



## Department of Commerce

Division of Securities  
John R. Kasich, Governor  
David Goodman, Director

January 9, 2013

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

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

Dear Ms. Murphy:

The Ohio Division of Securities (the "Division") appreciates the invitation of the Securities and Exchange Commission (the "Commission") for views on the Commission's regulatory initiatives under the Jumpstart Our Business Startups Act ("JOBS Act") prior to the Commission's official comment period. Title III of the JOBS Act is better known by its short title, the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012", or the "CROWDFUND Act."<sup>1</sup>

The CROWDFUND Act creates an exemption from registration under the Securities Act of 1933 (the "Securities Act") for issuers raising no more than \$1,000,000 through a public offering facilitated by an online funding portal or a broker-dealer that operates a funding portal. Traditionally, Section 4 of the Securities Act has provided exemptions from registration for offerings where the investor has access to the same level information that an investor would receive in a public offering or bargaining power to demand access to that information. The CROWDFUND Act, in contrast, provides an exemption for offerings in which the investor has almost no bargaining power and little information.<sup>2</sup> While Congress inserted several provisions into the Act that seek to mitigate the risk of harm to investors in light of these circumstances, the

---

<sup>1</sup> Section 301 of Title III of the JOBS Act, H.R. 3606, 112th Cong. (2012) (enacted).

<sup>2</sup> "While the various proposals being considered have been characterized as promoting jobs and economic growth by reducing regulatory burdens and costs, it is better to understand them as changing, in similar ways, the balance that existing securities laws and regulations have struck between the transaction costs of raising capital, on the one hand, and the combined costs of fraud risk and asymmetric and unverifiable information, on the other hand." *Examining Investor Risks in Capital Raising*: Hearing on H.R. 3606 Before the Subcomm. on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, 112th Congress 1-2 (2011) (statement of Professor John Coates IV, John F. Cogan, Jr. Professor of Law and Economics at Harvard Law School).

provisions were poorly constructed and are now subject to plain reading interpretations that could defeat those investor protections if not the entire statutory scheme. The Division realizes that the Commission cannot simply re-draft these flawed provisions, but hopes this letter identifies some of the more significant issues that the Commission will need to address as it seeks to pass rules to harmonize internal inconsistencies within the CROWDFUND Act as well as inconsistencies between the CROWDFUND Act and long-established standards under other securities laws and regulations.

This letter does not and cannot contain all of the comments or views that the Division has with respect to the CROWDFUND Act and the Commission's associated rulemaking therein. The Division urges the Commission to engage the full scope of its rulemaking authority when proposing rules under the CROWDFUND Act to effectuate Congress' intent to ease capital formation over the internet for small businesses and early-stage issuers without unduly sacrificing investor protections.<sup>3</sup>

## **I. The Crowdfunding Marketplace.**

### **A. Crowdfunding issuers are expected to fail at very high rates.**

Many investors that invest in offerings made pursuant to the new Section 4(a)(6) exemption will lose all or part of their investment. Statistics repeatedly demonstrate that most new businesses fail. Bureau of Labor Statistics data from March 2012 on establishment age show that 32.2 percent of businesses established in the year 2010 (two years) have failed or otherwise dissolved, 49.5 percent of businesses established in the year 2008 (five years) have failed or dissolved, and 65.6 percent of businesses established in the year 2002 (ten years) have failed or dissolved.<sup>4</sup> Survival rates vary across major industries, but Bureau of Labor Statistics data tend to show that even the industry that typically has the highest survival rates (healthcare) demonstrates a business failure rate of close to 50 percent ten years after the date of establishment.<sup>5</sup>

Whether a market that has such high rates of investment failure can have any integrity at all will largely depend upon the rules that are established by the Commission to govern the market place and the compliance of issuers and intermediaries with those rules.

---

<sup>3</sup> Section 2(b) of the Securities Act provides that “[w]henver pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine 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” (emphasis added).

<sup>4</sup> *Survival of private sector establishments by opening year*, Dept of Labor, Bureau of Labor Statistics (March 2012), available at [http://www.bls.gov/bdm/us\\_age\\_naics\\_00\\_table7.txt](http://www.bls.gov/bdm/us_age_naics_00_table7.txt).

<sup>5</sup> *Survival rate by selected industries, 2000 birth cohort, 2000–2010, in percent*, Dept of Labor, Bureau of Labor Statistics (March 2012), available at [http://www.bls.gov/bdm/entrepreneurship/bdm\\_chart4.htm](http://www.bls.gov/bdm/entrepreneurship/bdm_chart4.htm).

## **B. The Difficulties with Crowdsourced Diligence.**

In asking the Commission to take a light hand with its rulemaking, some proponents of the CROWDFUND Act have suggested that the “crowd” of potential investors is fully equipped to sift through the universe of proposed offerings listed on funding portals, conduct due diligence on those businesses and their principals, and identify and steer investors away from fraudulent offerings before they ripen into harm. As evidence of the success of this “wisdom of the crowd”, proponents often point to the crowd’s detection of a likely scam on the donation-crowdfunding website Kickstarter in connection with the posted fundraising campaign for a video game called “Mythic: The Story of Gods and Men.”<sup>6</sup> The campaign pitched Mythic to Kickstarter participants using allegedly stolen images and misleading information concerning its investors and business relationships.<sup>7</sup>

The Division appreciates that the crowd quickly and effectively detected the allegedly fraudulent Mythic disclosures, that Kickstarter impressively closed the Mythic solicitation within twenty four hours, and that no participants were harmed. The Division notes, however, that in the context of securities offerings, facially fraudulent disclosure is but one of many ways an issuer can conduct fraudulent activity. The types of frauds and misrepresentations the crowd will need to sort out to eliminate fraud will include, among others, whether material omissions have been made (in which case there would be no hard facts for the crowd to research and verify), whether the complex terms of the securities being offered are designed to disadvantage investors, whether financial statements have been prepared in a fraudulent or misleading manner, and, after the fact, whether an issuer’s failure was merely the result of bad business decisions or was fraud cloaked in competitive failure. Claiming that the crowd is immune from fraud because of its internet research savvy takes a far too simplistic view of the ways fraudulent and abusive practices occur in the securities context. As such, the Division urges the Commission not to rely on the “wisdom of the crowd” theory because it is effective at exposing only the simplest form of fraud—not those forms of fraud that pose the greatest risk to investors.

## **II. Warnings for Crowdfunding Participants.**

### **A. Issuers Bear the Burden of Proof.**

Issuers and intermediaries, particularly those that have never issued securities or sold securities on behalf of others previously, may not fully comprehend their obligations under state and federal securities laws. They may not understand the importance and consequences of fully complying with the conditions for an exemption from registration, or be in a position to bear the consequences of an unregistered sale. The Commission must remind issuers that exemptions

---

<sup>6</sup> See, e.g., “Kicked to the Curb: Wisdom of the Crowd Roots Out Apparent Fraud”, *available at* <http://crowdfundinglaw.wordpress.com/2012/05/03/kicked-to-the-curb-wisdom-of-the-crowd-roots-out-apparent-fraud-6/>.

