listing these Rule 506 offerings, for example, on an internet site, shall not be required to register as a broker or dealer. Id. § 201(b)(1).
become effective—Congress gave limited discretion to the Commission regarding the regulatory implementation of Section 201. On July 10, 2013, the Commission promulgated its final rules under Title II of the JOBS Act by adding a new subsection (c) to Rule 506. The result is that offerings under Rule 506(c) may now be made pursuant to a general advertising, provided that all purchasers in the Rule 506(c) offering are accredited investors.62

Even before the JOBS Act eliminated the prohibition against general advertising, Rule 506 offerings limited to accredited investors were very popular. Empirical data show, for example, that over a recent 25–month period there were 27,234 Regulation D offerings, and that 25,591 of those offerings (94%) were made under Rule 506.63 Based on a smaller sample of 1000 Regulation D filings, empirical data also show that the vast majority of all Regulation D offerings, including Rule 506 offerings, were limited to accredited investors. Within that smaller sample, 88.5% of all Regulation D offerings were limited to accredited investors,64 and 91.2% of all Rule 506 offerings were limited to accredited investors.65

Amending Rule 506 to allow a broad solicitation for investors undoubtedly will enhance the popularity of Rule 506 offerings even further. After the Commission’s rules implementing the JOBS Act, issuers relying on Rule 506(c) and limiting purchasers to accredited investors essentially are subject only to the special integration rules of Rule 502(a)66 and the modest holding period imposed

62 17 C.F.R. § 230.506(a)–(c) (2014). Rule 506 offerings involving non–accredited purchasers continue to be subject to the prohibition against any general advertising.


64 Campbell, The Wreck of Regulation D, supra note 26, at 929 tbl.V.


66 17 C.F.R. § 230.502(a) (2014). Securities Act Release No. 9414 (July 10, 2013). The same day the Commission adopted amendments to Rule 506 permitting a general solicitation in Rule 506(c) offerings, the Commission in a separate release also adopted “bad boy” provisions applicable to Rule 506 offerings. See Disqualification of Felons and Other “Bad Actors” From Rule 506 Offerings, Securities Act Release No. 9414, 78 Fed. Reg. 44,730 (July 24, 2013) (to be codified at 17 C.F.R. pts. 200, 230 & 239). Those provisions make the exemption provided by Rule 506 unavailable in instances where the issuer or other parties with material management relationships with the issuer or a material role in the distribution of the Rule 506 securities have, for example, been convicted of illegal acts in connection with the offer and sale of securities. The application of bad boy provisions to Rule 506 are unimportant with regard to the matter of whether small businesses have efficient access to external capital. Id. at 44,749.
by Rule 502(d).\(^6\) Importantly, such offerings made in reliance on Rule 506(c) continue to enjoy preemption from the registration requirements of state blue sky laws.\(^6\) Also, availability of the exemption provided by Rule 506(c) is not predicated on disclosure of investment information to offerees or purchasers,\(^6\) sophistication of offerees or purchasers,\(^7\) or any limit in the number of offerees or purchasers.\(^7\) Combining these attractive features with the right to solicit broadly for investors will make Rule 506 even more attractive to businesses searching for external capital.

Whether the changes in Rule 506 wrought by the JOBS Act are sound as a matter of economic policy—that is, whether such changes in this very important exemption from registration facilitate an efficient allocation of capital to small businesses—may be more problematic, however.

After the JOBS Act amendments and regulatory implementation, the only material investor protection device imposed as a condition for a Rule 506(c) offering is the purchaser's status as an accredited investor.\(^7\) Thus the issue—one which seems, at least to me, to have slipped under the radar for decades\(^3\)—is the extent to which accredited investor status is a sensible

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The proposed amendments enhance the obligation to file Form Ds in connection with offerings under Rule 506(c), id. at 44,851 (to be codified at 17 C.F.R. § 230.502(a)(1), (a)(4)(v)), and expand the amount of information required in such Form D filings, id. at 44,852-55 (to be codified at Form D, 17 C.F.R. § 230.509). The proposed amended regulations also require general solicitations under new Rule 506(c) to contain certain legends, id. at 44,852 (to be codified at 17 C.F.R. § 230.509(a)), and a temporary obligation to submit written offering materials to the Commission, id. at 44,852 (to be codified at 17 C.F.R. § 230.510T).


\(^6\) 17 C.F.R. § 230.502(b). As described in note 67, supra, the Commission has proposed amendments to Rule 506 and Form D that would require issuers using Rule 506(c) to provide investors with prescribed legends and to file with the Commission offering circulars (if any) used in connection with such offerings.

\(^7\) Purchasers under Rule 506 must be either sophisticated ("capable of evaluating the merits and risks of the prospective investment") or accredited. 17 C.F.R. § 230.506(b)(2)(ii) (2014).

\(^7\) See 17 C.F.R. § 230.506(b)(2)(i); see also id. § 230.502(b)(2)(ii) (excluding accredited investors from the limitation on number of purchasers under Regulation D).

\(^7\) See supra notes 69-71 and accompanying text.

\(^7\) The notion that wealth may be an appropriate consideration for private placements first came to prominence in old Rule 146, 17 C.F.R. § 230.146, which required that all offerees either be "capable of evaluating the merits and risks of the prospective investment" or be "able to bear the economic risk of the investment." See 17 C.F.R. § 230.146 (1980). In its earliest guidance, the Commission had emphasized other factors (e.g., number of offerees; size of the offering), which did not include wealth. See also SEC v. Ralston Purina Co., 346 U.S. 119, 125-27 (1953) (emphasizing
criterion for an exemption from the registration requirements of the 1933 Act. More particularly, the issue is whether investor wealth, which is the primary basis for accredited investor status, is an appropriate basis for an exemption from the registration requirement of the 1933 Act.

Restated and framed in economic terms, the question is: Does an exemption from registration based only on the wealth of the purchaser facilitate an efficient allocation of capital? While it seems certain that this change in Rule 506 creates an economic benefit by lowering transaction costs in accessing external capital, the exemption may, on the other hand, generate economic costs by increasing the probability that investors in such cases lack the skill and information necessary to allocate their capital to its highest and best use.

One can, of course, argue either side of this issue. One may argue, for example, that wealthy people do not necessarily have access to the same kind of information that would be found in a registration statement. On the other hand, it may be reasonable to assume that wealth amounts to an acceptable approximation of an investor’s ability to “fend for himself.” Wealthy investors may be presumptively smart and have the economic juice to extract investment information. Also, of course, they may be able to hire investment advisors to help them evaluate the merits and risks of an investment.

It has always seemed curious to me that we have never had a vigorous conversation about this controversial matter. Nonetheless, if one assumes that wealth provides an appropriate level of investor protection, then permitting a general solicitation in Rule 506(c) offerings makes economic and policy sense.

