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FREEING INVESTOR CAPITAL FOR SMALL BUSINESS

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INTRODUCTION

Something has gone wrong with small business in America. For the first time since statistics were kept, the rate of business failure now exceeds the rate of business creation.[1] It isn't that businesses are failing more often than usual; rather, new business creation has slowed markedly and the rate continues to slow further. At a time when the labor-force participation rate is at multi-decade lows,[2] the moribund state of small business is alarming.

As with any large problem, there are many contributing factors. A critical one has been the shortage of capital for business investment, particularly for small businesses. Without sources of capital, new businesses with irregular cash flow (or none at all) often are unable to meet payroll, invest in research or product development or seek out new customers. Enabling small businesses to access the capital they need is an urgent priority of public policy. Yet small businesses are having a harder time getting capital through the traditional financial system.

Banks are less willing to lend to small businesses than ever before, both because of deteriorating creditworthiness after the recent economic downturn and because small-business lending is simply no longer as profitable. More stringent banking regulations impose additional costs and the wave of bank mergers (particularly, the decline of community banks)[3] has diminished the local knowledge of community businesses that used to be banks' competitive advantage.[4] Additionally, lacking a strong secondary market for small-business loans, in contrast to the market for conforming mortgage loans,[5] banks are unwilling to carry small-business lending risks on their books. The business of banking instead has turned disproportionately to providing consumer and housing loans.[6]

1. Source: U.S. Census, Business Dynamics Statistics. See also Ian Hathaway and Robert E. Litan, "Declining Business Dynamism in the United States: A Look at States and Metros," *Brookings Institution*, May 2014. http://www.brookings.edu/~/media/research/files/papers/2014/05/declining%20business%20dynamism%20litan/declining_business_dynamism_hathaway_litan.pdf

2. Bureau of Labor Statistics, "Labor Force Participation Rate," *United States Department of Labor*, June 2, 2015. http://data.bls.gov/timeseries/LNS11300000

3. Institute for Local Self-Reliance, "Access to Capital for Local Businesses," April 15, 2014. http://ilsr.org/rule/financing-local-businesses/

4. Karen Gordon Mills and Brayden McCarthy, "The State of Small-Business Lending: Credit Access During the Recovery and How Technology May Change the Game," *Harvard Business School*, July 22, 2014. http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf Summarized in Karen Mills, "Why Small-Business Lending Has Not Recovered," *Forbes*, Aug. 4, 2014. http://www.forbes.com/sites/hbsworkingknowledge/2014/08/04/why-small-business-lending-has-not-recovered/; Robert Adams and Jacob Gramlich, "Where Are All the New Banks? The Role of Regulatory Burden in New Charter Creation," Federal Reserve, 2014. http://www.federalreserve.gov/econresdata/feds/2014/files/2014113pap.pdf ; Rework America (Markle Economic Future Initiative), *America's Moment: Creating Opportunity in the Connected Age*, W.W. Norton, 2015: pps. 97-100, 108; cf. Eugene Fama, "What's Different About Banks?" *Journal of Monetary Economics*, Vol. 15, 1985: 29-39; cf. Milton Marquis, "What's Different About Banks—Still?" FRBSF *Economic Letter*, April 6, 2001. <http://www.frbsf.org/publications/economics/letter/2001/el2001-09.html>

5. *America's Moment* 93, 103

6. *America's Moment* 92-3. Of course, the supposed safety of housing loans became the foundation for a dizzying superstructure of derivatives, culminating in the 2008 banking crisis. Perhaps a reasonable level of riskiness in banking would have been healthier overall.

To some degree, loan-guarantee programs offered by the Small Business Association mitigate the risks to banks and make them more willing to lend to new businesses. Indeed, SBA-guaranteed loans grew to more than $30 billion in the 2011 fiscal year, compared to $17.9 billion in FY2009 and $22.6 billion in FY2010.[7] After a slowdown, lending recovered to almost $30 billion in FY2014. During that year, the SBA also provided the bulk of the $5.5 billion loaned to small businesses by Small Business Investment Companies (SBICs).[8]

However, SBA eligibility rules tend to require that potential borrowers must be unable to secure financing from any other source. Rather than supporting those startups with the best prospects, the SBA's eligibility rules tend to select for marginal businesses.[9] Moreover, the volume of such loans is insufficient to meet the market's needs. In the 2014 Small Business Credit Survey, more than half of small and startup businesses reported they were unable to secure any bank credit at all.[10] Many small businesses instead rely on business credit cards. About 37 percent of small businesses surveyed in May 2012 reported they relied on credit cards, which carried an average interest rate of 15.6 percent.[11]