<sup>7</sup> Lewis Humphries, “Is Kickstarter A Viable Platform for Business Startups”, *SAN FRANCISCO CHRONICLE*, October 26, 2012 *available at*: <http://www.sfgate.com/business/investopedia/article/Is-Kickstarter-A-Viable-Platform-For-Business-3985419.php>.

from registration are construed narrowly,<sup>8</sup> and that the burden of proof for compliance with an exemption from registration is always upon the issuer.<sup>9</sup> Furthermore, the preemption of state laws under the National Securities Markets Improvement Act (“NSMIA”) requires an issuer claiming the benefit of a federal exemption to prove that every condition to the claimed exemption has been satisfied.<sup>10</sup> This is so because public policy generally favors the registration of securities offerings.<sup>11</sup>

**b. The Potential “Domino Effect” and Retroactive Loss of the Exemption.**

As written, the crowdfunding exemption set forth in Section 4(a)(6) poses significant liability risks to issuers and intermediaries from each other and from unrelated third parties. Any one crowdfunding participant’s failure to fully comply with Sections 4(a)(6) and 4A could, by operation of the statute, set in motion a “domino effect” that destroys the otherwise compliant exemptions of *other* issuers and intermediaries. Consider the following example and sequence of events:

1. ABC Corp, a crowdfunding issuer, posts its crowdfunding offering to a funding portal, XYZ Portal, and begins selling securities.
2. ABC Corp sells securities to an individual investor in excess of the limits set forth in Section 4(a)(6)(b), causing ABC Corp’s offering of securities to lose its Section 4(a)(6) exemption. Every sale of ABC Corp’s securities through XYZ Portal could be deemed an unregistered sale.
3. ABC Corp’s unregistered sales cause XYZ Portal to lose its status as a “funding portal” as defined in Section 3(a)(80) of the Securities Exchange Act of 1934 (the “Exchange Act”) because the sale was not made “pursuant to” or in compliance

---

<sup>8</sup> SEC v. Platforms Wireless Intern. Corp., 617 F.3d 1072, 1082 (9th Cir. 2010) (“Exemptions from registration provisions are construed narrowly ‘in order to further the purpose of the Act: To provide full and fair disclosure of the character of the securities and to prevent frauds in the sale thereof.’”).

<sup>9</sup> SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953) (“Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable.”); Sorrell v. SEC, 679 F.2d 1323, 1326 (9th Cir. 1982). (“Exemptions are construed narrowly and the burden of proof is on the person claiming the exemption,” *citing* SEC v. Blazon Corp., 609 F.2d 960 (9th Cir. 1979)).

<sup>10</sup> Brown v. Earthboard Sports USA, Inc., 481 F.3d 901, 912 (6th Cir. 2007).

<sup>11</sup> SEC v. Cavanaugh, 445 F.3d 105, 106 (2d Cir. 2006) *citing* Notice of Adoption of Rule 144, 1933 Act Release No. 33-5223 (Jan. 11, 1972) (“Persons who offer or sell restricted securities without complying with Rule 144 are hereby put on notice by the Commission that in view of the broad remedial purposes of the Act and of public policy which strongly supports registration, they will have a substantial burden of proof in establishing that an exempt from registration is available for such offers or sales and that such persons and the brokers and other persons who participate in the transactions do so at their risk.”).

with Section 4(a)(6) of the Securities Act. All of the sales that XYZ Portal transacted through its platform could be deemed unlicensed sales.<sup>12</sup>

4. Any issuer offering any security through XYZ Portal after ABC Corp's noncompliance could *also* lose its Section 4(a)(6) exemption and possibly be found liable for unregistered sales. If ABC Corp's unregistered sales causes XYZ Portal to cease to be a "funding portal," *all* other issuers offering securities through XYZ Portal could be found in violation of Section 4(a)(6)(C) because transactions may only be conducted through a broker or funding portal that complies with the requirements of section 4A(a).<sup>13</sup>

In the preceding example, the party committing the violation that triggered the "domino effect" was an issuer; however, it could just as easily have been the intermediary. Section 4(a)(6) exempts only transactions that are "conducted through a broker or funding portal that complies with the requirements of Section 4A(a)."<sup>14</sup> If an intermediary fails to fully comply with all of the requirements of Section 4A(a), all of the issuers using that intermediary could lose their exemption, and, if the intermediary was a funding portal, it could lose funding portal status.<sup>15</sup> The outcome of the "domino effect" is that, regardless of the nature of the party committing the violation, any noncompliance with the conditions for and obligations of the exemption might result in innocent third parties suffering consequences through no fault of their own.

Certain conditions of the Section 4(a)(6) exemption, such as the requirement on issuers to file annual reports under Section 4A(b)(4), are ongoing obligations that create contingent unregistered sale liability extending far beyond the point of sale of securities (unlike any exemption condition previously seen in the Securities Act). As a result, the failure of a crowdfunding issuer to file the required annual report, even after that issuer's crowdfunding

---

<sup>12</sup> Under new Section 3(a)(80) of the Exchange Act, a "funding portal" is defined as any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, *solely pursuant to section 4[(a)](6) of the Securities Act of 1933. . .* (emphasis added). If an issuer using a funding portal intermediary fails to satisfy any of the exemption's conditions, including both the pre-sale and post-sale requirements under Section 4A, one could argue that the transaction was not made "pursuant to" section 4(a)(6) due to the noncompliance. *See, e.g.,* Brown, 481 F. 3d at 912 (6th Cir. 2007). Since an intermediary may only be a "funding platform" so long as it is involved in sales of securities "solely pursuant to section 4[(a)](6)", the unregistered sale might cause the intermediary to lose its status as a funding portal (subjecting it to liability for unlicensed sales in any jurisdiction where those sales were conducted).

<sup>13</sup> Section 4(a)(6)(C): "the transaction is conducted through a broker or funding portal that complies with the requirements of section 4A(a);".

<sup>14</sup> *Id.*

<sup>15</sup> Note that because "broker-dealer" status does not hinge on selling *solely* Section 4(a)(6) exempt securities (as does a funding portal), the broker-dealer would not appear to *automatically* lose its status as a broker-dealer for failing to comply with Section 4A(a), but could be subject to discipline by its regulator for that failure. Due to the particular wording of the statute, therefore, issuers may find it preferable to list their Section 4(a)(6) exempt offering with a broker-dealer's platform in an effort to insulate themselves from the potential "domino effect" that might result from the failure of other issuers to comply with the Section 4(a)(6) exemption.

offering has closed, could retroactively destroy the exemptions of all issuers that used the same funding portal.

The Division is concerned that legitimate small issuers may be exposed to the risk of civil liability and other sanctions due to the conduct of other issuers or their crowdfunding intermediaries. Similarly, legitimate funding portals may lose their “funding portal” status and face potential liability for conducting unlicensed sales due to the acts or negligence of careless, unsophisticated, or unscrupulous issuers. The Commission should issue guidance to all crowdfunding participants of these risks and their obligation to monitor and police other participants. The success of the crowdfunding exemption will be dependent, in large part, upon the current and future due diligence of crowdfunding participants.

### **III. Disclosure.**

#### **A. Single Document Disclosure.**

Sections 4A(a) and 4A(b) impose certain disclosure obligations on both crowdfunding intermediaries and crowdfunding issuers. For example, Section 4A(a)(3) requires the crowdfunding *intermediary* in a Section 4(a)(6) exempt offering to “provide such disclosures, including disclosures related to risks and other investor education materials, as the Commission shall, by rule, determine appropriate.” Under Section 4A(b), *issuers* are required to provide to investors a number of typical offering disclosures including, among others, the business’s name and legal status, the names of directors and officers, a description of the business of the issuer, and a report of financial condition.

The Division encourages the Commission to mandate a single-offering-circular standard, incorporating disclosures prepared by both the intermediary and the issuer. One disclosure document is simpler and may encourage investors to more fully review and consider the document. Moreover, a single offering document would be consistent with other types of offerings where two parties are responsible for preparing disclosure (for example, in an underwritten public offering, underwriters and issuers generally work together to craft a single disclosure document).

#### **B. The Difference between Disclosure that Complies with the Section 4(a)(6) Exemption and Disclosure that Complies with the Securities Laws.**

The antifraud provisions of federal and state securities laws, which will apply in full to crowdfunding offerings employing the new Section 4(a)(6) exemption, require that disclosures in connection with the offer and sale of securities must be accurate and *complete* in all material respects.<sup>16</sup> Section 4A(c)(1)(B) provides that an “issuer” (which includes an intermediary for

---

<sup>16</sup> See, e.g., Sections 10b, 12(a)(2) and 17A of the Securities Act; see also Ohio Revised Code Section 1707.44(G).

