



# *The Commonwealth of Massachusetts*

*Secretary of the Commonwealth  
State House, Boston, Massachusetts 02133*

*William Francis Galvin  
Secretary of the Commonwealth*

August 8, 2012

Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: Comments on the Securities and Exchange Commission's Regulatory Initiatives  
under the JOBS Act: Title III, Crowdfunding

Dear Ms. Murphy:

The Office of the Secretary of the Commonwealth, Massachusetts Securities Division appreciates this opportunity to share our views and comments on the Commission's Regulatory Initiatives under Title III of the Jumpstart Our Business Startups Act ("JOBS Act"), the crowdfunding exemption, prior to the Securities and Exchange Commission's ("S.E.C.") official comment period for proposed regulations.

## **Policy Concerns**

Title III of the JOBS Act creates a new exemption under Section 4 of the Securities Act for crowdfunding offerings. A goal of crowdfunding is to permit small, early-stage, and emerging companies to raise capital in offerings that are directed to a large number of investors, each of whom may invest a limited amount.

Crowdfunding represents a significant departure from long-established rules for public offerings of securities. A key principle of the exemption is that "crowds" of potential investors will be able to sift through proposed offerings and distinguish the best ones. Crowdfunding advocates assert that this process permits group decision making, which will help direct investors' funds to meritorious offerings. While this picture of the potential benefits of crowdfunding is undeniably attractive, as regulators we must be vigilant that the exemption will not become a tool for financial fraud and abuse.

Longstanding problems in the markets for small and speculative stocks show the pitfalls of relying on the wisdom of crowds. It is clearly possible to deceive large groups of investors, and it is definitely possible for fraud operators to swindle individuals. Unscrupulous penny stock promoters have used misrepresentations to market obscure and low-value stocks to individuals, often through pump and dump schemes. These kinds of fraud operators have not gone away.

Crowdfunding is designed to permit the smallest investors to participate in securities offerings by early-stage companies. Our experience is that these investors are especially vulnerable in the small-company segment of the market. In this segment of the market, company information may be limited or simply false, and investors typically lack investment sophistication and are often insufficiently cautious.

The typical crowdfunding offering will be small (many may be far below \$1 million), so there is the great risk that these offerings will fly under the radars of many regulators. Also, because the exemption will be simple and inexpensive to use, it is likely that there will be a large number of crowdfunding offerings. If problems develop in this market, regulators will end up filing enforcement actions against a very large number of small targets. In view of the characteristics of this market, state and federal regulators must coordinate their efforts and resources to effectively address the issues and potential problems that crowdfunding will present.

The Commission's rules for crowdfunding must require the kind of thorough, plain-English disclosure that neophyte investors need to evaluate these offerings and the people behind them. The Commission's rules must uphold and strengthen investor protection requirements, such as the annual purchase limits, that apply to these offerings. The Commission's rules must also strengthen the ability of federal and state regulators to oversee these offerings and the intermediaries who sell them. Crucially, the rules must create a foundation for regulators to cooperate in policing this new market.

Apart from the potential for fraud in initial stock offerings, crowdfunding may also serve as a new channel that fraud promoters can use to distribute penny stocks widely to the public. Such promoters could later manipulate the stocks if they begin to trade in an over-the-counter market. Therefore, we urge the Commission to take all possible steps to prevent crowdfunding offerings from being the first stage in the distribution of penny stocks that may later be manipulated.

A great deal is at stake with the crowdfunding rules, particularly the potential expansion of fraud in this area with accompanying harm to small investors. We urge the Commission to adopt strong investor-protective rules for crowdfunding offerings. To fall short of this standard creates the risks that crowdfunding will become a notorious debacle and that many small investors will be harmed.

### **The Commission's Notice to the Public Regarding Crowdfunding Rules**

We commend the Commission for clearly stating that, by law, there is no crowdfunding exemption until the Commission's rules for crowdfunding have been adopted,<sup>1</sup> and for accepting advance comments. These actions by the Commission reflect an attitude of clear disclosure and transparency that is appropriate for rules that

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<sup>1</sup> See Information Regarding Use of the Crowdfunding Exemption in the JOBS Act, April 5, 2012, at <http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm> .

will affect many small investors. Moreover, these actions should help promote good compliance by issuers and intermediaries once the rules are adopted.

## **The Crowdfunding Exemption – Section 302**

### Investor Purchase Limits.

Under the exemption, an investor may purchase the greater of \$2,000 or 5% of annual income or net worth in a 12 month period if the investor's income or net worth is less than \$100,000, and up to 10% of income or net worth if the investor's net worth is greater than \$100,000, up to a total investment of \$100,000 in a 12-month period. This limitation also applies to each investor's aggregate investment in all crowdfunding offerings over a 12-month period.

