

Document Purpose: **Comments Submission for SEC Proposed Rules**

File No: **S7-05-20**

File Title: **Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets**

In Response to: **Sec II, Sub F-2. Regulation Crowdfunding and Regulation A Eligibility**

Introduction

We're excited and inspired by the fact that the SEC is continuously looking for ways to improve and streamline the regulatory factors around Regulation Crowdfunding. It's a monumental task, and we're grateful for the painstaking work that goes into thinking about every facet of raising capital from the general public.

Many of the proposed changes such as utilizing the higher of the net worth/income for unaccredited investors; easing restrictions on amounts invested by accredited investors; and increasing the maximum amount issuers are able to raise per annum under Reg CF are all highly effective and beneficial changes.

With that, we have a number of concerns around the deleterious effects of: **Section II, Sub-Section F-2**, whereby the SEC proposes to harmonize the limitations on the types of eligible securities issuable under Reg CF with Reg A. Below is a bulleted list that summarizes our primary comments concerning said change followed by a more detailed explanation of our reasoning.

Document Summary In Response to Request for Comment #78

Should we harmonize the limitations on the types of eligible securities issuable under Regulation Crowdfunding with Regulation A as proposed?

- Harmonization raises antitrust concerns because it will permanently entrench as leaders the current oligopoly of three Reg CF intermediaries who hold 80% of the market by primarily offering equity, debt, and convertible debt for issuers (almost entirely consisting of incorporated entities).¹ The probability of inadvertently incentivizing collusion, consolidation or other antitrust behavior among them to prevent new entrants from entering the marketplace would dramatically limit the number of jobs the JOBS Act was designed to create.
- The majority of security types defined in the Securities Act of 1933 will be ineligible for crowdfunding with no market evidence or investor backlash to suggest any should be restricted.
- Not all company types eligible for Reg CF ("company" as defined in the Investment Company Act) lend themselves to equity, debt, or convertible securities.

If so, what would be the effect on issuers, investors, and the market of limiting these categories of securities?

- Harmonization will extinguish crowdfunding innovation because it dampens the organic evolution of the industry, overall.

¹ https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf

- Standard equity forces a company into a binary path of being acquired or going public in order for investors to receive any return.
- Debt and convertible debt forces young companies to pay back their investors on a timetable that may not align with growth, particularly in the era of Covid-19. This can lead to failure and job loss.
- Additional safer, lower-risk, simpler funding options gaining popularity among accredited investors, companies, and the investment community at large, are being disregarded.

In the alternative, should we modify Regulation Crowdfunding only to exclude particular security types, such as SAFEs?

- The one page document referenced in file no. S7-05-20, “Investor Bulletin: Be Cautious of SAFEs in Crowdfunding,” which seems to be the genesis for the proposed exclusion, is now more than 3 years old.² While it posits troubling concerns with SAFEs vis a vis Regulation Crowdfunding, it contains no statistics or other objective evidence to suggest that SAFEs have been confusing to Reg CF investors. Respectfully, it contains conjecture. In practice, there have been no issues with SAFEs with respect to crowdfunding and no overt reason to ban them. Further study is required.

Elaboration of Request for Comment #78

Harmonization Raises Antitrust Concerns By Creating a Crowdfunding Oligopoly and Could Foster an Environment of Forced Collusion or Consolidation in Order to Grow

As reported in the SEC’s 2019 study of regulation crowdfunding, approximately 80% of Reg CF crowdfunding occurs through three intermediaries.³ These happen to be Republic.co, StartEngine.com, and Wefunder.com, all of whom have Reg CF issuers which are overwhelmingly corporations.⁴ Each of these intermediaries have experienced nearly 100% year over year growth on the heels of the three investment options the committee is proposing to back. Each of these portals takes an extremely narrow view of the company types they accept as issuers—corporations being the sole type. Locking in these three security types thus all but guarantees market dominance for these companies within Reg CF in perpetuity. The opportunity for new Reg CF entrants to innovate with new business models leveraging other legal security types will have been extinguished, along with the jobs those would have created.

A decision to harmonize begs hard questions which can’t be validated at this time in history, and therefore should give pause to limiting security types. Why would the market need another Reg CF portal that offers the exact same thing as the three leaders? How is a new Reg CF entrant expected to compete with the three dominant players when it’s only permitted to do what they’re doing? Why would issuers want to post their offering on a new entrant’s portal, when the market leaders have substantial traffic and product maturity? Given the understandable limitations on marketing to protect investors, a new entrant can’t be expected to out-market these leaders as a growth strategy, can it?