In essence, the amended Rule 506 imposes the investor protection device—in this case, accredited investor status—at the point of purchase rather than the point of offer. This enables the issuer to make a broad and efficient search for external capital without generating any additional, material risks to either the offerees or the purchasers in the Rule 506(c) offering. The unaccredited offerees are unharmed by the general solicitation, since they are not permitted to purchase. The ultimate investors (the accredited purchasers) suffer no harm as a result of offers having been made to unaccredited investors who do not purchase, and the accredited purchasers themselves presumptively

\footnote{Framing this in the Supreme Court’s language in \textit{SEC v. Ralston Purina Co.}, wealth may amount to an acceptable proxy for investors’ ability to “fend for themselves” or investors’ “access to the same kind of information . . . [found in] a registration statement.” 346 U.S. at 125–27.}
are protected by their accredited status\textsuperscript{73} and by antifraud provisions in federal securities laws.\textsuperscript{76}

In short, assuming that investor wealth is an appropriate basis for an exemption from registration, Rule 506(c) amounts to a rational and efficient balance of capital formation and investor protection. Efficient capital formation is enhanced by the ability of issuers to solicit broadly, and investors are protected by limiting purchasers to wealthy investors.

The problem with the JOBS Act, therefore, is not that it allows a wide solicitation for investors in Rule 506(c) offerings. The problem is that the JOBS Act does not extend that model—permitting a broad solicitation for investors, imposing investor protection devices at the point of purchase, and eliminating state authority over registration—to other exemptions from registration.

Small businesses have an especially compelling need for the extension of this efficient model to exempt offerings made in reliance on Rule 147\textsuperscript{77} (the intrastate exemption), Rule 504,\textsuperscript{78} Rule 505,\textsuperscript{79} and Regulation A.\textsuperscript{80}

Although small businesses can use new Rule 506(c), accredited investors amount to a very small percentage of the entire population and an especially challenging cohort of investors for small businesses. While it is difficult to come up with exact quantified data on this, it may be that less than five percent of the general population would meet the present definition of "accredited investor."\textsuperscript{81} Limiting investors to such a small percentage of the population presents disproportionate difficulties for small businesses, which normally have small capital requirements and are located, in many instances, outside major population centers and distant from a significant pool of wealthy investors.

For small businesses to be able to compete for external capital, they need other efficient exemptions from registration that are not limited to

\textsuperscript{75} No doubt, permitting a general advertising or general solicitation without imposing an investor protection device at this offer stage will draw criticism from some as exacerbating the chance of fraud. For example, in reporting comments received in response to the proposed SEC rule permitting general solicitations and advertising in connection with a Rule 506 offering, the Commission reported that some "commenters expressed concern that the proposed amendment, if adopted, would increase the risk of fraudulent and abusive Rule 506 offerings." Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, Exchange Act Release No. 69,959, 78 Fed. Reg. 44,771, 44,775 (July 24, 2013) (to be codified at 17 C.F.R. 230, 239 & 242). For the reasons articulated in the textual discussion, such criticisms are unpersuasive.

\textsuperscript{76} As an obvious example, an issuer's misstatement or omission of a material fact in connection with its sale of its securities may generate serious criminal and civil liability for the issuer as a result of a violation of Rule 10b–5. 17 C.F.R. § 240.10b–5 (2014).

\textsuperscript{77} Rule 147, 17 C.F.R. § 230.147 (2014).

\textsuperscript{78} 17 C.F.R. § 230.504 (2014).

\textsuperscript{79} 17 C.F.R. § 230.505 (2014).


\textsuperscript{81} Internal Revenue Service data from 2007 show that only 3.172% of all tax returns reported income of $200,000 or more. Bryan, supra note 46, at 4 fig.A.
accredited investors. As described earlier in this Article, none of the other attractive exemptions from registration presently available for small business financing—the intrastate exemption of Rule 147, Rule 504, Rule 505 and Regulation A—provide small businesses with an efficient access to external capital. Issuers offering securities under these exemptions are neither able to solicit broadly nor free from state authority over registration.

The amendment to Rule 506 permitting a broad solicitation in Rule 506(c) offerings will be warmly received in some quarters and, as The Wall Street Journal predicted, "unleash a wave of ads." Whether small businesses will materially benefit from the change is perhaps less clear. The Wall Street Journal article referenced immediately above was entitled: SEC Set To Erase Ad Block On Funds, and it highlighted the impact of the new Rule 506(c) on "hedge funds [and] private-equity firms." While the benefit of Rule 506(c) on truly small businesses may be more modest than the impact on large funds, the amendment implements a sound overall philosophy, which should provide a model for a reevaluation of other exemptions from registration that are (or should be) important to small businesses. Specifically, new Rule 506(c) permits issuers to solicit broadly for external capital, imposes investor protection devices at sale (not at offer), and relieves issuers—especially important to small businesses—from the pernicious effects of state registration requirements. That balance enhances capital formation while ensuring that investors are protected.

It is a model worth replicating in other exemptions.

**B. Title III of the JOBS Act: Crowdfunding**

Title III of the JOBS Act (the Crowdfunding Act) authorizes an exemption from registration for the offer and sale of securities through a technique that has come to be called crowdfunding. The Crowdfunding Act is intended to provide a statutory structure within which small companies are able to raise a relatively modest amount of capital through unregistered offerings conducted over the internet.

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82 See supra notes 30–61 and accompanying text.
83 Andrew Ackerman & Jessica Holzer, SEC Set To Erase Ad Block on Funds, WALL ST. J., July 10, 2013, at C3.
84 Id.
The Crowdfunding Act is a blend of mandatory statutory provisions that must be met in any offering under the exemption provided by the Act and a delegation of authority to the Commission to enact rules respecting the terms of the exemption. The mandatory provisions of the Crowdfunding Act include limitations on the aggregate amount that may be sold under the exemption and on the amount that may be purchased by any single investor. Generally stated, the mandatory statutory provisions of the Crowdfunding Act include a $1 million dollar limitation on total sales by the issuer and a limitation on the maximum amount of purchases by any single investor of between $2000 and $100,000, depending on the circumstances.

The Act requires that the issuer's crowdfunding transaction be conducted exclusively through the website of a broker or a "funding portal" (intermediaries or financial intermediaries) that meets strict statutory requirements. The Act also prohibits the issuers from advertising the crowdfunding offer, "except for notices which direct investors to the funding portal or broker."