Some types of small businesses draw outside investment from the venture capital community, but this is a very limited pool. Federal regulations on the securities industry restrict who can own investments not registered with the Securities and Exchange Commission (SEC) and publicly traded on the securities exchanges. For the most part, venture capital is carried out under the exemptions of Regulation D of the Securities Act of 1933,[12] which ensure that average investors are prohibited from participating. To be involved in venture capital, you must either be an institutional investor, or an "Accredited Investor" (someone with at least $1 million in investible assets, individual income of at least $200,000 or household income of at least $300,000 per year).[13] The SEC's Accredited Investor regulations have been justified on grounds that investments not validated by national regulators are too risky for typical unsophisticated investors.[14] Instead, regular investors are generally told to invest in purportedly "safer" publicly traded securities. At a time when many decry growing inequality, there is a certain irony that federal law reserves the most important class of investments to the wealthiest investors.[15]

Only about 8.5 million Americans meet today's Accredited Investor requirements. The SEC is considering revisions to the standard that may cut that number by at least half.[16] And few Accredited Investors actually are involved in venture capital or angel investing,[17] as such investments carry substantial risk and government regulations make them nontransferrable before an initial public offering.[18] They are thus not suitable for many who desire predictable investments and liquid assets. All told, the American venture-capital sector invested more than $33 billion in private companies in 2013[19] and $48 billion in 2014.[20] By contrast, U.S. IPOs raised $55 billion[21] and $85 billion[22] the past two years, while defined-contribution retirement plans invested $133 billion and $153 billion in the securities markets.[23] Even state lotter-

7. SBA News, "Jobs Act Loan Incentives Led to Record SBA Loan Approval Volume," *U.S. Small Business Administration*, Oct. 5, 2011. https://www.sba.gov/content/jobs-act-loan-incentives-led-record-sba-loan-approval-volume-supporting-over-30-billion-0

8. SBICs are privately managed investment funds that are exempt from registering with the Securities and Exchange Commission (SEC) provided that they invest specified percentages of their portfolio in small business loans, per the Small Business Investment Act of 1958. See "Agency Financial Report Fiscal Year 2014: Today's SBA: Smart, Bold, Accessible," *U.S. Small Business Association*, Nov. 17, 2014. https://www.sba.gov/sites/default/files/aboutsbaarticle/1-FY%202014%20Agency%20Financial%20Report.pdf; Cf. "Investing in an SBIC," *U.S. Small Business Association*, https://www.sba.gov/content/investing-with-sbic

9. *America's Moment*, pg.104.

10. Federal Reserve Banks of New York, Atlanta, Cleveland, and Philadelphia, "Joint Small Business Survey Report, 2014," *Federal Reserve Bank of Cleveland*, January 2015. https://www.clevelandfed.org/en/Community%20Outreach/Community%20Development/2014%20Small%20Business%20Credit%20Survey.aspx

11. Federal Reserve, "Report to the Congress on the Availability of Credit to Small Businesses," September 2012. http://www.federalreserve.gov/publications/other-reports/files/sbfreport2012.pdf

12. Cf. Office of Investor Education and Advocacy, "Regulation D Offerings," U.S. Securities and Exchange Commission, Oct. 28, 2014. http://www.sec.gov/answers/regd.htm; Daniel M. Gallagher, "Grading the Commission's Record on Capital Formation: A+, D, or Incomplete?" U.S. Securities and Exchange Commission, March 27, 2015. http://www.sec.gov/news/speech/032715-spch-cdmg.html

13. Office of Investor Education and Advocacy, "Investor Bulletin: Accredited Investors," U.S. Securities and Exchange Commission, Sept. 23, 2013. http://www.investor.gov/news-alerts/investor-bulletins/investor-bulletin-accredited-investors

14. See, for example, the attitudes expressed by SEC Commissioner Luis Aguilar in "Revising the 'Accredited Investor' Definition to Better Protect Investors," U.S. Securities and Exchange Commission, Dec. 17, 2014. http://www.sec.gov/news/statement/spch121714laa.html

15. Cf. *America's Moment* 4.

16. Luis Aguilar, ibid. http://www.sec.gov/news/statement/spch121714laa.html; GAO-13-640, "Securities and Exchange Commission: Alternative Criteria for Qualifying as an Accredited Investor Should be Considered," U.S. Government Accountability Office, July 2013. http://www.gao.gov/assets/660/655963.pdf

17. That is, investing in startups (often for friends and family) without going through a formal venture capital fund.

18. Some in the SEC support the idea of a "venture exchange" that would permit non-public shares to be traded. See Luis Aguilar, "The Need for Greater Secondary Market Liquidity for Small Businesses," U.S. Securities and Exchange Commission, March 4, 2015. http://www.sec.gov/news/statement/need-for-greater-secondary-market-liquidity-for-small-businesses.html

19. Wilmer Hale, "2014 Venture Capital Report." http://www.wilmerhale.com/uploadedFiles/Shared_Content/Editorial/Publications/Documents/2014-WilmerHale-VC-Report.pdf

20. PricewaterhouseCoopers/National Venture Capital Association, "Annual Venture Capital Investment Tops $48 Billion in 2014, Reaching Highest Level in Over a Decade, According to the MoneyTree Report," *National Venture Capital Association*, Jan. 16, 2015. http://nvca.org/pressreleases/annual-venture-capital-investment-tops-48-billion-2014-reaching-highest-level-decade-according-moneytree-report/