If these three portals merge with or acquire each other, the country may well be left with a duopoly, or monopoly in mere years. We realize antitrust concerns fall within the purview of the Department of

² https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes

³ https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf

⁴ <https://crowdwise.org/funding-portals/2019-equity-crowdfunding-stats-data/>

Justice, and perhaps it's an issue with which they could be consulted on before decisions are made. However, we implore the SEC to consider the ramifications regardless now, because innovation to create jobs is needed now, particularly in the era of Covid-19.

The Securities Act of 1933 Definition of Securities Should be the Standard for Reg CF Security Types, Each Restricted or Limited by the SEC Only When Issues or Complications Arise

The seminal law defines securities as:

“...any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

While we agree that the intent of the JOBS Act was not to facilitate investment instruments such as treasury stocks, puts, calls, straddles, options, or privileges entered into on a national securities exchange relating to foreign currencies via Reg CF crowdfunding, other securities defined herein are perfectly applicable to entities raising capital via Reg CF. Moreover:

1. There's no significant quantitative or qualitative data that can be used to determine the entire breadth of security types that could safely and successfully be offered to the public via Reg CF issuers. One only needs to consider the sheer volume of security types offered to the general public by investment banks.
2. There aren't enough regulated funding portals or enough variance among them to make an educated, informed decision on what security types to exclude.
3. The quick restriction of all security types sans equity, debt and convertible debt may be a well-intended overreaction to an internal SEC bulletin highlighting potential risks of SAFEs as they were first thought to be three years ago.

To refer to securities other than equity, debt, and convertible debt as “non-traditional securities” in regulation crowdfunding, as written on page 157 of file no. S7-05-20, could be a tenuously legal and shortened view of the market. First, it must be asked if there's a legal definition, or generally accepted list of “non-traditional securities” accepted by the SEC and the investment community as a whole. The authors of this document have yet to unearth any reports that suggest the formalization of such a list.

Moreover, the SEC gives “Simple Agreements for Future Tokens and certain revenue sharing agreements” as non-traditional examples in footnote 351. A more accurate categorization of these with regard to Regulation Crowdfunding would be “less frequent securities”. This is because there's nothing traditional yet about Regulation Crowdfunding, as its been in existence for a handful of years. It seems there is an unwarranted, underlying assumption that “non-traditional” security types are automatically more risky, confusing and will result in an increase of dissatisfied investors.

It's absolutely conceivable that less frequently utilized security types will become more common, more transparent, safer for and more liquid for investors, while also being more diverse, and thus, form fitting for issuers and generating potentially exponential quantities of jobs.

Not All Types of Companies Lend Themselves to Equity, Debt, or Convertible Securities

As referenced in footnote 329 of file no. S7-05-20:

“Under the Investment Company Act, a company means a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in a case under title 11 of the United States Code or similar official or any liquidating agent for any of the foregoing, in his capacity as such.”

Investors in partnerships, associations, and any organized group of persons whether incorporated or not might be better served from offering other security types defined in the Securities Act of 1933.

For example, creative businesses centered around a project, such as a feature film, music or literary work may well be better financed by other security types defined in the Securities Act, such as participation in a profit-sharing agreement or transferable shares. In the U.S. alone, more than 2 million Americans are employed in the entertainment industry.⁵ On Kickstarter.com alone, an unregulated rewards-based crowdfunding portal, more than \$3 billion has been given away to entertainment projects with no oversight or accountability.⁶

This is an example of an industry that could port itself to Regulation Crowdfunding. The author's research suggests that this industry and others will shift to Regulation Crowdfunding as people grow tired of giving away their money to for-profit projects that are often misrepresented and frequently don't actually get made. With harmonization, the U.S. economy would never have the benefits of seeing these billions of dollars invested responsibly through Regulation Crowdfunding and the tens or hundreds of thousands of jobs this could create. Additionally, money would flow back into the community that supports the industry, thus creating a financial win-win for all parties concerned.