Finally, the Crowdfunding Act requires that the issuer, at the time of the offering, disclose to investors and file with the Commission a significant amount of investment information, including financial information, and delegates to the Commission the authority to require "other information as the Commission may by rule prescribe." The Act requires that the offering be followed by some form of periodic reporting by the issuer, although the statute leaves broad discretion to the Commission to define the nature and extent of this obligation of the issuer.

88 Id. § 302(a), 15 U.S.C. § 77d(a)(6)(A) ([A]ggregate amount sold to all investors ... during the 12-month period ... is not more than $1,000,000.
89 Id. § 302(a), 15 U.S.C. § 77d(a)(6)(B). The maximum amount that any single investor may purchase from an issuer under the exemption "during the 12 month period" cannot exceed: (i) if the investor's annual income or net worth is less than $100,000, the greater of $2,000 or 5% of the investor's annual income or net worth; and (ii) if the investor's net income or net worth is more than $100,000, 10% of the investor's annual income or net worth, "as applicable," not to exceed $100,000. Id.
90 Id. § 302(a), 15 U.S.C. § 77d(a)(6)(C). "Funding Portal" is defined to limit the portal's activities essentially to the passive facilitation of the flow of investment information between the issuer and potential investors. JOBS Act § 101(b)(2) (2012), 15 U.S.C. § 78c(a)(80) (2012). For example, the funding portal cannot provide "investment advice," "solicit purchases," or compensate its employees bases on sales, meaning no commissions can be paid. Id.
93 Id. § 302(b), 15 U.S.C. § 77d-1(b)(i).
94 The Crowdfunding Act requires the issuer to "not less than annually, file with the Commission and provide to investors reports of the results of operations and financial statements of the issuer, as the Commission shall, by rule, determine appropriate, subject to such exceptions and termination dates as the Commission may establish, by rule." Id. § 302(b), 15 U.S.C. § 77d-1(b)(4).
The Crowdfunding Act—indeed, the entire crowdfunding movement—is not without its challenges. It was clear from the beginning that any regulatory implementation of the Act by the Commission would be contentious. In the first place, parties on both sides of this matter—those who believe in regulatory intrusion into the free market for securities and those who believe otherwise—are deeply invested in their positions, vocal, not without forums in which to express their views, and, indeed, at least in some instances, not without political influence. Secondly, the implementation of the Act involves a clash of cultures, a clash between the traditions prevalent in world of securities regulators (the Commission, for example) and the traditions in the world of technology entrepreneurs. New financial intermediaries are certain to appear and, at least in many cases, be managed by technology entrepreneurs who have little experience in (or patience with) the more risk adverse traditions of regulators of securities.

It was also clear from the beginning that the mandatory provisions of the Act itself may make it difficult for the Commission to construct an efficient regulatory crowdfunding regime for small businesses in search of external capital.

Notwithstanding such practical and regulatory challenges, my view was, and continues to be, that the fundamentals of the Crowdfunding Act are, at least in a broad sense, sound. The Act offers the Commission the opportunity to construct a new exemption from registration that enables small businesses to solicit broadly and efficiently for external capital through the use of modern technology. The Act, at least as a general matter, provides the Commission a rational (albeit challenging) framework for a disclosure regime that balances the capital formation needs of small issuers with investor protection. The Act does not, either as a matter of language or practical effect, limit investors to accredited investors, and the Act enables small businesses to solicit for external capital free from the debilitating effect of state registration laws and regulations.\textsuperscript{95}

Stated somewhat alternatively, properly implemented by the Commission, the Act increases the opportunities for small businesses to attain a new form of financial intermediation, one that may be reasonably priced and broadly available,\textsuperscript{96} and one that facilitates small businesses' efficient access to external capital.

The Commission has now promulgated its first iteration of proposed regulations (crowdfunding regulations) under the Crowdfunding Act.\textsuperscript{97} While this first iteration may offer a sensible path for some offerings by some small

\textsuperscript{95} The Crowdfunding Act amended the 1933 Act to preempt state registration authority over securities offered under the crowdfunding exemption. \textit{Id.} § 305(a), 15 U.S.C. § 77q(b)(4)(C).

\textsuperscript{96} For data regarding the use of financial intermediation offerings of $1 million or less under Regulation D, see supra Table I.

businesses—particularly offerings in amounts at or near the one million dollar limit imposed by the Crowdfunding Act—the crowdfunding regulations fail to achieve along the entire range of the exemption the essential balance between capital formation and investor protection. The proposed crowdfunding regulations also are plagued by legal technicalities that will make it difficult for small businesses to take full advantage of the exemption from registration.

For the crowdfunding regulations to work—to provide an appropriate access to external capital for small businesses—relative offering costs (offering costs as a percentage of proceeds from the offering) in crowdfunding transactions must be at a level that is rational and economically efficient. As described earlier, offering costs that amount to a large percentage of the total offering may kill the deal.98

Three types of offering costs generated by the Crowdfunding Act and the proposed crowdfunding regulations can be identified. First and most apparent are the costs generated by the mandatory disclosure requirements of the Crowdfunding Act and the proposed crowdfunding regulations. Second are the opportunity costs that may be generated by the requirement that the issuer of securities under the Crowdfunding Act and regulations forego the use of any other type of offering. Finally, there are the costs to small businesses relying on the crowdfunding exemption that result from their obligations to ensure that the financial intermediaries they use are compliant with the Crowdfunding Act and the proposed regulations.

Consider first the costs of the mandatory disclosure required by the Act and the proposed regulations. Setting the efficient level of mandatory disclosure is certainly the most difficult decision for the Commission in connection with its regulatory implementation of the Crowdfunding Act, and I fear the Commission has missed it badly in this first iteration.

There are two disclosure obligations in the crowdfunding regulations: the ex ante obligation, which is the obligation to provide investment information at the point of offer and sale, and the ex post obligation, which is the obligation to provide continuing information after the offering is completed.

Considering first the ex ante disclosure obligations, one finds, depending on how one counts, that the proposed crowdfunding regulations require issuers to provide the Commission and investors with approximately twenty categories of financial and non-financial investment information.99 I see in these requirements soaring relative offering costs100—especially for offerings of less than $500,000—generated by the amount and, at least in some cases, the nature of information that is required to be disclosed and by the practical necessity of the issuer's engaging expensive professionals in constructing the

98 See supra notes 20–21 and accompanying text.
100 For an explanation and discussion of "relative offering costs," see supra notes 20–21 and accompanying text.
required disclosures. In short, I am unable to find an efficient regulatory balance between small business capital formation and investor protection.