In order to assure that the purchase limit applicable to each offering is complied with, we ask the Commission to require that the issuer and the intermediary designate a key person who will be responsible to assure that the limit is met. If the limit is violated, this key person should be subject to discipline, including a potential bar from participation in future crowdfunding offerings.

In order to make the overall limit that an investor may invest in all crowdfunding offerings in a 12-month period meaningful, the Commission should require intermediaries to share information about who has invested in these offerings and the amounts of their investments. This will allow other intermediaries to check compliance with this limit. A public or private clearinghouse could be established to facilitate the sharing of this information.

### Requirements for Crowdfunding Intermediaries.

Intermediaries may be brokers or crowdfunding portals, as defined in the JOBS Act.

The Securities Division urges that the portal registration process should be transparent, and that registration materials and forms be as accessible as possible. Potential investors, state regulators, the financial press, and others will benefit from having convenient, real-time access to these registration materials through an open system. Such information is particularly necessary in the crowdfunding context because the portals and their principals may have little or no track record that investors can research.

Intermediaries are required to provide disclosures for crowdfunding offerings that include such risk disclosures and investor education materials as the Commission may determine appropriate by rule. The Securities Division stands ready to work with the Commission to help devise effective, plain-English, disclosure and educational materials. As crowdfunding develops and as any problems become apparent, it will probably be necessary to revise and update these materials. Among other issues, this disclosure should make clear to investors the risks that they may have no meaningful voting power as minority shareholders, and that there may never be a liquid market for their shares.

The Act requires that intermediaries ensure that each investor affirm that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such loss. The intermediary must also ensure that each investor answers questions demonstrating an understanding of the level of risks applicable to investments in startups, emerging businesses, and small issuers; an understanding of the risk of illiquidity; and an understanding of such other matters as the Commission determines by rule. Intermediaries should be required to designate a key person who will bear the responsibility to assure that these statutory requirements are met.

The Securities Division strongly urges that the Commission's rules should prevent these required representations from being used against investors if they bring suit against issuers and selling persons for securities law violations. While we support procedures that will educate and warn investors about early-stage company investments, we oppose the use of rote and conclusory statements in the investor representations as a tool to fend off legal liability.

#### Measures to Reduce Fraud – Background Check

Intermediaries are responsible to take measures to reduce the risk of fraud in crowdfunding transactions, including obtaining a background check and regulatory history check on each company officer, director, and 20%-or-greater shareholder. This background information should be made publicly available in order to inform investors about crowdfunding issuers and the people behind them. If the Commission declines to require that this information be available to the public, it should be made available to potential investors before they commit their funds. If the Commission declines to adopt this requirement, the information should, at a minimum, be provided to state and federal securities regulators.

We urge the Commission to explicitly require the use of an independent escrow agent to hold investor funds until the target offering amount is reached. The standards for the escrow agent should follow the standards for escrow agents used in a general business context.

#### Requirements of Crowdfunding Issuers

Crowdfunding issuers are responsible to make disclosures about the offering available to investors and to file that information with the Commission.

In the crowdfunding context, it is imperative that the disclosure provided to investors be as clear and user-friendly as possible. We urge the Commission to promulgate a crowdfunding disclosure form or template for this purpose. SEC Form 1-A (used in Regulation A offerings) and the NASAA Small Corporate Offering Registration Form ("SCOR"), which uses a question and answer format, provide useful models for a crowdfunding disclosure document.

The disclosure should be in plain, clear language and should be as thorough as necessary to inform inexperienced investors. We urge that for offerings under \$100,000 financial statements should be prepared according to generally accepted accounting

principles, even though those statements do not need to be independently reviewed or audited. It is likely that many issuers will price their securities based on high company valuations; therefore, we urge that the disclosure document should provide detailed information on company valuation, along with disclosures regarding the risks of buying securities of an early-stage company at a high valuation.

The Commission should require issuers to file all advertising and other materials that issuers create relating to crowdfunding offerings.

If the issuer will use any promoters in connection with the offering, the promoters should be identified to the Commission, other regulators, and the public, and the amount and structure of promoter compensation should be disclosed.

All of the information filed with the Commission should be provided to the states when the issuer files it. This level of transparency will permit regulators to promptly detect and act on problems, and will foster federal-state cooperation.

The Commission's rules should specify that the exemption will not be available for blank check companies or for investment vehicles such as hedge funds. We believe that permitting these kinds of high-risk and often complex entities to use the exemption is not consistent with the statutory goal of deterring fraud and unethical non-disclosure in crowdfunding offerings.

In order to address some of the risks that may arise from high company valuations, we urge the Commission to require that if an offering exceeds certain valuation limitations (based, for instance, on company financial ratios), then the shares held by company insiders should be subject to a lock-up which would terminate after a period of time (*e.g.*, after three years) or after the company meets certain financial benchmarks (*e.g.*, when the company achieves profitability).