21. Renaissance Capital, "US IPO Market 2013 Annual Review," Jan. 2, 2014. http://www.renaissancecapital.com/ipohome/review/2013usreviewpublic.pdf

22. Renaissance Capital, "US IPO Weekly Recap: Record 2014 IPO Market Finishes with a $2 Billion Cancer Biotech," NASDAQ, Dec. 19, 2014. http://www.nasdaq.com/article/us-ipo-weekly-recap-record-2014-ipo-market-finishes-with-a-2-billion-cancer-biotech-cm425412

23. Federal Reserve Board of Governors, "Z.1 Financial Accounts of the United States: Fourth Quarter 2014," *Federal Reserve*, March 2015: pg. 35. http://www.federalreserve.gov/releases/z1/Current/z1.pdf

ies raised more than venture-capital firms, with $68 billion and $70 billion in tickets sold.[24]

In part because of its relatively small size, the venture-capital sector also tends to be remarkably parochial, making a disproportionate amount of its investments in firms located where VC managers actually live. More than 40 percent of recent VC funding went to firms in the tiny area of Silicon Valley.[25] Furthermore, as VC funds have grown in size, there is evidence that VC funding is increasingly focused on more mature firms that can make use of larger infusions of money and are presumably safer bets.[26]

This parochial focus also leads VC firms to neglect portions of the economy outside of the "sexy" sectors of software development and biotech. In particular, firms engaged in capital-intensive research to develop novel technologies, like clean energy and other heavy-manufacturing projects, are in what has been termed the business-capital "valley of death"; they are too risky for banks but VCs see them as taking too long to generate profits.[27] Research shows it is precisely these kinds of firms ("knowledge-intensive industries") that serve as the nucleus for high-growth economic ecosystems.[28]

It should be noted that, while small companies face difficulties in accessing capital, this is not a time of general capital scarcity. By most measures, individuals and corporations have more accumulated capital than ever before in history. The problem is that an excessive portion of that capital has gone into liquid securities in the stock or bond markets, rather than being channeled into productive business investment.[29] At a time when corporations such as Apple and Verizon have accumulated cash stores so large they don't know how to profitably deploy them, our national rate of net domestic investment has dropped to levels not seen since the Great Depression.[30] From 2003 until now, more than half the earnings of companies in the Standard & Poor's 500 index have been used to repurchase shares. Most of the rest was paid out in dividends.[31] For our largest companies, R&D investment is so low it's practically a rounding error. For that reason, our economic dynamism increasingly depends on small businesses, making it all the more urgent to alleviate their capital shortages.

In short, a tremendous capital mismatch is holding back the American economy.[32] New approaches are needed.

CROWDFUNDING

Alternatives have emerged in recent years that allow some businesses to access capital through nontraditional means, such as new Internet-based platforms that match those seeking capital with those who want to invest.[33] Starting in 2006, the American *peer-to-peer lending* (P2P) sites Prosper.com and LendingClub began to serve as online marketplaces that would allow borrowers to request loans from individual lenders. (The U.K. site Zopa had been operating since 2005, and likely was the first online P2P lender globally.) Almost immediately, the SEC cracked down on the sites, accusing them of selling unregistered securities.[34] In 2008, Prosper and LendingClub both took a "quiet period" and ultimately registered their loans as public securities.[35] They now provide both primary loan origination and secondary markets for loan notes, administered by Foliofn.[36] Over time, more P2P lenders have emerged, including several that specifically target small businesses or real-estate development.[37] Prosper and LendingClub remain the largest lenders by volume, and lending is increasing rapidly. Prosper made $1.6 billion in loans in 2014 and $595 million in Q1 2015,[38] while LendingClub made more than $4 billion in loans in 2014.[39]

These sites begin to fill the gap left by diminished bank lending. Over time, they likely will become serious competitors to the traditional banking industry. However, current P2P lending volumes are still relatively small. As a source of business capital, P2P lending also has other limitations. Nearly

24. "Sales of State Lotteries in the United States from 2009 to 2014 (in Billion U.S. Dollars)," *Statista*, 2015. http://www.statista.com/statistics/215265/sales-of-us-state-and-provincial-lotteries/

25. *America's Moment* 101.

26. Basil Peters, "Venture Capital Firms Are Too Big," *AngelBlog*, Dec. 4, 2008. http://www.angelblog.net/Venture_Capital_Firms_Are_Too_Big.html; cf. America's Moment 100.

27. William Kerr and Ramana Nanda, "Financing Constraints and Entrepreneurship," *Harvard Business School*, 2009. http://www.hbs.edu/faculty/Publication%20Files/10-013.pdf (pg. 13)

28. *America's Moment* 156-164.

29. *America's Moment* 88.

30. *America's Moment* 89.

31. *America's Moment* 96.

32. *America's Moment* 19.

33. David Freedman and Matthew Nutting, "A Brief History of Crowdfunding: Including Rewards, Donation, Debt, and Equity Platforms in the USA," freedman-chicago.com, May 31, 2015. http://www.freedman-chicago.com/ec4i/History-of-Crowdfunding.pdf; cf. *America's Moment* 33, 105-6.