Section 4A(c) purposes)<sup>17</sup> has potential liability under Section 12(a)(2) of the Securities Act for material misstatements and omissions.

The Division is concerned that, absent additional guidance and rulemaking from the Commission, crowdfunding issuers and intermediaries may mistakenly believe that making the disclosures required in a Section 4(a)(6) exempt offering will be sufficient to fully comply with federal and state securities laws. However, the disclosures required by the exemption do not provide the type of comprehensive disclosure that is necessary to protect issuers and intermediaries from fraud liability. For example, an issuer may fail to disclose executive compensation, pending or anticipated legal proceedings, indemnification of and limitations on liability for directors and officers, recent sales of unregistered securities, issues related to economic dilution, and risk factors<sup>18</sup> because the Section 4(a)(6) exemption does not expressly require those disclosures. These irregularities will be more pronounced for new and unsophisticated issuers that do not hire securities counsel or accounting professionals to help develop their offering and prepare adequate disclosure.

Similar issues were raised during the prominence of Rule 504 exempt offerings, and were addressed by state securities regulators and the North American Securities Administrators Association (“NASAA”). Together, NASAA and state securities regulators developed NASAA Form U-7 and an accompanying manual to assist issuers in making compliant disclosure. The Commission took a similar approach with Form 1-A, part II. The “question and answer” format of Form 1-A, part II, model A and NASAA’s Form U-7 are particularly friendly to novice issuers, and lend themselves to the development of software or internet-based forms that could assist issuers and intermediaries in reaching the market more quickly with more accurate and complete disclosure. Nonetheless, the Commission should remind issuers and intermediaries that they are obligated to provide investors with complete and accurate disclosure, and that material information must be disclosed to investors even if it does not fit neatly into a standardized template or disclosure form.

---

<sup>17</sup> Defined in Section 4A(c)(3) of the Securities Act for purposes of liability under Section 4A(c)(1)(B) as including “any person who is a director or partner of the issuer, and the principal executive officer or officers, principal financial officers, and controller or principal accounting officer of the issuer (and any person occupying a similar status or performing a similar function) that offers or sells a security in a transaction exempted by the provisions of section 4[(a)](6), and any person who offers or sells the security in such offering.” The term “issuer” for purposes of this liability is sufficiently broad to conclude that funding portals and broker-dealers are included within the term for the purposes of Section 4A(c)(1)(B) and Section 12(a)(2) liability.

<sup>18</sup> Section 4A(b)(1)(H)(v) requires the issuer to disclose “risks to purchasers of the securities related to minority ownership in the issuer, the risks associated with corporate actions, etc.” The provision of education material to investors will likely include generic boilerplate risk factors regarding crowdfunding investment, generally. Other than these minor disclosures, the CROWDFUND Act does not expressly include any specific risk factor disclosure requirements, such as company, industry or economic risk factor disclosure.

**C. Require a “No regulatory review” legend.**

Each offering should clearly disclose that the issuer is seeking an exemption from both state and federal securities registration and therefore no regulatory agency has reviewed the offering. The offering should clearly state that an investor must make his or her own investment decision. The offering should also clearly state that regulatory agencies do not recommend or endorse the investment for any offeree and that any representation to the contrary is a violation of state and federal securities laws. This disclosure is similar to that required by Rule 253(d) of the Securities Act. As more fully discussed in the following sections, the legend should also state that projections or forecasts of future performance are prohibited in connection with the offering and that past performance is no guarantee of future results.

**D. Restrict the Use of Forecasts or Projections.**

The Commission should consider restricting if not prohibiting outright the use of any direct or indirect forecasts or projections of the issuer’s future financial performance, whether by the issuer, the intermediary, or any officer, director, employee or agent of either. In the Division’s experience, forecasts and projections are often rife with fraud, bear no reasonable basis in reality, and fail to identify the assumptions made and the sources of information relied upon (often because no such information *is* relied upon in making the projections). Startups frequently make comparisons to successful companies without appropriate disclosure of the material differences that are likely to cause them to fail to achieve similar status. Figures commonly projected such as gross revenue, cash flows, net income, and return on investment are highly alluring to investors and often sway their investment decisions. When businesses fail, forecasts and projections are common causes of investor complaints and may result in enforcement actions.

Section 27A of the Securities Act of 1933 and Section 21E of the Exchange Act provide a safe harbor for forward-looking statements made by companies subject to the reporting requirements of Sections 13(a) or 15(d) of the Exchange Act. Conversely, there is no safe harbor for forward-looking statements made by companies not subject to the reporting requirements of Sections 13(a) or 15(d) of the Exchange Act. Companies that do not qualify for these safe harbor provisions, yet choose to make forward-looking statements, may look only to the judicially-created Bespeaks Caution Doctrine to immunize such statements from grounding fraud liability. In the Division’s view, the central element of the Bespeaks Caution defense (and the most problematic for crowdfunding issuers) is that the matter being projected “had a sound factual or historical basis.”<sup>19</sup>

It is widely accepted that the CROWDFUND Act was intended to be, and will be, used by very young issuers, and even true start-ups. An issuer with little or no operating history has

---

<sup>19</sup> “While analyzing the nature of the statement, the court must emphasize whether the ‘prediction suggested reliability, bespoke caution, was made in good faith, or had a sound factual or historical basis,’” *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir. 1991) (quoting *Isquith v. Middle South Utils., Inc.*, 847 F.2d 186, 204 (5th Cir. 1988)).

no historical basis on which to reasonably predict future operating results. The factual or historical basis on which to reasonably predict future financial returns becomes even more tenuous where a business is led by inexperienced management, employs new or unproven processes, offers new or untested products or services, or enters new markets with unknown levels of demand and competition. It is difficult to see how any young entity or start-up can, in good faith and with “a sound factual or historical basis,”<sup>20</sup> predict its future financial performance. The Division respectfully requests the Commission, pursuant to its authority under Section 4A(b)(5), prescribe rules restricting the use of any direct or indirect forecasts or projections of the issuer’s future financial performance, whether by the issuer, the intermediary, or any officer, director, employee or agent of either.

**E. Provide guidance regarding “Business Plan” Disclosure.**

Section 4A(b)(1)(C) of the Securities Act requires that each crowdfunding issuer provide a “description of the business of the issuer *and the anticipated business plan of the issuer.*” Traditionally, a business plan was a planning document prepared by management for internal use only, and not intended to be disseminated outside the company. Among start-up companies, however, the word “business plan” has taken on the meaning of a marketing document used to pitch investors. These documents typically include provocative marketing language, market and competitive analyses, and financial projections, among other information.<sup>21</sup> These business plans are designed to solicit investment, not to disclose the materials terms and risks of a securities offering. They are not tailored for prospective investors, nor drafted with the securities laws in mind. Accordingly, the Commission should clarify the meaning of the term “business plan,” as used in Section 4A(b)(1)(C) of the Securities Act, so that issuers do not inadvertently provide to investors a document that opens the issuer to potential civil and criminal liability.

**F. Require Annual and Post-Dissolution Filings.**

Section 4A(b)(4) requires as part of the exemption that issuers make a filing “not less than annually” with the Commission of “reports of the results of operations and financial statements.”<sup>22</sup> The failure to make this filing would result in a retroactive loss of the exemption. The most appropriate interpretation is to require the annual filing of updated financial statements for the fiscal year end in the form as referenced in Section 4A(b)(1) which were provided to investors. Smaller issuers should not be required to obtain an audit. However, the Commission should require audited financial statements for the larger size offerings over \$500,000 and for smaller issuers if during the course of their business they obtain an audit for other purposes. The Commission should also issue guidance to the crowdfunding issuer in filing its “results of operations,” which is most analogous to Items 303 of either Regulation S-B or S-K. The

---

<sup>20</sup> *Id.*

<sup>21</sup> For an example of the advice given to a new business when it is preparing a business plan to secure traditional financing, see the Small Business Administration’s guide “How to Write a Business Plan” *available at* <http://www.sba.gov/category/navigation-structure/starting-managing-business/starting-business/how-write-business-plan>.