The sheer volume, detail, and practical complexity of this ex ante disclosure information is perhaps even more vivid—and thus daunting—when viewed through the lens of one who has written disclosure documents required by the Securities Act of 1933 and the Securities Act of 1934. A few examples out of the twenty or so categories of information will make the point. Risk factors must be disclosed,101 and initially identifying the issuer’s risk factors and constructing the required disclosures is a matter that necessarily will involve significant time from the issuer’s counsel.102 Required disclosure about “ownership and capital structure” are especially challenging.103 Six separate disclosures are required, including how the rights of principal shareholders could impact crowdfunding investors,104 “how the [crowdfunding] securities . . . are being valued, and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions”105 and a description of the special risks of minority ownership.106 Finally, there is the obligation for a narrative “description of the financial condition of the issuer,”107 a requirement that seems to be a first cousin to the “Management’s Discussion and Analysis”108 required, for example, in Form 10-Ks that are filed under the Securities Exchange Act of 1934.109

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102 One practical point regarding the costs of meeting the crowdfunding disclosures should be made. It is likely a small business utilizing the crowdfunding exemption will be an unseasoned issuer—one that for the first time is preparing offering documents required by securities regulators. This makes it likely that outside counsel will literally draft the whole of the disclosure rather than—as is typical in an offering by a seasoned issuer—merely reviewing the work of the issuer itself. This significantly increases attorney fees for the crowdfunding issuer. Drafting risk disclosures offers an example of this. A seasoned issuer, one for example that is reporting under the Securities Exchange Act of 1934, can simply update and revise as necessary its “Risk Factors” section from a prior Commission filing. Obviously, such a low cost disclosure is impossible in a crowdfunding offering.
104 Id. at 66,552 (to be codified at 17 C.F.R. § 227.201(m)(4)).
105 Id. at 66,552–53 (to be codified at 17 C.F.R. § 227.201(m)(4)). This disclosure will involve complex present value calculations and an understanding and disclosure of future reorganizations and how such transactions may impact shareholder wealth.
106 Id. at 66,553 (to be codified at 17 C.F.R. § 227.201(m)(3)) (requiring disclosure of “[t]he risks . . . to minority ownership in the issuer and the risks associated with corporate actions including additional issuances of securities, issuer repurchases of securities, a sale of the issuer or of assets of the issuer or transactions with related parties”).
107 Id. (to be codified at 17 C.F.R. § 227.201(s)).
The ex ante disclosures required by the proposed crowdfunding regulations also include financial statements.110 The financial statements provided to investors and the Commission must "include a balance sheet, income statement, statement of cash flows and statement of changes in owners' equity and notes to financial statements prepared in accordance with U.S. generally accepted accounting principles," and the financial statements must cover at least two years or since the inception of the company.111 The Commission's crowdfunding regulations, consistent with the Crowdfunding Act,112 offer a modest, stepped approach to the certification or audit requirements of these financial statements. For offerings of $100,000 or less, the statements must be "certified by the principal executive officer of the issuer to be true and complete in all material respects;" for offerings between $100,000 and $500,000, the statements must be "reviewed by a public accountant who is independent of the issuer," and for offerings between $500,000 and $1,000,000, the financial statements must be "audited by a public accountant who is independent of the issuer."113

The burden of the foregoing ex ante required narrative and financial disclosures is significantly increased by the obligation in the proposed crowdfunding regulations114 for the issuer to provide ex post disclosures—extensive and protracted post–offering disclosures that seem modeled on the periodic disclosures under the Securities Exchange Act of 1934. These ex post disclosures raise total offering costs and may, in fact, be the most daunting for all disclosures for small businesses seeking to use the crowdfunding exemption. Essentially, the issuer is required annually to provide all the information—including financial information—required ex ante at the point of offering, except for information about the nature and terms of the original offering.115 This periodic reporting may go on forever.116 It is difficult to see how any small issuer would knowingly agree to such terms. It is even more difficult to see any policy supporting such an extensive and protracted

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111 Id. (to be codified at 17 C.F.R. § 227.201(t)(Instruction 2)).


114 The Crowdfunding Act delegates broadly to the Commission the authority to dictate the terms of this annual reporting obligation. CROWDFUND Act § 304(b), 15 U.S.C. § 77d-1(b)(4) (imposing an obligation to file such annual reports "as the Commission shall, by rule, determine appropriate, subject to such exceptions and termination dates as the Commission may establish, by rule").


116 Id. (to be codified at 17 C.F.R. § 227.202(b)) (stating that the issuer is obligated to continue the annual filing until the issuer becomes a reporting company under the 1934 Act, the issuer of a third party purchases all the securities issued in the crowdfunding offering, or the issuer dissolves itself).
obligation. In short, the ex post disclosure obligations are significantly out of balance.

The purpose here is not to provide a detailed, section by section analysis of the disclosure requirements for a crowdfunding offering. The purpose, instead, it to provide a few of the more glaring examples of the Commission's loss of balance in its crowdfunding regulations. The Commission in its first iteration of its crowdfunding regulations has failed to appreciate the impact on small issuers of the relative offering costs generated by the crowdfunding disclosure obligations. For the new exemption to work, the Commission must step these disclosure requirements, requiring less disclosures for small crowdfunding offerings and more disclosures for larger crowdfunding offerings. Absent such a stepped approach, the crowdfunding exemption will be functionally unavailable for many offerings. Especially adversely impacted by the failure of the Commission to adopt such a stepped approach will be offerings by small business with small external capital needs, which seems exactly counter to the whole purpose of the JOBS Act.

Another cost for issuers relying on the crowdfunding exemption is in the nature of an opportunity cost and is principally the result of the impact of that old and sinister concept of integration.\textsuperscript{117}

The terms of the Crowdfunding Act require that the "issuer...shall...not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker."\textsuperscript{118} The proposed crowdfunding regulations reiterate this statutory prohibition, limiting the issuer's right to communicate with investors to "communication channels provided by the intermediary on the intermediary's platform."\textsuperscript{119}

On its face, this limitation seems consistent with the balance struck by crowdfunding exemption. Part of the investor protection for crowdfunding investors is this limit on aggressive selling efforts by the intermediary or the issuer. The Act and the crowdfunding regulations, therefore, essentially limit permissible selling efforts to the electronic posting of the offer and providing potential investors with disclosures of prescribed investment information.

\textsuperscript{117} See Rutheford B Campbell, Jr., The Overwhelming Case for Elimination of the Integration Doctrine Under the Securities Act of 1933, 89 Ky. L.J. 289 (2001) [hereinafter Campbell, Integration Doctrine]. That article explains the integration concept as follows:

Under the integration doctrine, a single "offering" or "issue" of securities cannot be split. . . . Accordingly, if an issuer attempts to bifurcate a single offering into two separate components and qualify each component under a separate exemption . . . , courts or the Commission may conclude that the two putatively separate offerings in fact amount to a single offering and thus may "integrate" the two transactions into a single offering. Once this integration occurs, the breadth of the offering or issue is defined, and all the offers and sales within this defined offer or issue must . . . meet all the requirements of a single exemption . . . .