34. For the cease-and-desist order against Prosper, see Securities and Exchange Commission, "Securities Act of 1933 Release No. 8984," Nov. 24, 2008. https://www.sec.gov/litigation/admin/2008/33-8984.pdf

35. E.g. Lending Club blog, "Lending Club Completes $600 Million SEC Registration and Offers New Alternative for Consumer Credit," Lending Club, Oct. 14, 2008. http://blog.lendingclub.com/lending-club-sec-registration/

36. E.g. "Trade Notes on Note Trader by Folio Investing," Prosper.com. https://www.prosper.com/invest/how-to-invest/trading-platform/

37. A fairly comprehensive list of U.S. peer-to-peer lenders of all kinds can be found at "Marketplace Lending Platforms," *Lendvious*, https://www.lendvious.com/resource-library/marketplace-lending-platforms.

38. Alan Vermut, "Prosper Platform Surpasses $3 Billion in Loans, Closing Out Record First Quarter," Prosper, March 31, 2015. http://blog.prosper.com/2015/03/31/prosper-platform-surpasses-3-billion-in-loans-closing-out-record-first-quarter/

39. "Lending Club Statistics," Lending Club, March 31, 2015. https://www.lendingclub.com/info/statistics.action

all the U.S. P2P sites that allow investing by non-accredited investors only provide unsecured, fixed-interest loans. These are relatively riskier than secured loans, making them less attractive for investors. The lack of secured lending options also makes it harder for borrowers to establish creditworthiness and raises their interest-rate costs. New businesses may not have the regular cash flows needed to support recurring, fixed debt-service payments, which is why equity finance has been so important in the startup world. Though increasingly important to small businesses, P2P lending alone will not solve the problem.

P2P lending is considered part of the broader category of *crowdfunding*. Starting in the 2000s, new sites such as ArtistShare (2003), Indiegogo (2008) and Kickstarter (2009) emerged, offering a platform for "rewards-based" funding.[40] Similar to P2P lending, these sites allow people to contribute to projects they would like to back. However, crowdfunded contributions are not investments. Project backers receive no company equity or debt payments. Most projects instead offer either discounted services or merchandise or other more intangible rewards. Crowdfunding campaigns thus tend to favor entrepreneurs who already have established reputations, can mobilize large groups of supporters on social media and have a sexy product to offer.

Because crowdfunding does not convey equity to supporters, such campaigns have sometimes allowed entrepreneurs to pocket outsized gains from their projects with no benefit to backers. The Oculus Rift virtual reality project raised $2.4 million from Kickstarter supporters, and then was acquired by Facebook for $2 billion in cash and stock. None of that money flowed through to the initial backers, some of whom angrily demanded refunds (to which they were not entitled).[41]

As more or less an altruistic undertaking, crowdfunding has had negligible impact on small businesses in general. However, some companies have recognized the potential for using a crowdfunding or P2P platform to enable equity investments. Companies such as AngelList, SeedUps and Fundable all set up investing platforms to facilitate a more democratic style of venture capital. They would allow investors to invest directly in the equity of specific startups, rather than having to go through large VC funds, whose minimums and fees are quite high. Other sites, such as Patch of Land and RealtyShares, facilitate investment in senior-secured real estate debt.

Unfortunately, all of these sites restrict participation to Accredited Investors, thanks to the excessive costs involved in publicly registering securities. Given current regulations, it is simply easier for such platforms to raise capital through the Regulation D exemption, which means average investors remain excluded. The nascent crowdfunding scene is hobbled by a regulatory framework that impedes liquidity and restricts access only to the wealthiest investors.

JOBS ACT OF 2012

Crowdfunding advocates have in recent years lobbied Congress extensively for regulatory reform. Ultimately, an overwhelming bipartisan majority in Congress passed the JOBS Act of 2012, which (among other things) streamlined regulations for securities issues by small companies, in part to facilitate crowdfunded investing. Under Title III of the act, the SEC was directed to draw up regulations that would allow average Americans to invest directly in small companies.

The SEC balked. While other provisions of the act, most of them favorable to Wall Street incumbents, were swiftly put into place, SEC Chairwoman Mary Schapiro argued that liberalizing restrictions on crowdfunding would lead to increased securities fraud. She argued more time was necessary to formulate regulations that would protect investors from being scammed.[42] Despite vocal congressional impatience, years passed before the SEC finally made significant movement on the topic.

On March 25, 2015, the SEC announced an expansion to the existing "Regulation A" framework for small, unregistered securities issues. The final rule and form amendments officially just took effect June 19, 2015.[43] Previously, Regulation A issues were limited to $5 million and had onerous restrictions, such as the need to get approval for a securities issue in *every* state where shares were offered. Thus, Regulation A was seldom used. As part of its rulemaking, the SEC created two different tiers of "Regulation A+" issues.

The new rules allow companies to issue up to $20 million of securities under Tier 1, provided that they qualify under SEC guidelines and register on the state level (taking advantage of the new Coordinated Review Program, which offers a streamlined method for registering in several states at once).[44] Alternatively, they may issue up to $50 million under Tier 2, if they pre-empt the states and seek approval directly from the SEC. The latter option requires firms

40. "Brief History of Crowdfunding," *supra* note 33.