<sup>22</sup> Section 4A(b)(4).

Division also encourages the Commission to require the crowdfunding issuer to report its number of employees on both a full time and part time basis in order to gauge the efficacy of the new exemption in fulfilling the Congressional intent to create jobs. The information should be filed no later than 90 days after the end of the issuer's fiscal year in a similar manner to annual reports on Form 10-K.<sup>23</sup>

The Division encourages the Commission to establish rules that require a failed business which issued securities pursuant to the Section 4(a)(6) exemption to file a final annual report, in the year of failure, providing final financial statements and disclosing to investors the material reasons for the liquidation, dissolution, wind-down or bankruptcy. Requiring this disclosure will serve as a deterrent to fraudulent issuers from guising the theft of investor funds in the cloak of a "business failure." More important, this type of disclosure will provide crowdfunding investors with useful information concerning the causes and consequences of failure for emerging businesses and business start-ups. This information can then be used by the crowd to better evaluate the investment proposals of other issuers to determine which proposals are likely to succeed. This report will also be useful to the market in gauging the efficacy of crowdfunded businesses in creating jobs. The Division notes that this suggested disclosure mirrors various disclosures required by the Commission in the context of a failing company that reports on EDGAR pursuant to the Exchange Act.<sup>24</sup> Similarly, if an issuer does not reach its crowdfunding target amount, that issuer should only be required to make one annual filing disclosing this fact.

#### **IV. Offering Limits and Integration.**

The plain language of Section 4(a)(6) includes many complex concepts that will need to be considered and expanded upon by the Commission. These concepts include (1) a new and untested form of integration that can be read as imposing a radical and unprecedented limitation on capital formation activities by issuers who make a Section 4(a)(6) exempt offering, and (2) investor concentration limits which are, at best, unclear and must be policed by crowdfunding intermediaries according to Section 4A(a)(8) of the Securities Act.

##### **A. Integration.**

Section 4(a)(6)(A) imposes the following integration standard on crowdfunding issuers:

*"(A) the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, is not more than \$1,000,000;"*

---

<sup>23</sup> Exchange Act Rule 13a-1 in part, "Annual reports are to be filed within the period specified in the appropriate Form." Form 10-K, General Instructions, A.(2)(c).

<sup>24</sup> For example, the Division notes that issuers are required to publicly file a certificate of dissolution before requesting relief from Section 12(g) of the Exchange Act's reporting requirements, and are required to make disclosures on Form 8-K, 10-Q and 10-K concerning an issuer's bankruptcy.

Due to perhaps a single misplaced comma (i.e., the one that follows the word “transaction” rather than the word “paragraph”), the foregoing statutory provision could be interpreted as subjecting a crowdfunding issuer to a \$1,000,000 lifetime limit on raising capital, regardless of how that capital is raised, rather than an annual \$1,000,000 limitation that crowdfunding proponents and others commonly understand the requirement to be. When read as the former, any amounts raised in excess of \$1,000,000 would cause the issuer to lose the Section 4(a)(6) exemption, resulting in an unregistered sale (retroactively and perhaps in perpetuity).<sup>25</sup>

The Division questions whether Congress intended a lifetime \$1,000,000 cap on crowdfunding issuers, but believes that this section was crafted and should be construed to place some prudential limits on the amount of capital an issuer may raise while making a Section 4(a)(6) exempt offering. The Division would ask the Commission to issue guidance as to whether it interprets the integration standard set forth in Section (4)(a)(6)(A) as a lifetime or an annual limitation. Guidance interpreting Section 4(a)(6)(A) as an annual limitation would be consistent with existing notions of integration under the securities laws (for example, the notion that integration is reviewed on a “rolling period” basis and not just as a “look-back”)<sup>26</sup> and would harmonize Section 4(a)(6)(A) with other provisions of Section 4A (in particular, Section 4A(g) which is discussed below).

#### **B. Section 4A(g) Rule of Construction.**

Section 4A(g) of the Securities Act provides:

*“(g) RULE OF CONSTRUCTION.—Nothing in this section or section 4[a]6 shall be construed as preventing an issuer from raising capital through methods not described under section 4[(a)](6).”*

Despite some commenters suggesting that this section bars the application of any integration standard to crowdfunding offerings,<sup>27</sup> the Division asserts that this position is not

---

<sup>25</sup> A plain language reading could lead to other strange results. Because the parenthetical language regarding the amounts sold in reliance upon the Section 4(a)(6) exemption only includes a “look back” of 12 months (rather than a 12 month rolling period), the issuer would retain an exemption for the first \$1,000,000 of an offering sold in one year, but could lose the exemption for any amounts sold over \$1,000,000 during the same year. The later investors would have the right to a rescission offer under the laws of most jurisdictions, while the first \$1,000,000 of investors would not, despite the issuer’s overall noncompliance with the exemption. This is so because, with respect to the first \$1,000,000 raised in the crowdfunding offering, there would have been no other amounts sold in reliance on the Section 4(a)(6) exemption during the preceding 12 months that exceeded the exemption’s limits. The “look back” issue only arises for the first dollar (and all subsequent dollars) after \$1,000,000 raised through crowdfunding during any given year.

<sup>26</sup> Rules 504(b)(2) and 505(b)(2) of Regulation D integrate other dollar amounts under Section 3(b) of the Securities Act “within the twelve months before the start of and during the offering” into offerings relying upon the Rule 504 and 505 exemptions. Additionally, Rule 502(a) of Regulation D looks six months prior to the start of a Regulation D offering and six months after the completion of a Regulation D offering for purposes of integration.

<sup>27</sup> See, e.g., the letter dated October 29, 2012 submitted to the Commission by the CrowdFund Intermediary

supported by the express language of Section 4(a)(6)(A). While Section 4(a)(6)(A) imposes an aggregate dollar limit on the amount of all types of securities sold by an issuer during a specified time period (classic integration language), Section 4A(g) focuses specifically on the “methods” of raising capital, and does not speak to anything that resembles an integration standard (e.g., temporal limits, dollar limits, types of securities, etc.).

Taken together, Sections 4(a)(6)(A) and 4A(g) should be read harmoniously such that Section 4A(g) allows crowdfunding issuers to raise capital by other means, while Section 4(a)(6)(A) integrates all sales by such other means together under a \$1,000,000 per year ceiling (should the Commission interpret the latter in this manner). This way, Section 4A(g) is read as additional guidance supporting Section 4(a)(6)(A).

Note, however, that Section 4(a)(6)(A) and Section 4A(g) only prevent integration that would destroy the Section 4(a)(6) exemption (subject to the \$1,000,000 aggregate capital limit). The Division believes that the use of the crowdfunding exemption concurrently with or around the same time as another offering may destroy the exemption used in the other offering (due to the general solicitation aspects of crowdfunding, among other reasons). It appears that Congress has not, as a matter of statutory interpretation, modified traditional integration standards set forth in the Commission’s Securities Act Releases Nos. 4434 and 4552, Rule 147, Rule 152, Rule 502(a) under Regulation D, and the Commission staff’s no-action guidance in Black Box Incorporated (June 26, 1990). Therefore, issuers would need to resort to the facts and circumstances framework established in current integration guidance to determine whether, for example, the Rule 506 safe harbor would be lost if a Rule 506 offering and a crowdfunding offering are run concurrently or within 6 months of one another. It seems possible that an issuer could continue to benefit from the crowdfunding exemption (provided the total amount of capital raised by the issuer through any method does not exceed an aggregate of \$1,000,000) but lose the Rule 506 safe harbor because it is integrated into the crowdfunded offering.