\textsuperscript{118} CROWDFUND Act § 302(b), 15 U.S.C. § 77d–1(b)(2).

The problem, however, is that this tough limitation on selling strategies, when considered together with the integration doctrine, may generate significant opportunity costs for an issuer attempting to utilize the crowdfunding exemption. In essence, it forecloses a small business issuer utilizing the crowdfunding exemption from the opportunity to market its securities in face-to-face transactions, even with local, accredited potential investors.

Consider, for example, a situation in which an issuer needs to raise $1 million in external capital. If the issuer undertakes a crowdfunding offering in that case, it could not engage in any face-to-face selling efforts with potential investors in the issuer's community. To do so would likely be contrary to the limitation on selling efforts, described above. Even if all the local potential investors were, for example, accredited investors and thus qualified as investors under Rule 506, offering and selling shares to such accredited investors would likely violate Section 5 of the 1933 Act and destroy the crowdfunding exemption as well. The reason is because of the integration doctrine. It seems certain that the two components of the $1 million offering—the part of the offering sold on the internet through the crowdfunding exemption and the part of the offering sold in face-to-face transactions to accredited investors—would be integrated.\(^{120}\)

If that happens, the integrated offering would meet neither the requirements of the crowdfunding offering—since the issuer would seem to violate the crowdfunding prohibition against advertising—nor the requirements for the exemption provided by Rule 506—since the offering would include sales to unaccredited investors over the Internet.

The result of this for the small business issuer is that it would have to choose between an internet offering and a face to face offering. That is a significant disadvantage for a small business struggling to raise capital, and requiring the issuer to choose between crowdfunding and a Rule 506 offering advances no economic or social policy, such as investor protection.

Integration, as I have argued in prior articles, has never made any sense. If a crowdfunding offer is made, the bases for an exemption from registration are disclosures and the limitation on aggressive selling techniques. The fact that at the same time the issuer is also engaged in selling securities to accredited investors under Rule 506 in no way harms or compromises the underlying policy of the crowdfunding exemption. Nor do the crowdfunding sales compromise the underlying policy of the exemption provided by Rule 506, which is primarily based on the fact that all purchasers are accredited.\(^{121}\)

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\(^{120}\) Regulation D has its own integration safe harbor. See 17 C.F.R. § 230.502(a) (2014). That safe harbor, however, offers only one-way protection. That is, it protects only the Regulation D offering and not, in the case I am hypothesizing, the crowdfunding offering. Also, the Regulation D integration safe harbor protects only in instances where the two offerings are six months or more apart. Id. (providing protection only in the case the offerings “are made more than six months” apart).

\(^{121}\) Campbell, Integration Doctrine, supra note 117, at 319–24 (providing examples demonstrating the nonsense of applying integration in exempt offerings).
While the Commission has seemed over time to recognize the lack of any policy supporting the application of the integration concept by developing a number of safe harbors from the application of the integration concept, the crowdfunding regulations and the accompanying release proposing those regulations are woefully lacking in regard to this important matter. The Commission simply ignored this issue in its proposed crowdfunding regulations by providing no integration safe harbor protection for crowdfunding. Instead, curiously and inappropriately, the Commission in the release proposing the crowdfunding regulations merely states what is apparently its opinion that "we believe" there should be no integration.

The Commission needs a complete two-way integration safe harbor for all crowdfunding offerings. While this will not be a simple matter to reduce to a regulation, the Commission in its release has offered an approach that may make some sense. Efficient access to capital for a small business issuer using the crowdfunding exemption requires that the small business at the same time be allowed to deal with potential investors in a face to face manner.

Small business issuers relying on the exemption provided by the proposed crowdfunding regulation will also encounter the costs generated by the risk that the financial intermediary involved in the crowdfunding transaction is not compliant with the Crowdfunding Act and the crowdfunding regulations. Both the Act itself and the crowdfunding regulations predicate the crowdfunding exemption on a "transaction [that] is conducted through [an intermediary] ... that complies with the requirements of" the Crowdfunding Act.

The impact of this will require the issuer to take steps to ensure that the intermediary has complied with all the steps necessary to meet the requirement of a "broker" or a "funding portal." The amount of investigation the issuer takes in order to ensure that the intermediary is compliant with the Crowdfunding Act will certainly be based on a cost-benefit analysis by the small business issuer. The cost to the small business issuer will include both the out of pocket

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122 For a discussion of the Commission's regulatory integration safe harbors, see id. at 311-19.


124 It is interesting that the Commission has effectively neutralized the pernicious impact of integration in the new Regulation A regulations but has failed so badly to neutralize the integration problem in the Crowdfunding regulations. See infra note 149.


The crowdfunding regulations require that the crowdfunding offering be "conducted through an intermediary that complies with ... [the intermediary requirements of the Crowdfunding Act] and the related requirements in Regulation Crowdfunding." Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70741, 78 Fed. Reg. at 66,531 (proposed Nov. 4, 2013) (to be codified at 17 C.F.R. § 227.100(a)(3)).
expenses of any investigation and the residual negative value remaining after investigation that, notwithstanding the investigation, the intermediary does not actually meet the statutory requirements. Both amount to economic costs that must be absorbed by the issuer.

The Commission should eliminate or significantly reduce this cost through its crowdfunding regulations.\(^2\) Society gains essentially nothing by encouraging issuer expenditures to audit intermediary compliance with intermediary obligations. Intermediary compliance with the intermediary’s statutory and regulatory obligations is best and most efficiently achieved by penalties on the intermediary for its compliance failures. Penalties on issuers for intermediary non-compliance are misdirected and increase offering costs for small businesses.

The second and third of the offering costs describe immediately above—the cost generated by the risk of integration in a crowdfunding offering and the cost generated by the risk of the non-compliant intermediary—are easily dealt with by the Commission through the exercise of its regulatory authority and involve no difficult policy choices. Neither of those two costs generates any benefit to society or the economy. Structuring an efficient level of disclosure, of course, is more challenging, but it is a challenge well within the Commission’s expertise and experience.

**C. Title IV of the JOBS Act (“Small Business Capital Formation”) and the Commission’s Regulation A Rules**

Section 3(b)(1) of the 1933 Act\(^3\) delegates broad authority to the Commission to enact regulatory exemptions from registration. The only limitations on the Commission’s authority are that the regulatory exemptions cannot exceed $5 million and must be “in the public interest.”\(^4\)

The Commission, acting under this delegated authority, enacted Regulation A.\(^5\) Regulation A allows the issuer to make a public offering of its

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\(^4\) JOBS Act § 401(a)(1), 15 U.S.C. § 77c(b)(1) (amending Securities Act of 1933 § 3(b)) (authorizing the Commission to enact exemptions in situations in which registration “is not necessary in the public interest and for the protection of investors”). Congress made explicit that in enacting regulations “in the public interest” the Commission should “consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.” 15 U.S.C. § 77b(b) (2012).

securities in an amount up to $5 million. The exemption is predicated on the issuer's filing an offering statement with the Commission (roughly equivalent to a registration statement) and providing each investor with an offering circular (roughly equivalent to a prospectus).