Crowdfunding companies will be required to file and provide to investors periodic reports of the results of their operations, not less than annually. We urge the Commission to create a standardized form or template for this ongoing disclosure. As with other company and selling person disclosures, we believe this information should be publicly available and shared with other regulators.

#### **Funding Portal Regulation – Section 304**

The JOBS Act creates a new category of selling persons, crowdfunding portals, that are exempt from broker-dealer registration if they limit their activities and meet the requirements of the Act.

Just as the JOBS Act limits the crowdfunding exemption to United States issuers, the Commission's rules should require that portals must be chartered and based in the United States. Permitting non-U.S. entities to become crowdfunding portals will raise serious problems of legal jurisdiction and practical problems of regulation. It will be difficult or impossible for the Commission, an SRO, or a state to visit and examine an overseas portal. Permitting non-U.S. entities to register as portals would deprive

regulators of basic information they need to understand the kind of business that portal is conducting.

Because portals will play key roles in providing disclosure to potential investors and screening out unqualified investors, the Commission should establish high regulatory standards for portals. Among other factors, the Commission's rules should prohibit or strictly limit conflicts of interest, and should prevent the payment of indirect selling remuneration to the portal and its principals.

The Commission's rules for portals should include conduct rules that are comparable to the broker conduct rules, and should designate practices that are prohibited because they are dishonest and unethical.

The portals bear the responsibility to assure that investors are qualified to buy crowdfunding securities, and to ensure that investors demonstrate that they understand the risks of crowdfunding. Each portal should be required to designate a key person who is responsible to assure that those requirements will actually be met.

We also urge the Commission to set high standards for the national securities association that will register the crowdfunding portals. The association's rules should include conduct rules and should designate dishonest and unethical conduct practices applicable to crowdfunding portals.

Broker-dealer firms are subject to regulation by the Commission, FINRA, and the states where they do business. This system has operated to protect investors in a time of limited regulatory resources by permitting each regulator to focus on the tasks it does best. The Commission should apply to portal regulation the best aspects of the multiple-regulator system that now applies to broker-dealers.

### **Relationship with State Law – Section 305**

The JOBS Act specifically grants certain oversight roles to the states with respect to crowdfunding offerings. These include permitting states to receive notice filings for issuers with their main place of business in the states, notice filings in the state where more than 50% of an offering is sold, and the ability to regulate portals in states where they have their main place of business. State rules for portals may not be any greater than federal rules for portals, so it is important that the federal rules can be effectively enforced by both the S.E.C. and the states. The requirement that the Commission consult with the states in connection with its rules for crowdfunding makes clear Congress's intent that federal and state regulators should work together to regulate this market.

Portals will be required to register in their home states. The states will be able to enforce their own requirements so long as those requirements match federal requirements. Again, it is critical that the Commission's rules be constructed so that they can be enforced by both the Commission and the states. In this regard, we request that the crowdfunding SRO's rules should be made explicitly enforceable by the states.

### **Social Media Issues**

We expect that various kinds of social media will be used in tandem with crowdfunding. This may involve forums or message sharing through a portal's website; it may involve current social media channels (especially Twitter and Facebook); and is likely to involve new channels and technologies.

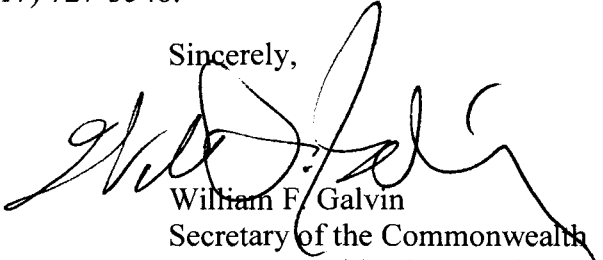
There is the great risk that pump and dump operators will use social media to improperly promote these offerings. We ask that the Commission's rulemaking anticipate such potential problems, and that any new rules include measures to prevent and address them. We also ask the Commission to maintain ongoing vigilance in this rapidly developing area, and to specifically notify the market that the Commission will revise and update the federal crowdfunding rules to address any abuses as they emerge.

### **Conclusion**

State securities regulators are justly described as cops on the beat in their local markets. State agencies are close to their local investors and small businesses, including potential crowdfunding issuers and portals. The states have demonstrated that their flexibility and ability to act quickly permit them to take effective action to stop fraud against their citizens. The advent of crowdfunding will place even greater responsibilities on the states because these offerings will typically involve small issuers and less-experienced investors. We ask the Commission to work closely with the states at all stages of rulemaking to develop rules and systems that will permit the greatest possible transparency and real-time sharing of information between the Commission, SROs, and the states.

Thank you for your consideration of these comments. If you have questions or we can assist in any way, please contact me or Bryan Lantagne, Director of the Massachusetts Securities Division at (617) 727-3548.

Sincerely,



William F. Galvin  
Secretary of the Commonwealth  
Commonwealth of Massachusetts