### **C. Investor Concentration Limits.**

As a condition to the exemption, Section 4(a)(6) limits the amount of securities that can be sold to any investor that invests in crowdfunding securities:

*“(B) the aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12 month period preceding the date of such transaction, does not exceed—*

*(i) the greater of \$2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000; and*

*(ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum amount sold of \$100,000, if either*

*the annual income or net worth of the investor is equal to or more than \$100,000;*"

Due to perhaps the same misplaced comma (once again following "transaction" rather than "paragraph"), Section 4(a)(6)(B) is susceptible to the same plain meaning interpretation problems that plague Section 4(a)(6)(A)—namely, that Section 4(a)(6)(B) could be interpreted as a lifetime rather than annual limitation on the amount of capital that an issuer is able to raise from any single investor. As with 4(a)(6)(B), the plain language stands at odds with what the Division perceives to be Congressional intent in passing the JOBS Act. The Division would ask that the Commission also clarify whether the limitation in 4(a)(6)(B) is a lifetime or annual limitation on the amount a crowdfunding issuer can raise from any single investor.

The Commission should also resolve certain inconsistencies with the investment limits established in the two subparagraphs of Section 4(a)(6)(B). Note that issues of interpretation and application arise if an investor's annual income falls below \$100,000 but the investor's net worth exceeds \$100,000 (or vice versa). In such cases, both of the subparagraph investment limits are triggered, without any guidance as to which limit should control. In the interest of investor protection, the Commission may conclude that the stricter investment limitation should apply in such cases.

## **V. Crowdfunding Intermediaries.**

Section 4(a)(6)(C) states that the crowdfunding exemption is only available to offerings transacted through a broker or funding portal. Because Section 4(a)(6) offerings are exempt from registration and review by the Commission, and preempted from review by state securities regulators, Congress placed upon intermediaries the responsibility of serving as the primary gatekeepers to the crowdfunding marketplace. As such, the intermediaries must play a critical role in ensuring the integrity of the market and maintaining meaningful investor protections. It is crucial that the Commission's rulemaking recognizes the significance of this role, and requires crowdfunding intermediaries to uphold their obligation.

### **A. Prohibited Activities.**

Unlike broker-dealers, the activities of funding portals are significantly restricted under Title III of the JOBS Act. Funding portals may not offer "investment advice" or make "recommendations."<sup>28</sup> Strong guidance from the Commission may be needed to inform this new breed of industry professional about the broad scope of both recommendation and investment advice activities. This guidance may prevent them from creeping into practices prohibited by the statute down the road and would also inform the public of the extent of the lawful capabilities of funding portals.<sup>29</sup>

---

<sup>28</sup> One of the definitions at Section 3(a)(80)(A) of the Exchange Act defines "Funding Portal" as an intermediary that does not "offer investment advice or recommendations."

<sup>29</sup> The Division notes that efforts are already underway by some in the crowdfunding industry to hold themselves out to the public as "experts" and "advisors." The National Crowdfunding Association, a self-described trade

The statute further prohibits funding portals from engaging in a list of other activities, including but not limited to: soliciting sales of securities offered on its website or portal;<sup>30</sup> compensating persons for such solicitation;<sup>31</sup> compensating promoters or finders for providing the personal identifying information of any potential investor;<sup>32</sup> having directors, officers, or partners with any financial interest in an issuer using its services;<sup>33</sup> handling investor funds or securities; and engaging in other activities as the Commission, by rule, determines appropriate.<sup>34</sup> Based on these restrictions, the Division respectfully requests that the Commission adopt rules that ensure the activities of funding portals are limited to those intended by Congress—merely displaying or listing compliant offerings of crowdfunding issuers.

## B. Due Diligence Requirements.

Crowdfunding intermediaries will have extensive due diligence obligations under existing securities law and under the CROWDFUND Act. As an initial matter, new Section 4A(a)(5) of the Securities Act provides, in part, that crowdfunding intermediaries are to “take such measures to reduce the risk of fraud with respect to such transactions, as established by the Commission, by rule, . . .”<sup>35</sup> This section establishes a due diligence requirement by noting that the “measures to reduce the risk of fraud” *include* (but are not limited to) conducting a criminal and securities enforcement background check of officers, directors, and 20 percent shareholders of an issuer (a traditional due diligence activity). Moreover, given the balance of power in these transactions, the Division believes that crowdfunding intermediaries may be the only securities professionals with the bargaining power necessary to require access to the issuer’s information (given that the issuers cannot conduct a crowdfunding offering without the intermediary). This approach is consistent with prior case law recognizing similar information and power asymmetry

---

association representing crowdfunding industry participants, published a press release on October 2, 2012 announcing the creation of the “Certified Crowdfund Advisor” professional designation which purports to “identify the holder as being an expert in crowdfunding and thus professionally able to help everyone from small business owners to investors regarding how to participate in crowdfunding.” The press release is available at <http://www.marketwatch.com/story/here-come-the-certified-crowdfund-advisors-2012-10-02>.

<sup>30</sup> Section 3(a)(80)(B) of the Exchange Act.

<sup>31</sup> Section 3(a)(80)(C) of the Exchange Act.

<sup>32</sup> Section 4A(a)(10).

<sup>33</sup> Section 4A(a)(11). It has been argued by some aspiring funding portals that this provision does not prohibit the funding portal itself from having a financial interest in issuers using its services. *See, e.g.*, the views letter of Maurice Lopes, CEO of EarlyShares, to the Commission on August 16, 2012, *available at* <http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-127.pdf>. The Division urges the Commission to clarify that the statute prohibits funding portals from having a financial interest in an issuer using its services. If a portal held a financial interest in an issuer using its services, the portal’s officers, directors, or partners would hold an indirect financial interest in that issuer, through the portal. Section 4A(a)(11) prohibits an intermediary’s officers, directors, or partners “from having *any* financial interest in an issuer using its services” (emphasis added), which prohibition would include an indirect financial interest.

<sup>34</sup> Sections 3(a)(80)(D) and (E) of the Exchange Act.

<sup>35</sup> Section 4A(a)(5).

between issuers and investors with respect to over the counter stocks.<sup>36</sup> Additionally, as previously noted, Section 4A(c)(3) of the Securities Act includes all “sellers” (which necessarily includes crowdfunding intermediaries) within the definition of “issuer” for purposes of liability under Section 4A(c)(1)(B) (and by extension Section 12) of the Securities Act. Accordingly, *crowdfunding intermediaries* may be held liable for material misstatements and omissions in an issuer’s offering materials if the *crowdfunding intermediary* has not established a due diligence defense.<sup>37</sup>

Notwithstanding that the CROWDFUND Act imposes a due diligence obligation on crowdfunding intermediaries, due diligence obligations likely exist under already established law. For example, crowdfunding intermediaries are seemingly subject to Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.<sup>38</sup> Investors will view crowdfunding intermediaries not merely as passive “bulletin boards,” but as active gatekeepers that make representations regarding licensing and their affiliation with a self-regulatory agency, and offer various securities with different pricing. These are traditional case law factors that impose special obligations upon a seller.<sup>39</sup>

As in the case of an underwriter, the mere receipt of information from management and the mere reliance upon representations made by company officers may be insufficient for crowdfunding intermediaries to establish a due diligence defense. Courts have recognized that independent verification and review is a critical step in the due diligence process.<sup>40</sup> Accordingly,

---

<sup>36</sup> See, e.g., *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969) (“Sonic was an over the counter stock. Those who purchased through petitioners could not readily confirm the information given them. In *Charles Hughes & Co., Inc. v. Securities and Exchange Commission*, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944), this Court recognized the difficulties involved in over the counter stocks and the special duty imposed upon those who sell such stocks not to take advantage of customers in whom confidence has been instilled.”).