The Commission in its Regulation A rules took pains to tailor the filing and disclosure requirements in a way that balances investor protection with the capital formation needs of small businesses. Thus, for example, the narrative and financial disclosures were scaled back from the disclosure requirements applicable for registration pursuant to a Form S-1. The Commission also imposed no offeree or purchaser qualification requirements on Regulation A offerings (e.g., no sophistication or accredited investor requirements) or restrictions on the resale of Regulation A securities.

At the time of the enactment of the JOBS Act, Regulation A was the only generally available exemption from the registration requirements of the 1933 Act that permitted an issuer to engage in a broad, interstate search for external capital.

Notwithstanding the apparent attractiveness of Regulation A for offerings by small businesses, the Commission's carefully crafted regime turned out to be an utter failure. In recent years, Regulation A has been essentially unused.

The principal reason for the failure of Regulation A is the registration requirements in state blue sky laws. A small issuer using Regulation A for a wide offering is required, in addition to meeting the requirements of Regulation A, to meet the registration requirements—either by registering the securities with the state or qualifying for an exemption—in each state where its securities are offered. The transaction costs generated by state registration rules simply overwhelm any benefit small businesses may gain by using Regulation A.

Title IV of the JOBS Act adds new Section 3(b)(2) to the 1933 Act. That section directs the Commission to enact new regulations providing an
exemption from registration for offerings of up to $50 million. 140 Delegation of rule making authority to the Commission under this new Section 3(b)(2) is broad. Perhaps most important among the few statutory limitations on the Commission's delegated authority are, of course, the $50 million limit on a Section 3(b)(2) offering, 141 a statutory declaration that the securities are not "restricted securities," 142 and a requirement that issuers relying on the Section 3(b)(2) exemption "file audited financial statements with the commission annually." 143

The JOBS Act also deals with the important and politically sensitive matter of the preemption of state authority over registration of securities offered under the exemptions provided by Section 3(b). The JOBS Act amends NSMIA 144 to provide two bases for preemption of state registration authority over securities sold in a Section 3(b)(2) offering. First, state authority is preempted if those securities are "offered or sold on a national securities exchange." 145 The other basis for federal preemption of state authority over registration is if the securities in a Section 3(b)(2) offering are "offered or sold to ... qualified purchaser[s], as defined by the Commission." 146

The breadth of the legislative delegation of authority to the Commission in Title IV of the JOBS Act offers the Commission an opportunity to construct a new Section 3(b) regulatory exemption from registration that is efficient for small issuers and sound as a matter of policy. To achieve these benefits, however, the Commission, within the scope of its delegated authority, must enact regulations that balance investor protection and capital formation. Most important to a good outcome in that regard 147 is a regulatory regime that

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141 Id.
144 Id. § 401(b), 15 U.S.C. § 77r.
145 Id. § 401(b), 15 U.S.C. § 77(r)(4)(D)(ii). My assumption is that "offered or sold on a national securities exchange" means that the securities are listed for trading on the national exchange. This, of course, will never be the case for small businesses, since their securities are not traded on a national exchange.
146 Id. § 401(b), 15 U.S.C. § 77(r)(4)(D)(ii). Prior to the Jobs Act, the Commission had broad authority to expand preemption to cover any offer and sale to "qualified purchasers, as defined by the Commission." 15 U.S.C.A. § 77(r)(3) (Supp. 2011).
147 As described above, the integration doctrine generates significant problems for offerings under the proposed crowdfunding regulations. See supra notes 117–125 and accompanying text. The proposed Regulation A rules, however, contain a direct and generally effective safe harbor for Regulation A offerings. Proposed Rule 251, 17 C.F.R. § 230.251(c), provides Regulation A offerings "will not be integrated with ... [p]rior offers or sales of securities [or with] ... [s]ubsequent offers or sales that are ... [m]ade more than six months after the completion of the Regulation A offering ... [or made pursuant to] Regulation Crowdfunding." Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, Securities Act Release No. 9497, Exchange Act Release No. 71,120, 79 Fed. Reg. 3926, 4000 (proposed Jan. 23, 2014) (to be codified at 17 C.F.R. § 230.251(c)). As the language indicates, the proposed Regulation A safe harbor
conditions the Section 3(b) exemption on an efficient level of disclosure and that eliminates state registration authority over Section 3(b) offerings.

The Commission has now offered its first iteration of the new Regulation A regulations (proposed Regulation A rules). Unfortunately, the Commission's proposed regulations fail to offer small businesses an efficient disclosure regime or a sensible preemption option.

To facilitate the explanation of the proposed Regulation A rules and my criticism of those regulations, it is helpful to offer a brief word about the structure of the Commission's proposed Regulation A rules.

The new regulations dealing with offers and sales of securities in amounts above the prior $5 million limit of Regulation A are integrated into the preexisting regulatory structure of the Regulation A. Under the proposed Regulation A rules, offerings of up to $5 million are referred to as “Tier 1 offerings” and offerings of up to $50 million are referred to as “Tier 2 offerings.”148 The requirements for a Tier 1 offering and a Tier 2 offering are somewhat different. There is no lower threshold for Tier 2 offerings. Thus under the proposed Regulation A rules, an issuer offering $5 million or less can qualify for a Section 3(b) exemption by meeting the Tier 2 offering requirements.

It is also appropriate to reemphasize that the focus of this paper addresses the extent to which the JOBS Act facilitates the legitimate capital formation needs of small businesses. Because small business issuers typically have smaller capital needs and because it is the smaller offerings that create the most difficulties regarding high relative offering costs, my focus in the proposed Regulation A rules is primarily on offerings of $5 million or less.

Consider first the disclosure requirements under the proposed Regulation A rules for such a small offering. A small business issuer searching for $5 million or less in external capital could qualify for an exemption under Section 3(b) by meeting the disclosure requirements for a Tier 1 offering or a Tier 2 offering. The advantage for the issuer in electing to meet the Tier 1 disclosure requirements is that those disclosure requirements are less onerous (and thus less expensive) than the disclosure requirements for a Tier 2 offering.