41. Jason Schreier, "Oculus Kickstarter Backers are Demanding Refunds," *Kotaku*, March 26, 2014. http://kotaku.com/oculus-kickstarter-backers-are-demanding-refunds-1552041702

42. Steven Davidoff Solomon, "S.E.C.'s Delay on Crowdfunding May Just Save It," *New York Times Dealbook*, Nov. 18, 2014. http://dealbook.nytimes.com/2014/11/18/s-e-c-s-delay-on-crowdfunding-may-just-save-it-2/

43. "SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital," Securities and Exchange Commission, March 25, 2015. http://www.sec.gov/news/pressrelease/2015-49.html

44. "NASAA's Coordinated Review Program Setting New Service Standards," North American Securities Administrators Association, Feb. 12, 2015. http://www.nasaa.org/34628/nasaas-coordinated-review-program-setting-new-service-standards/

provide ongoing audited financial statements. Investors can only invest up to 10 percent of their income or net worth in Tier 2 issues. In either case, securities issues are available to all investors, not just Accredited Investors, and they would be freely transferrable (with a few conditions), permitting trading in secondary markets.[45]

There are drawbacks to the Regulation A+ rules. First of all, Massachusetts and Montana have both filed suit to challenge the SEC's preemption of the states under Tier 2.[46] They argue that such preemption exceeds the scope of the SEC's authority and contravenes existing laws; if their challenge is upheld, Tier 2 may have to be drastically reworked. (The SEC has subsequently denied Montana's request for a stay, arguing that the state securities commissioner did not demonstrate she is likely to prevail or that the state would be irreparably harmed if the rules are not stayed.)[47]

Second, even Regulation A+ is excessively cumbersome. Issuers must file offering circulars with the SEC before they offer shares, which "may receive the same level of scrutiny as a Form S-1 in an initial public offering";[48] creating such circulars and providing other required financial disclosures is a slow and expensive process. In the words of SEC Commissioner Daniel M. Gallagher:

> "[O]ur new rules don't do much to help facilitate capital formation. Tier 1, with state qualification, remains too expensive; and Tier 2, with ongoing reporting, will likely be too expensive as well."[49]

The new rules do not actually mention Title III of the JOBS Act at all, leading to speculation that the SEC will bury the special rules for crowdfunding.[50] Title III would have placed the heaviest regulatory requirements on the broker portals, rather than the individual issuers, an approach similar to that taken in the United Kingdom. Instead, crowdfunding would be considered no different from any other method of securities issue. The Regulation A+ framework ensures that all such issues would need SEC review before being allowed in multiple states.

45. See further discussions in Kiran Lingam, "The Reg A+ Bombshell: $50M Equity Crowdfunding," *SeedInvest*, March 25, 2015. http://www.seedinvest.com/blog/regulation-a-equity-crowdfunding-rules/; "Regulation A+: Final Rules Offer Important Capital Raising Alternatives," Morrison Foerster, March 26, 2015. http://www.mofo.com/~/media/Files/ClientAlert/2015/03/150326RegulationA.pdf

46. "Massachusetts, Montana Sue SEC Over JOBS Act," *ThinkAdvisor*, May 26, 2015. http://www.thinkadvisor.com/2015/05/26/massachusetts-montana-sue-sec-over-jobs-act

47. Securities and Exchange Commission, "Order Denying Stay," June 16, 2015. http://www.sec.gov/rules/other/2015/33-9808.pdf

48. Lingam, "Reg A+ Bombshell"

49. Gallagher, "Grading the Commission's Record," *supra* Note 12. Note, however, that Commissioner Gallagher is skeptical of the defunct Title III as well, arguing that, as written, it would be excessively bureaucratic.

50. Lingam, "Reg A+ Bombshell," *supra* Note 45.

CROWDFUNDING AT THE STATE LEVEL

The Securities Act of 1933, which governs securities registration, contains a potential exemption for unregistered securities that are marketed entirely within a single state. If federal regulators are slow to act, crowdfunding could find more success in the states. The first state to liberalize laws for within-state crowdfunding was Kansas. The "Invest Kansas Exemption" (IKE),[51] effective Aug. 12, 2011, contained a number of provisions that would be echoed by later legislation in other states. It exempts a crowdfunding issue from state registration requirements if the size of the issue is less than $1 million, the business is organized and operated within Kansas, the investors are Kansans and the issuance is done through a Web portal registered as a broker-dealer under the 1933 Securities Act. Average investors are allowed to participate, though their investments are capped at $5,000. However, as unregistered securities, the crowdfunded investments can't be resold, short of later registration or similar means.