<sup>37</sup> The Division notes that the CROWDFUND Act effectively holds crowdfunding intermediaries to the same due diligence standards as underwriters with respect to offering materials.

<sup>38</sup> *Hanly*, 415 F.2d at 595-96 (2d Cir. 1969), citing *Dlugash v. Securities and Exchange Commission*, 373 F.2d 107, 109 (2d Cir. 1967) (“Brokers and salesmen are ‘under a duty to investigate, and their violation of that duty brings them within the term ‘willful’ in the Exchange Act.”); see also *Securities and Exchange Commission v. Shainberg*, 316 Fed. Appx. 1, 3 (2d Cir. 2008).

<sup>39</sup> *Grandon v. Merrill Lynch & Co., Inc.*, 147 F.3d 184, 192 (2d Cir. 1998) (“Under the shingle theory, a broker makes certain implied representations and assumes certain duties merely by ‘hanging out its professional shingle.’”); *Capital Mgmt. Select Fund Ltd. v. Bennett*, 680 F.3d 214, 230 (2d Cir. 2012) (“An over-the-counter firm which actively solicits customers and then sells them securities at prices as far above the market as were those which petitioner charged here must be deemed to commit a fraud. It holds itself out as competent to advise in the premises, and it should disclose the market price if sales are to be made substantially above that level.”); *Charles Hughes*, 139 F.2d at 436-37 (“Recent cases have harmonized the older ‘shingle theory’ cases with the Supreme Court’s Rule 10b-5 fraud jurisprudence by identifying both a duty to disclose and a material omission.”). See also *Bissell v. Merrill Lynch & Co., Inc.*, 937 F. Supp. 237, 246 (S.D.N.Y. 1996) *aff’d*, 157 F.3d 138 (2d Cir. 1998).

<sup>40</sup> See *Escott v. BarChris Construction Corporation*, 283 F.Supp. 643, 697 (S.D.N.Y. 1968); *FEIT v. Leasco Data Processing Equipment Corp.*, 332 F.Supp. 544 (E.D.N.Y. 1971); *University Hill Foundation v. Goldman Sachs & Co.*, 442 F. Supp. 879, 898-99 (S.D.N.Y. 1976). See also *In re International Rectifier Securities Litigation* 1997 WL 529600 at \*7 (C.D. Cal. March 31, 1997) (quoting *In re Software Toolworks Inc.*, 50 F.3d 615, 621

the Commission's rulemaking should consider requiring crowdfunding intermediaries, particularly broker-dealers intermediaries recommending sales, to ask questions of accountants, officers and directors, suppliers, and customers; assess competitive risks; review the issuer's current financial health and its future financial prospects; consider general financial issues related to the issuer's business; and, be fully knowledgeable about the accuracy and completeness of the representations made to the investor. It may also be appropriate to require a physical on-site investigation of some issuers that lack audited financial statements or where red flags may be present.

Lastly, the Commission should clarify whether and the extent to which crowdfunding intermediaries will be permitted to delegate to, and rely upon, third-party service providers to conduct any such due diligence. The Division would hope that the Commission would not allow crowdfunding intermediaries to blindly rely upon such third-party agents in order to absolve themselves of their obligation to monitor the entire due diligence process.<sup>41</sup>

### C. Monitoring Investor Concentration Limits.

The Section 4(a)(6) exemption establishes two investor concentration limits. The first, discussed above, appears in Section 4(a)(6)(B) and requires issuers to monitor the amount of crowdfunded (and other) securities the issuer sells to any individual investor. New Section 4A(a)(8) establishes a second, overall investor concentration limit and imposes an obligation upon crowdfunding intermediaries to ensure the limit is effectively policed. Section 4A(a)(8) requires an intermediary to:

*“(8) make such efforts as the Commission determines appropriate, by rule, to ensure that no investor in a 12-month period has purchased securities offered pursuant to section 4[(a)](6) that, in the aggregate, **from all issuers**, exceed the investment limits set forth in section 4[(a)](6)(B).”* (emphasis added).

Section 4A(a)(8) makes clear that the maximum amount of securities that an investor can purchase from all crowdfunding issuers, regardless of the type of security or manner in which those securities were offered to the investor, may not exceed the dollar limits established in Section 4(a)(6)(B). Consider the following example:

---

(9th Cir. 1994)); *Weinberger v. Jackson*, 1990 U.S. Dist. LEXIS 18394 at \*6-9 (N.D. Cal. Oct. 11, 1990); *Chris-Craft Industries, Inc., v. Piper Aircraft Corporation* 480 F.2d 341,372-73 (2d Cir. 1972), *cert. denied*, 414 U.S. 910 (1973).

<sup>41</sup> See, e.g. *Competitive Assoc.'s Inc. v. Laventhal Kreckstein, Horwath and Horwath*, 516 F.2d 811, 813 (2d Cir. 1975) (entire syndicate protected by managing underwriter's adequate due diligence); see also *The Obligations of Underwriters, Brokers and Dealers in Distributing and Trading Securities*, Securities Act Release No. 33-5275, [Securities Act/Exchange Act Binder Vol. 2] Fed. Sec. L. Rep. (CCH) 6 4506B at 4057 (July 26, 1972) (reliance on managing underwriter is reasonable if the participating underwriter is satisfied that “the managing underwriter ma[de] the kind of investigation that the participant would have performed if it were the manager,” and that “the manager's program of investigation and actual investigative performance are adequate.”); *BarChris*, 283 F. Supp. at 696-97 (attorney's failure to adequately examine corporate minutes and contracts binding on underwriters).

1. Investor has a net worth and net income of less than \$100,000 per year. Under Section 4(a)(6)(b)(i), he can invest no more than \$5,000 in *any securities* offered by *any issuers* who have taken advantage of the Section 4(a)(6) exemption.
2. Investor purchases \$5,000 of the common stock of Issuer A through Issuer A's crowdfunding offering. Issuer A's offering is listed on a funding portal.
3. The next day, Investor, being a sophisticated but unaccredited investor, purchases \$5,000 of the common stock of Issuer B in a Rule 506 private offering. Issuer B, at the time of the private offering, has not engaged in crowdfunding.
4. Three months later, Issuer B begins offering its common stock in a crowdfunding offering on another funding portal.

By the operation of the language used in Section 4(a)(6), the following consequences could occur:

- A. Investor could be deemed to have exceeded his annual investment limits in Section 4(a)(6)(B)(i), because he purchased securities in excess of \$5,000 from two issuers that offered securities through the Section 4(a)(6) exemption. It does not appear to matter under Section 4(a)(6)(B) that the amounts in excess of \$5,000 were invested in a Rule 506 private offering. Section 4(a)(6)(B) appears to turn on whether the *issuers* were engaged in crowdfunding, not whether the *securities* purchased by the investor were purchased through crowdfunding.
- B. The fates of Issuer A and Issuer B are joined through their common investor. At the moment Issuer B commences its crowdfunding offering, Issuer A may retroactively lose its Section 4(a)(6) exemption and fall into an unregistered sale to Investor, because Investor exceeded his annual aggregate limit of securities purchases from crowdfunding issuers. All other sales by Issuer A pursuant to the now lost Section 4(a)(6) exemption could also be viewed as unregistered sales.
- C. Due to the "domino effect" described in Section II.B of this letter and the unregistered sale by Issuer A, Issuer A's funding portal could likewise be found to have lost its "funding portal" status under Section 3(a)(80) of the Exchange Act. If so, the "domino effect" would cause those issuers using the same funding portal as Issuer A to lose their Section 4(a)(6) exemptions and face liability for unregistered sales.<sup>42</sup>

---

<sup>42</sup> The "domino effect" could be further exacerbated by integration. For example, where an issuer conducts substantially similar crowdfunding offerings across multiple funding portals, that issuer's current or future failure to comply with Section 4(a)(6) could affect the "funding portal" status of multiple funding portals and all of the crowdfunding issuers offering securities on those funding portals. The many possible roads to a cascading failure insert a high degree of risk and uncertainty into the Section 4(a)(6) exemption.