Even in a Tier 1 offering, however, small business issuers face significant and expensive ex ante disclosure requirements in small offerings under the proposed Regulation A rules. Proposed Form 1-A, which provides requirements both for the offering statement and the offering circular, requires fourteen items of narrative disclosures, plus financial disclosures, in the case of Tier 1 offerings.149

While the Commission, to its credit, attempted in the proposed Regulation A rules to reduce the amount of disclosures compared to a registered offering,150

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148 Id. at 3927.
149 Id. at 4008, 4016–35 (to be codified at Form 1-A, 17 C.F.R. § 239.90).
150 For example, the description of the issuer's business required by Item 7 of the proposed regulations governing the offering circular, compared to the disclosures required by Regulation SK, reduces the number of past years that must be reflected in the Regulation A offering circular.

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the proposed narrative disclosures are still quite significant, especially as concerns the relative offering costs for smaller offerings under the proposed rules. The narrative disclosure requirements in the proposed Regulation A rules seem to be a first cousin—perhaps a double first cousin—to the requirements reflected in Regulation S–K.151 Indeed, the proposed Regulation A disclosures may become even closer to the Regulation S–K requirements when one considers that the small business issuer’s actual ex ante Regulation A disclosures will most likely be orchestrated by counsel who is experienced in securities matters and familiar and comfortable with Regulation S–K. One would expect such counsel to err on the side of more expansive disclosures, informed by her or his experience in 1933 Act and 1934 Act disclosures.152

Also, it is worth noting that Item 9 of proposed Form 1–A requires the small business issuer to provide a “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (MD&A).153 This particular section over the years has expanded to a major disclosure in documents filed under the 1933 Act and the 1934 Act, for example in Form 10–Ks154 of issuers reporting under the 1934 Act.

With regard to ex ante financial disclosures required in the proposed Form 1–A, small business issuers effecting a Tier 1 offering must provide two years of financial statements compiled and presented in accordance with GAAP.155 The statements must include balance sheets and statements of

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income, cash flows, and stockholders equity. The financial statements do not have to be audited, and the statements do not have to be compliant with Regulation S–X.

Tier 1 offerings generate no ex post periodic reporting requirements for small business issuers using the proposed Regulation A rules. The only ex post report required in a Tier 1 offering is a simple form, Form 1–Z, which provides the Commission with information about the offer itself. It requires no updated narrative or financial investment information.

Notwithstanding the modesty of the ex post reporting requirements, the disclosure obligations as a whole for Tier 1 offerings generate a substantial level of relative offering costs for a small business issuer seeking a small amount of external capital. It is, however, difficult for me to find fault with the financial disclosure requirements for a Tier 1 offering, except to offer the observation that the balance between investor protection and capital formation for smaller Tier 1 offerings (perhaps offerings of $2 million or less) might better have been struck by retaining the one year balance sheet requirement that was in place under the prior Regulation A regime.

The extent of narrative investment information required by the proposed Regulation A rules in a Tier 1 offering, however, is more problematic. It is difficult to conclude that the level of required disclosures, certainly in the case of smaller Tier 1 offerings (again, perhaps offerings of $2 million or less), amounts to a proper balance between investor protection and capital formation. Relative transaction costs in the case of small Tier 1 offerings under the proposed Regulation A rules may amount to an effective, practical bar to the use of Regulation A for small offerings.

The disclosure requirements for a Tier 2 offering are more onerous than the disclosure requirements for a Tier 1 offering. The principal ex ante disclosure differences are that in a Tier 2 offering financial statements must be audited, and compliant with a significant part of Regulation S–X.

The big disclosure change imposed on Tier 2 offerings, however, is the ex post periodic reporting requirement.

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156 Id. at 4035 (to be codified at Form r–A, Part F/S(b)(2) and (3), 17 C.F.R. § 230.90).
157 Id. at 4035–36. The required financial statements for a Tier 1 offering under the proposed Regulation A rules are similar to the preexisting Regulation A disclosure requirements, except the prior rules required only a one year balance sheet. See Form r–A, Part F/S, 17 C.F.R. § 239.90.
159 See Form r–A, Part F/S, 17 C.F.R. § 239.90.
161 Id. at 4036 (to be codified at Form r–A, Part F/S(c)(3), 17 C.F.R. § 230.90).
Issuers in Tier 2 offerings pick up obligations to file with the Commission annual reports,\textsuperscript{162} semiannual reports,\textsuperscript{163} and current reports,\textsuperscript{164} and this will certainly amount to a significant obligation for any small business issuer in a Tier 2 offering. The annual report, for example, must contain nearly the same information as the original offering statement, except for information about the original offering itself.\textsuperscript{165} The financial disclosures in the annual report require annual, two-year, audited statements that are GAAP compliant and compliant with Article 8 of Regulation S–X.\textsuperscript{166} These obligations continue until the issuer drops below 300 shareholders of record.\textsuperscript{167}

Considering these additional burdens, it may seem unlikely that any small offering of the type we are considering here—an offering of $5 million or less—would be made as a Tier 2 offering, even though that is certainly permissible. There is, however, a significant benefit for small business issuers who move their small offerings to a Tier 2 offering regime.

Specifically, the Commission’s proposed Regulation A rules effectively preempt state registration authority over Tier 2 offerings,\textsuperscript{168} while there is no effective preemption of state registration authority over Tier 1 offerings.

With regard to offerings of securities under the Tier 1 regime, the proposed Regulation A rules preempt state registration authority over the offers of such securities but not over the sales of those securities. This proposed preemption

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\textsuperscript{162} Id. at 4004 (to be codified at 17 C.F.R. § 230.257(b)(1)), 4041–46 (to be codified at Form 1–K, 17 C.F.R. § 239.91).

\textsuperscript{163} Id. at 4004 (to be codified at 17 C.F.R. § 230.257(b)(3)), 4046–51 (to be codified at Form 1–SA, 17 C.F.R. § 239.92).

\textsuperscript{164} Id. at 4004 (to be codified at 17 C.F.R. § 230.257(b)(4)), 4051–61 (to be codified at Form 1–U, 17 C.F.R. § 239.93).

\textsuperscript{165} Id. at 4041–46 (to be codified at Form 1–K, 17 C.F.R. § 239.91).

\textsuperscript{166} Id. at 3952.

\textsuperscript{167} Id. at 4004 (to be codified at 17 C.F.R. § 230.257(d)(a)). Although somewhat confusing, it appears that the issuer in a Tier 2 offering would be subject to the periodic reporting requirements for the year in which it offered securities in a Tier 2 offering, even if the issuer had less than 300 shareholders. Id. at 3964–65 (issuer with less than 300 shareholders may terminate “at any time after completing reporting for the fiscal year in which the offering statement was qualified”).