More than a year later, Georgia became the second state to make crowdfunding legislation effective. The framework is similar to Kansas' rules, except that non-accredited investors can contribute up to $10,000 per company.[52] Kansas and Georgia were quickly followed by a rush of other states, including Wisconsin, Michigan, Alabama, Indiana and Texas. Most recently, Arizona passed a crowdfunding law March 30,[53] Colorado passed its own law April 13 [54] and Minnesota did so June 13.[55] All told, at least 39 states either have enacted or are actively considering legislation to liberalize intrastate crowdfunding. Florida and North Carolina both voted down crowdfunding exemptions, but North Carolina currently is considering a new version of the bill.[56]

This rush of new laws offers the promise of unleashed entrepreneurism at the state level. However, thus far, volume on the state crowdfunding portals has been underwhelming. As of late 2013, only a handful of companies made use of the

51. "The Invest Kansas Exemption - 'IKE'," Office of the Kansas Securities Commissioner. http://www.ksc.ks.gov/DocumentCenter/View/228

52. Patrick Clark, "Kansas and Georgia Beat the SEC on Crowdfunding Rules. Now Others Are Trying," *Bloomberg Business*, June 20, 2013. http://www.bloomberg.com/bw/articles/2013-06-20/kansas-and-georgia-beat-the-sec-on-crowdfunding-rules-dot-now-others-are-trying

53. "Bill Status Overview: HB2591," Arizona State Legislature, last accessed June 3, 2015. http://www.azleg.gov//FormatDocument.asp?inDoc=/legtext/52leg/1r/bills/hb2591o.asp&Session_ID=114

54. Tamara Chuang, "Hickenlooper Signs Equity-Crowdfunding Law to Let Anyone Invest Locally," *Denver Post*, April 13, 2013. http://www.denverpost.com/business/ci_27906349/hicklooper-signs-equity-crowdfunding-law-let-anyone-invest

55. Minnesota Office of the Reviser of Statutes, "Chapter 469: Section 469.43," Minnesota Legislature, June 13, 2015. https://www.revisor.mn.gov/statutes/?id=469.43#stat.469.43.1

56. Anthony Zeoli, "State of the States - List of Current Active and Proposed Intrastate Crowdfunding Exemptions (Updated)," *CrowdfundingLegalHub*, last updated June 2015. http://crowdfundinglegalhub.com/2015/01/16/state-of-the-states-list-of-current-active-and-proposed-intrastate-exemptions/

exemptions in Kansas and Georgia.[57] Wisconsin and Indiana saw more companies list issues, including a surprising number of craft breweries.[58] But in most states, the number of successful listings is in the single digits. It also frequently has taken a long time for intrastate crowdfunding portals to be launched. In Michigan, for example, Public Act 264 (the "Michigan Invests Locally Exemption," or MILE) was enacted at the end of 2013. Only after the law passed was the crowdfunding company MichiganFunders.com founded and the site only opened to the public in February 2015.[59]

One problem is that few investors or entrepreneurs are aware that intrastate crowdfunding is an option. This lack of awareness has been exacerbated by an April 2014 SEC decision to ban the use of company websites or social media to promote intrastate offerings, on the grounds that social-media posts could reach out-of-state investors.[60]

Other potential investors are leery of the complexity of crowdfunding and the risks of fraud and mismanagement on the part of firm owners. Crowdfunding portals generally lack advanced tools to vet companies, beyond their marketing pitch and some high-level data. Investors accustomed to the copious data available from publicly traded companies find the opacity of crowdfunded securities frustrating. Moreover, in nearly all of the states that have passed crowdfunding legislation, intrastate securities are not tradable on secondary markets. (The sole exception is Michigan, which passed the "Michigan Investment Markets" law shortly after MILE to allow intrastate securities to be traded in a state exchange.)[61] In short, the markets for intrastate crowdfunded securities are illiquid, speculative, complex and clunky. That anyone has invested on the state level at all is as much a testament to irrepressible human optimism as it is to the soundness of the trading infrastructure.

Nonetheless, improving the ecosystem of intrastate crowdfunding could have considerable benefits, even as the revised Regulation A+ is implemented. Application of the new SEC rules is expected to be unduly onerous; one analyst expects them "to have the same high hurdles that today keep most businesses from being able to participate in securities markets."[62] By contrast, states such as Texas have quite permissive regulations that would allow nearly any established company to solicit capital. While such a loose approach may well enable more fraud in the short term, ultimately, it would allow many more businesses to solicit funding than could do so using the SEC's regulatory avenues.

State-level crowdfunding portals also allow for more experimentation, both in establishing appropriate regulatory frameworks and in the actual mechanics of investing. Fifty states competing to win "business" away from the federal system can be expected to find new ways to accommodate both companies and investors that wouldn't be feasible for the highly constrained SEC.

Private portals are beginning to offer new ways to raise capital. So-called "revenue-share investing"[63] has gained popularity and may be more suitable for many kinds of businesses than either debt or equity issues. That could help avoid the homogenization of investment types seen in the SEC-regulated securities markets and lead to more creatively channeling capital to businesses.