- D. Issuer B may also lose its Section 4(a)(6) exemption for its crowdfunding offering and fall into unregistered sales (if any securities were sold through the crowdfunding offering) through no fault of its own. Under Section 4A(a)(8), a funding portal is charged with ensuring “that no investor in a 12-month period has purchased securities offered pursuant to section 4[(a)](6) that, in the aggregate, from all issuers, exceed the investment limits set forth in section 4[(a)](6)(B).” When Issuer B proposed to list a crowdfunding offering with its funding portal, that funding portal must, consistent with Section 4A(a)(8), review Issuer B’s outstanding securities offerings and all of the investors in those offerings to ensure that no investor in Issuer B’s securities had other investments in other crowdfunding *issuers* that could exceed the limits set forth in Section 4(a)(6)(B). The funding portal should have determined that, if it listed Issuer B’s crowdfunding offering, Investor would exceed his annual aggregate investment limits in the securities of crowdfunding issuers. The funding portal should have informed Issuer B that it was ineligible for the Section 4(a)(6) exemption for 12 months following Investor’s investment in Issuer A. In failing to do so, Issuer B’s crowdfunding offering may not be viewed as “conducted through a broker or funding portal that complies with the requirements of section 4A(a),” because Issuer B’s funding portal failed to comply with Section 4A(a)(8).
- E. Due to Issuer B’s unregistered sales and the “domino effect”, Issuer B’s funding portal has sold securities other than Section 4(a)(6) exempt securities. Accordingly, Issuer B’s funding portal would no longer have “funding portal” status under Section 3(a)(80) of the Exchange Act. Issuers listing crowdfunding offerings on Issuer B’s funding portal have conducted sales through an entity other than a broker or funding portal (as required by Section 4(a)(6)(C)). The offerings of these issuers would therefore lose the Section 4(a)(6) exemption and potentially face liability for unregistered sales.
- F. Issuer B may *also* lose its Rule 506 safe harbor and private offering exemption due to integration of the Rule 506 offering with Issuer B’s crowdfunding offering (or the unregistered sales that purported to use the crowdfunding exemption). The purported crowdfunding offerings included general solicitation and sales to unaccredited investors, which, if integrated, would void both a traditional Rule 506 exemption, and a Rule 506(c) exemption, as currently proposed.

These unintended consequences reflect the balancing act that Congress walked between the original intent of the CROWDFUND Act (to establish an exemption for offerings where investors could make only a *de minimus* investment) and the calls of interested parties to expand the amount of capital that issuers could raise through crowdfunding offerings. Congress’ tradeoff in allowing larger investments pursuant to the CROWDFUND Act was to draw clear limits on the amounts that could be raised from any individual and to impose stiff penalties for breaching those limits.

The severity of the consequences, and the complex interactions between the many securities of various issuers and the holdings of various investors, necessitate a centralized approach to ensuring that investors do not exceed their limits and that issuers do not unknowingly void their exemptions. Congress, recognizing the importance of the investment

limits as well as the complexity of maintaining them, placed the obligation for policing these interactions upon crowdfunding intermediaries, the central party in interactions between issuers and investors in a Section 4(a)(6) exempt offering. Congress stressed the importance of the crowdfunding intermediary's role in policing the interactions between issuers' offerings and investors' holdings by requiring the Commission to establish rules that would “ensure that no investor . . . exceed[s] the investment limits set forth in section 4[(a)](6)(B).”

The Commission's rulemaking task in this regard is substantial. Congress ostensibly has held each crowdfunding intermediary responsible for knowing *all* of the investments held by investors, knowing *all* of the securities (regardless of how those securities are offered) issued by *any* issuer using the Section 4(a)(6) exemption (including those issuers who are offering securities pursuant to Section 4(a)(6) *via* other crowdfunding intermediaries), and continually monitoring the offerings of Section 4(a)(6) issuers (including issuers using other crowdfunding intermediaries) to ensure that they do not make offerings to investors who have reached their investment limits or offerings that would cause the issuer to lose their Section 4(a)(6) exemption. It will be incumbent upon the Commission, FINRA and the self-regulatory organization responsible for regulating “funding portals” to figure out ways for these actors to share information regarding investors and issuers to achieve compliance with the Act. The Commission may find it necessary to establish a clearinghouse that will maintain all of the relevant information concerning issuers and investors participating in Section 4(a)(6) offerings.

#### **D. Investor Education.**

Separate from the offering circular, “other investor education materials” must be provided to the investor pursuant to Section 4A(a)(3). The Intermediary must “ensure” that the investor reviews the materials and positively affirms that the investor understands and can bear the risk of loss of the entire investment. Section 4A(a)(4)(A) requires the intermediary to ensure that the investor “review investor-education information, in accordance with standards established by the Commission, by rule.” The provision requires intermediaries to:

*“(3) provide such disclosures, including disclosures related to risks and other investor education materials, as the Commission shall, by rule, determine appropriate;*

*(4) ensure that each investor—*

*(A) reviews investor-education information, in accordance with standards established by the Commission, by rule;*

*(B) positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss; and*

*(C) answers questions demonstrating—*

*(i) an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers;*

*(ii) an understanding of the risk of illiquidity; and*

*(iii) an understanding of such other matters as the Commission determines appropriate, by rule;” (emphasis added)*

The language in Section 4A(a)(4)(A) is unclear as to whom the “standards established by the Commission” refer to; the intermediary or the investor. Does that section require the Commission to create a standard of review that an investor must follow when reviewing the investor-education information? Or, must the Commission establish standards by which the intermediary “ensure[s] that each investor reviews” the education materials? If the former interpretation is correct, then the Division is unaware of any analogous instance in which the Commission has established standards of review applicable to investors prior to investing. The other plausible interpretation is that the “standards established by the Commission” refer to the obligation of the intermediary to “ensure that each investor reviews investor-education information.” This seems the more likely intent of Congress, as requiring the investor to follow a standard of review prescribed by the Commission is unprecedented and unworkable on its face. Under either interpretation, to “ensure” is a very high standard for the intermediary to satisfy. The Division requests the Commission to clarify this provision.

Section 4A(a)(4)(C) appears to require a questionnaire as the prospective investor must “answer questions” demonstrating his or her understanding of risk and other matters the Commission deems appropriate. The Commission should adopt specific and comprehensive rules under this section regarding the education of investors on the risks of investing in “startups, emerging businesses, and small issuers.” Note that this requirement appears different from the “positively affirms” understanding language used in the section immediately preceding. Presumably, an investor who affirms understanding but does not answer the questions correctly is precluded from investing in the crowdfunding issuer.

Clear guidance is required to inform intermediaries, issuers, investors, and other regulators as to what the investor education materials must be and how to ensure compliance. We encourage the Commission to work on these challenging issues with NASAA and investor advocacy groups that work closely with investors and, therefore, have a sound understanding of what information and education investors need in order to make informed and suitable investment decisions.

## **VI. Deal Structure.**

### **A. Timing: The Period for Delivery and Review of Disclosure, Investor’s Rights of Rescission and Breaking Escrow.**

The Commission should closely review Sections 4A(a)(6) and 4A(a)(7) to ensure that the timeline for the CROWDFUND Act’s disclosure delivery requirements, investors’ rights of rescission, and the issuer’s right to break escrow are harmonized in a way that is practical for issuers while maintaining investor protections.