Allowing issuers to terminate periodic reporting in such cases may amount to a significant mitigation of the relative transaction costs for a small business issuer relying on the Tier 2 offering regime for its small offerings.

\textsuperscript{168} Section 18(a)(1)(A) of the Securities Act of 1933 preempts state authority over registration with regard to the offer or sale of a “covered security.” § 18(a)(1)(A), 15 U.S.C. § 77q(a)(1)(A) (2012). Section 18(b)(3) of the Securities Act of 1933 includes a security offered or sold to “qualified purchasers, as defined by the Commission by rule” in the definition of a “covered security” Id. § 18(b)(3), 15 U.S.C. § 77t(b)(3).

rule is both curious and unfortunate, and it is ineffective to protect small business issuers from the pernicious impact that state authority over registration has on small business capital formation. Indeed, the preemption rule in its present form most likely amounts to the death knell for Tier I offerings.

To understand the problems of a small business issuer attempting to meet the state registration requirements in a Tier I offering, imagine a situation in which a small business issuer proposes to offer its securities broadly in all fifty states. Assume that the issuer gets indications of interest from potential investors in ten states and thus proposes to sell its securities under the proposed Regulation A rules in a Tier I offering in all ten of those states. The issuer still has to meet the registration requirements respecting sales in each of those states, and there is what may be a significant complication regarding the issuer’s meeting the state registration requirements regarding those sales.

Assume—as quite likely may be the case—that the small business issuer proposes to rely in each of those states on the particular state’s version of its limited offering exemption. The conditions for some of those state exemptions will almost certainly involve strict limitations on offers by the issuer. Consider as an example the requirements for a small offering exemption under the Uniform Securities Act. That exemption is predicated on the issuer’s meeting three conditions: (1) no more than ten offers; (2) a reasonable belief that “all the buyers . . . are purchasing for investment”; and (3) no commission paid to intermediaries in connection with the offering.

What is unclear, however, is the impact of the federal preemption on the state’s requirements regarding the offer. Does the preemption merely mean that the original broad solicitation by the small business issuer enjoys the benefit of preemption with regard to the broad offer, leaving the exemption for the sale dependent on the issuer’s meeting, for example, all the three conditions described above, including the ten offer limit? Or, does the preemption change the conditions for a sale pursuant to the state small offering exemption, with the result that a small business issuer meets the requirements for an exempt sale under state’s small offering exemption if the issuer meets only the other two conditions described above—(2) buyers purchasing for investment and (3) no commissions paid?

This latter interpretation—that the state exemption can now be met merely by purchasing for investment and no commissions—seems problematic. It essentially changes the state small offering exemption to permit an unlimited number of sales of unregistered securities, an outcome that arguably is inconsistent with the policy bases for the legislative decision to exempt such sales.

170 Id. The small offering exemption for the District of Columbia limits the exemption to “an offer . . . to not more than 25 persons.” D.C. CODE § 31-3604.02(12)(A) (Lexis Nexis 2012). The small offering exemption in Colorado limits offers to “not more than twenty persons.” COLO. REV. STAT. § 11-51-308(1) (2013).
Alternatively, a court could declare the exemption entirely nullified—and thus unavailable—as a result of the federal preemption over the offer. By eliminating the principal condition for the exemption, the entire exemption, a court might find, simply fails.

The expense of attempting to qualify the sale under multiple state exemptions, especially when complicated by uncertainty regarding the requirements of the exemptions after preemption of state authority over offers, would seem to make the expenses and risks too high to be useful to small business issuers in search of a relatively small amount of external capital.

The likely outcome here, if the Commission holds to its proposed preemption rules, is that Regulation A will provide an attractive alternative for larger, non-public companies in search of a sizeable amount of external capital. Unfortunately, it is also nearly certain that the preemption regime of the proposed Regulation rule will ensure that Regulation A will continue to be unused by small business issuers in search of relatively small amounts of capital.\footnote{Small business issuers may respond in one of two ways to this problem. First, of course, the small business issuer may abandon entirely the Regulation A exemption, either by foregoing capital formation altogether or by utilizing a less desirable path to meeting the registration requirements of the 1933 Act. Second, the small business issuer may move to a Tier 2 offering under Regulation A, even for its small offerings (i.e., offerings within the Tier 1 offering range of $5 million or less). While this would increase both the \textit{ex ante} and \textit{ex post} offering expenses, it would allow the small business issuer to enjoy the benefits of preemption. Such a response can be observed in Regulation D offerings, where approximately 80\% of small offerings that are within the range covered by Rule 504 ($1 million or less) are made under the more onerous provisions of Rule 506. The reason for this is that offerings under Rule 506 preempt state authority over the registration. \textit{See} Campbell, \textit{The Wreck of Regulation D}, supra note 26, at 926–33.}

We continue to return to the same issues. In order for exemptions to work for small business issuers, relative offering costs—disclosure costs, in the case of Title IV of the JOBS Act—must be at an efficient level, and state registration requirements have to be eliminated by preemption. The Commission significantly failed in its proposed Regulation A rules to meet those conditions.

This is all fixable by a revision of the Commission’s proposed Regulation A rules, but the question is the will of the Commission to fix the problem, especially the problem of state authority over registration. In an article I wrote shortly after the JOBS Act was passed, I predicted, pessimistically, that the Commission would not be willing to exercise fully its delegated authority to preempt state authority over offerings by small business issuers under the revised Regulation A.\footnote{Campbell, \textit{Failure to Resuscitate}, supra note 27, at 317.} The proposed Regulation A rules suggest that, unfortunately, I was substantially correct.

One cannot but notice the irony that Title IV of the JOBS Act is entitled “Small Company Capital Formation.”
Conclusion

An efficient access to external capital by businesses is essential to a market economy. Small businesses, which amount to a vital component of our market economy, face not only structural and economic disadvantages but also legal obstacles in their search for essential external capital.

The JOBS Act, at least apparently, was aimed at reducing inefficient legal rules governing small businesses' access to capital. While the Act itself is something of a mess, it did offer the Commission an opportunity to construct regulatory regimes to ameliorate the problems of small businesses in regard to capital formation. The Commission, however, has failed to take full advantage of this opportunity.

The JOBS Act change in Rule 506 offerings to permit a broad solicitation for investors will help small businesses. The exemption from registration, however, is limited to sales to accredited investors, and that by definition is a limited capital market for small businesses.

The first iteration of the Commission's crowdfunding regulations and its new Regulation A rules need substantial work in a second iteration. Without significant changes, the crowdfunding will be less available for small business issuers than efficiency would require, and the new Regulation A rules may be essentially unavailable for small businesses.

As stated above, these problems regarding the crowdfunding regulations and the proposed Regulation A rules are fixable, if the Commission has the will.