While there are problems inherent in restricting the pool of investors in a given firm to a single state, there are some for whom this feature of intrastate crowdsourcing is a virtue. A growing movement for "slow money,"[64] "impact investing"[65] or "locavesting"[66] seeks to forge closer connections between businesses and the communities around them. A capital-seeking firm might deliberately choose to issue securities on an intrastate exchange instead of a national exchange, specifically to affiliate itself with the local-investing movement and its own community. A vibrant system of state exchanges would expand this sort of choice in our financial system.

Small businesses are poorly served by our traditional financial institutions, particularly banks. It appears that crowdfunding, and small-scale securities more generally, is a promising new option for such businesses. Though there have been improvements to federal regulation of such markets, complying with existing rules remains expensive and cumbersome, with the most promising investments limited to

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57. Clark, "Kansas and Georgia," *supra* Note 51.

58. Solomon, "S.E.C.'s Delay on Crowdfunding," *supra* Note 42.

59. Jon Zemke, "Can Local Crowdfunding Startups Compete in a Crowded Field?" *Metromode*, Feb. 4, 2015. http://www.metromodemedia.com/features/michigan-crowdfunding0375.aspx

60. William Franks, "The State of Crowdfunding in Michigan," *Grand Rapids Business Journal,* Sept. 17, 2014. http://www.grbj.com/blogs/13-law/post/80599-the-state-of-crowdfunding-in-michigan

61. Amy Cortese, "A Way for Local Businesses to Grow," *New York Times*, Oct. 24, 2014. http://www.nytimes.com/2014/10/25/opinion/a-way-for-local-businesses-to-grow.html?_r=0

62. *America's Moment* 106.

63. In revenue-share investing, a firm borrows money without having a fixed interest rate. Instead, the firm specifies the total amount to be repaid, with a fixed nominal profit, and designates a set percentage of its revenues to be used to repay the investment. If revenues are high, the investment is repaid more quickly and the effective rate of return rises, since the profit was recouped more quickly. If revenues are low enough that a balance is still outstanding at maturity date, it immediately comes due. See further explanations in "How It Works," *Bolstr*, https://bolstr.com/how-it-works; "Revenue Share Investing," *Localstake*, https://localstake.com/investor_security_types

64. Slow Money is a nonprofit that channels social investment to small farmers, among other recipients. Their website is https://slowmoney.org/

65. Matthias Rieker, "The Payoffs of Investing Locally," *Wall Street Journal*, Aug. 15, 2014. http://www.wsj.com/articles/the-payoffs-and-pitfalls-of-investing-locally-1408115125

66. Amy Cortese, *Locavesting: The Revolution in Local Investing and How to Profit From It.* Wiley: 2011. Cf. *America's Moment* 57.

Accredited Investors. Intrastate crowdfunding exchanges might change that, but only if they generate much more volume and institutional depth.

OPENING 401(K)S TO INTRASTATE CROWDFUNDING

The key question remains: how can crowdfunding be made a viable part of the small-business capital landscape without throwing open the doors to rampant fraud?

There are many possible answers, whose implementation presents varying degrees of difficulty. The most powerful single step would be for the SEC finally to implement the crowdfunding regulations called for by the JOBS Act, and for those regulations to be sufficiently flexible to allow much more capital to flow from investors to small businesses. Revising the ban against Internet publicity would help, as well. While we await that happy day, this paper proposes slight modifications to a different set of regulations, which could have the effect of allowing investors to access crowdfunding markets through an existing investment vehicle: the 401(k) account.

For most small investors, their single largest fund of investible assets is found in their 401(k) accounts. As of June 30, 2014, 401(k) accounts held about $4.4 trillion in assets, the majority of which were invested in mutual funds.[67] 401(k) and other "qualified" retirement accounts are regulated by the Department of Labor under the Employee Retirement Income Security Act of 1974 (ERISA); participants in a plan are limited to the investment options made available by their employer and the administrator of the plan.[68] Some plans allow employees to invest only in a small, curated selection of mutual funds; others make available a "brokerage window," permitting participants to invest in publicly traded stocks and bonds or mutual funds that are not part of the default plan lineup.

Some plans include life insurance products, or investment options that pay a guaranteed rate of interest, albeit with required holding periods and hence less liquidity. Some types of mutual funds also have restrictions on rapid deposits and withdrawals, to allow the funds to hold relatively illiquid assets (like microcap stocks) that are thinly traded. Some plans offer access to variable annuities, which similarly have early-surrender penalties.

The feature of 401(k) plans that should interest us is that they offer a regulatory and administrative structure that allows average investors to access relatively complex investments easily. The other interesting feature of 401(k) plans is that plan administrators and sponsoring companies are required to be fiduciaries. Any investment options they provide must meet standards of reasonable prudence.[69] Not every plan provides access to every investment; sponsors and providers have a great deal of discretion over what they choose to offer. As a result, any risk posed to 401(k) participants by a new and untested asset class would be mediated by the judgment of their employer and the plan provider.

Thus, 401(k)s (and qualified plans more generally) are a natural forum to expand people's freedom to invest. They also offer a platform to allow the financial industry to begin learning about crowdfunding and to gradually refine its judgments, with limited risk of harm to individuals.