Section 4A(a)(6) provides that Intermediaries shall:

*“(6) not later than 21 days prior to the first day on which securities are sold to any investor (or such other period as the Commission may establish), make*

*available to the Commission and to potential investors any information provided by the issuer pursuant to subsection (b);” (emphasis added)*

Section 4A(a)(6) effectively provides that an intermediary may begin sales of an issuer’s crowdfunding offering 21 days after required disclosures have been delivered to the Commission and posted on the intermediary’s platform for public view. As a practical matter, this interpretation eases the burden on issuers (since they would not have to track a 21 day “disclosure delivery” period for each individual investor), and maintains consistency with public offering practices.

Section 4A(a)(7) establishes additional investor safeguards in the form of escrow requirements and an investor rescission right. Specifically, Section 4A(a)(7) requires an Intermediary to:

*(7) ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, and allow all investors to cancel their commitments to invest, as the Commission shall, by rule, determine appropriate;<sup>43</sup>*

Due to the substantial risks involved and the potential for investor loss, the Division urges the Commission to permit an investor to cancel his or her commitment until the day that funds are permitted to be released from escrow. This is consistent with prevailing private offering practice, where an investor is generally not bound to the investment until the transaction closes. Additionally, because an investor who provides the “final” investment causing the issuer to achieve its target offering amount should receive the same level of protection as the very first investor, the Commission should mandate that funds may not be released from escrow until 21 days after the target offering amount has been reached. This ensures that the “final” investor or investors are given adequate time to review and consider the issuer’s disclosure and an appropriate period in which to rescind offers—particularly if the “final” investors have been motivated or pressured into investing “at the last minute” by the appearance of “missing out” on a successful crowdfunding.

Lastly, because the CROWDFUND Act does not prohibit issuers from raising additional funds after an issuer’s target offering amount has been achieved (subject to the aggregate \$1,000,000 limitation), the Commission should consider giving investors who invest *after* the target offering amount has been reached a 21 day rescission right, to ensure each investor has ample time to review and consider the disclosure materials.

---

<sup>43</sup> This rescission right is also stated in Section 4A(b)(1)(G) as an issuer requirement. Section 4A(b)(1)(G) states that the issuer must provide investors a “reasonable opportunity to rescind the commitment to purchase the securities.”

## **B. Escrow and Target Offering Amount Mechanics.**

The Commission should require escrowed funds to be held by a regulated independent third-party financial institution, such as a bank or registered broker-dealer. The Division further encourages the Commission to require that escrowed funds be returned to investors after the lesser of one year or the stated end of the offering period if the target offering amount is not reached by that time. It should be made clear that any interest earned on escrowed funds accrues to the benefit of a rescinding investor. Both the issuer and intermediary should be entitled to rely on a regulated independent third-party financial institution to satisfy these requirements.

The Commission should also clarify what is permitted when establishing a “target offering amount” in accordance with Section 4A(a)(7). If the target offering amount may be freely set by the issuer, there is nothing to prevent the issuer from setting an arbitrarily low number simply to break escrow as soon as possible. This would circumvent the investor protections intended by Section 4A(a)(7). The Division urges the Commission to establish rules requiring that the target offering amount bear some reasonable relation to the total offering amount sought by the issuer.

## **D. Risk and Reward Shifting.**

Given the significant risks inherent in crowdfunding for both issuers *and* investors, insiders of crowdfunding issuers may attempt to insulate themselves from risk by shifting it onto the investor. As previously discussed, crowdfunding investors will not have the bargaining power necessary to negotiate the terms of a Section 4(a)(6) offering. Promoters in crowdfunded debt or equity offerings could employ many structures and schemes to allocate the majority of risk to investors while retaining the majority of the reward. Some of the many risk/reward allocation terms an issuer could employ include disparate and dilutive pricing terms; non-voting classes of securities; grants of options, warrants, restricted shares, and other forms of equity and cash-based compensation awards that dilute investors or permit insiders to enjoy risk free profit taking at the expense of investors; call or redemption rights that could be used opportunistically to prevent investors from participating in the long-term appreciation of an investment; debt that is unfairly subordinated or inadequately collateralized, etc.

With respect to crowdfunded debt offerings, the Commission should consider adopting some of the following structural requirements: requiring adequate collateralization by requiring first liens on the assets acquired with the proceeds of the offering; requiring personal guarantees of insiders where the collateralization is inadequate; not permitting a crowdfunded debt offering where the debt exceeds three times existing equity; requiring clear events of default and timely notice to investors upon events of default; and restricting the issuance of more senior capital without the affirmative vote of a majority of the crowdfunded debt holders.

With respect to crowdfunded equity offerings, the Commission should consider adopting some of the following structural requirements: prohibiting unfair dilution of voting rights, book value of shares, and distribution rights; limiting economic dilution to no more than 20% of an investor’s initial investment, restricting the grant and exercise of options, warrants, and shares to insiders; restricting the disposition of other equity and cash-based awards, such as dividend equivalent rights and organizational and offering expenses, to insiders; and preventing the

subordination of voting rights of crowdfunded equity securities without the affirmative vote of at least a majority of the outstanding holders of those securities.

**D. Certain Issuers Should Be Prevented from Using the Exemption.**

Although most of the commentary surrounding the new Section 4(a)(6) exemption from registration has focused on its use by small businesses and start-ups, Section 4(a)(6) may be used by entities of any size, age or financial health. Failing business may attempt to use the crowdfunding exemption in a last-ditch effort to avoid bankruptcy and dissolution. Determining whether to prolong a failing business' existence is a complex analysis better borne by more traditional financing sources that have the expertise to evaluate and support a failing business. Accordingly, the Commission should consider adopting rules that prohibit the use of the crowdfunding exemption<sup>44</sup> by an issuer whose liabilities exceed the fair market value of its assets (as determined immediately prior to the offering).<sup>45</sup> Any issuer who becomes insolvent during an open crowdfunding offering should, together with the intermediary, be required to suspend the offering.

The Commission should also consider prohibiting the use of the crowdfunding exemption for blind pools or blank check companies. The very purpose of the CROWDFUND Act is to ease capital formation for small businesses and small business start-ups that have a business plan but limited access to capital. In fact, the Section 4(a)(6) exemption, as informed by Section 4A(b) of the Securities Act, requires an issuer to affirmatively disclose its "business plan" to investors. It would be inconsistent with those goals to allow blind pools and blank check companies, which do not have articulated business plans or purposes, to use the crowdfunding exemption. Note that the Commission has adopted a similar set of exclusions from the use of Section 4(a)(6)'s nearest analog, Rule 504. The Commission should adopt language similar to Rule 504(a)(3) of Regulation D and exclude:

*"A development stage company that either has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person. . ."*<sup>46</sup>

\* \* \* \* \*

---

<sup>44</sup> The Division notes that foreign entities, companies registered under the Exchange Act, and investment companies are excluded from using the Section 4(a)(6) exemption for crowdfunding offerings. Section 4A(f)(4) of the Securities Act permits the Commission to adopt rules that provide additional exclusions from the use of the Section 4(a)(6) exemption.

<sup>45</sup> Many states, including Ohio, restrict the sale of securities by insolvent issuers. For example, Ohio Revised Code Sections 1707.44(D) and (F) prohibit the sale of an insolvent issuer with intent to deceive the investor; a violation of these prohibitions constitutes a penalty under Ohio Revised Code Section 1707.99. Section 412 of the Uniform Securities Act provides similar restrictions for states that have adopted it.

<sup>46</sup> Rule 504(a)(3), in part.

The Division appreciates the Commission's consideration of its views as it undertakes its historic rulemaking under the CROWDFUND Act. If you have any questions or concerns, please contact Mark Heuerman, Registration Chief Counsel, at (614) 644-9529 or me at (614) 644-7435.

Very truly yours,

A handwritten signature in black ink that reads "Andrea L. Seidt". The signature is written in a cursive, flowing style.

Andrea L. Seidt  
Commissioner  
Ohio Division of Securities