This paper therefore proposes ERISA regulations be modified to allow up to 10 percent of a 401(k) participant's assets to be invested in *intrastate* securities that have a *liquid secondary market* in the state in which the plan is registered. State-registered investment options would only be available at the discretion of the plan administrators, as with other investments, and they would be free to set other limits as well.

Note that such a rule change requires that the investments be regulated by the state, and that they be liquid. At the moment, almost no intrastate crowdfunded investments have a secondary market (with the noted exception of Michigan). Practically speaking, it would take some time for the first dollar of 401(k) assets to be directed to a local crowdfunded security, even if the rule change were to take effect immediately. Plan administrators need to set up investment vehicles that allow their participants to invest easily. Even then, the magnitude of direct investments is likely to be small. Early adopters likely would not be the largest plan administrators like Fidelity or Vanguard, but niche administrators seeking to appeal to employers owned by crowdfunding or local-investing enthusiasts.

Yet the indirect effects of such a rule change could be far more profound than the direct investments alone. By offering the prospect of billions of dollars in investment, the rule change would stimulate state officials and private companies to improve their intrastate markets to make them compliant. More liquid markets in crowdfunded securities would be devised and regulatory frameworks set up to structure them. Additional oversight may be proposed to make traded investments more "prudent," through disclosure or other requirements, with regulatory competition among the states serving as a countervailing force to temper the temptation

67. "Frequently Asked Questions about 401(k) Plans," Investment Company Institute, September 2014. http://www.ici.org/policy/retirement/plan/401k/faqs_401k

68. "Investing in Your 401(k)," Financial Industry Regulating Authority. http://www.finra.org/investors/investing-your-401k

69. Cf. "Retirement Plan Fiduciary Responsibilities," Internal Revenue Service, Nov. 5, 2014. http://www.irs.gov/Retirement-Plans/Retirement-Plan-Fiduciary-Responsibilities; "Frequently Asked Questions About Retirement Plans and ERISA," United States Department of Labor. http://www.dol.gov/ebsa/faqs/faq_compliance_pension.html

to adopt requirements that are too onerous. In short, market institutions likely would develop that make intrastate crowdfunding a truly compelling investment, in much the same way that the $10 million Ansari X-Prize stimulated creativity and development in the field of space flight.[70]

Before a dollar of 401(k) assets ever enters these markets, the improved state exchanges likely would see a great increase in volume. Members of 401(k) plans would become more educated about local investing and would see fewer obstacles to investing in local companies on their own. Liquid secondary markets would allow them to exit their positions, reducing risk and making such investments more attractive. Improved regulatory frameworks would allow investors to screen for high-quality companies, instead of clicking the "buy" button on a thinly described website and hoping for the best.

One can imagine a virtuous cycle. Improved institutions lead to increased investing, leading to more liquidity and more capital flowing to companies, which leads to more companies listing their shares, which leads to increased investing. Every local company that lists an offering would publicize it to its loyal customers, who then could become market participants and improve the functioning of that state exchange. By the time 401(k)s allow their participants to invest through the plan, state exchanges would be vibrant marketplaces where small companies can raise capital from their own communities.

Note as well that the proposed regulatory change does not specify *what kind* of state-regulated investments could be purchased in a 401(k) plan. There is no reason to limit investment types artificially, especially when dealing with small companies for whom issuing "conventional" securities such as equity may not be appropriate. Experimentation in capital structures is healthy, and a welcome change from the stasis that afflicts the national securities markets. Once again, the states can be the laboratories of democracy—enabling the creativity and experimentation that are at the heart of the American Dream.[71]

CONCLUSION

When trying to direct more capital to small businesses, we have several options. We can treat the current tangle of securities regulations as a black box and simply create more government mandates to force a solution, and potentially make the problem worse. We can try fundamental reforms of securities regulations, which would be welcome but extremely difficult. Or we can find points of great leverage where a minor change to the rules would have drastic effects throughout the investing ecosystem. Allowing 401(k)s to invest in intrastate securities would be such a leverage point; with luck, it would lead to a great improvement in the functioning of state exchanges, and provide small businesses with the capital they so desperately need.

ABOUT THE AUTHOR

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He has worked in financial advising and investment management for more than a decade, most recently as part of the AIG Advisor Group.

He was also one of the early lenders on peer-to-peer lending site Prosper.com starting in 2006, which taught him invaluable lessons about the possibilities and perils of crowdfunded investing. Following that experience, he spent the next several years studying the rationale and implications of the ancient religious restrictions on lending found in Judaism, Christianity and Islam; some of that research informed his recent monograph on real-estate finance, No More Foreclosures: The Case for Flexible Homeownership.

Oren graduated with honors with a bachelor's in political science from Yeshiva College in 2007, and received his doctorate in political science from George Mason University in 2014. His dissertation was on "just war" ethics applied to both state and non-state actors.

70. Mike Wall, "How SpaceShipOne and X Prize Launched Commercial Spaceflight 10 Years Ago," Space.com, Oct. 3, 2014. http://www.space.com/27339-spaceshipone-xprize-launched-commercial-spaceflight.html

71. *America's Moment* 4.