Harmonization will extinguish crowdfunding innovation because it dampens the organic evolution of the industry, overall

Innovation drives economic growth. This is one of the most consistent findings in macroeconomics, and it's been true for centuries.⁷ Our country's predilection for innovation and entrepreneurial drive is the primary reason for America's economic preeminence. Innovation from small business accounts for 44% of U.S. economic activity.⁸

We believe this applies to Regulation Crowdfunding. This will be brought on in the coming years by new intermediary entrants who innovate on ways to position an array of security types. If those companies fail, that is the invisible hand of the market. But capitalism, innovation, as well as the

⁵ <https://datausa.io/profile/naics/arts-entertainment-recreation>

⁶ <https://www.kickstarter.com/help/stats>

⁷ <https://www.brookings.edu/research/technology-and-the-innovation-economy/>

⁸ <https://advocacy.sba.gov/2019/01/30/small-businesses-generate-44-percent-of-u-s-economic-activity/>

wherewithal and willingness to support less frequent securities early on will lead to more businesses funded and more jobs for Americans.

We are of the opinion that it's too early in the life of Regulation Crowdfunding for harmonization. Overall, the industry and investors would benefit greatly from a more pliable, graduated approach to how security types are regulated, so that as the industry eventually matures, we are left with a job/capital creation machine that is efficient, fair, simple and lucrative.

It's our firm perspective that the SEC intends to continue its steadfast vigilance in protecting investors while also encouraging the industry to grow at whatever scale the market sees fit. For this reason, Regulation Crowdfunding and certainly Reg CF requires more time for innovation to take hold—in the same vein as other society-improving industries that took many years to mature: electric power generation, transmission and distribution; motor vehicle manufacturing; scheduled air transportation; pharmaceutical and medicine manufacturing; online investing of publicly traded assets—and more.

This being said, we certainly agree that it's never too early to ban problematic security types that prove harmful to investors, and observe and track those that may be but are not yet studied.

Equity, Debt, and Convertible Debt Carry Risks Equivalent to SAFEs and Greater Than Other Securities

Equity forces a company into an either or position of being acquired or going public in order for their investors to receive a fair, timely return. Equity elongates the payback period. It increases the risk of receiving a fair return. And it increases the knowledge base an average investor must have to assess the risk inherent in the investment. Our review of Form C's from the three major funding portals reveals that a large majority of issuers employ complex dilution schemes as well as have terms which give their company broad leeway to determine if and when investors shares can be reclassified, therefore implicitly giving the company the ability shift investor shares to classes that have little voting rights or none at all.

Form S7-05-20 references an internal SEC bulletin which states this lack of voting rights is the primary concern of SAFEs, that investors won't have voting rights. But this is equivalently a reality of equity crowdfunding and of equity investing in general. It always has been. And it has yet to spark any sort of a public backlash that could harm the reputation of crowdfunding. Quite the contrary. Equity crowdfunding is truly experiencing exponential growth.

In this time of crisis, the SEC has an awesome opportunity not only to afford Reg CF startups the chance to offer additional security types so the market can innovate and emerge stronger, but to encourage this with supportive policy, aggressive oversight, and tight cooperation with intermediaries offering less frequent securities.

Safer, Simpler, Lower Risk Securities are Increasing in Popularity Among Investors and Companies

We are all concerned that unaccredited or unsophisticated investors may not be able to clearly distinguish between security types, and hence, we want to make it simple for them. But what, for example, is more simple than a share of a revenue stream?

A new trend in venture capital is revenue-based investments.⁹ Revenue-based investors have an incentive to help the company grow in the short term, because faster growth means faster payments and a higher internal rate of return. Unlike equity, there's no dilution to ownership or control, since revenue-based investors do not take any equity. Payments can be flexible—the company only pays a percentage of the revenue it brings in, so it doesn't suffer cash crunches and miss payments, which is a risk to investors of debt securities. Investors earn capital early instead of waiting for what is often more than a decade for an exit of an equity funded startup.

One example of this is Altered Ventures—a \$36 million VC fund created in 2018 to invest in new projects: primarily video games created by software developers that target emerging markets such as virtual and augmented reality. The company can be described as a “non-traditional” VC model that provides 100% of the funds to develop and publish a game “in exchange for a revenue share from the project's top-line” rather than taking an equity stake.¹⁰

As previously mentioned, this type of “non-traditional” approach is gaining steam offline due to its simplicity, lower intrinsic risk and more timely payback period. Its use in Regulation Crowdfunding is a natural progression and explicitly covered in the Securities Act of 1933 definition of a security (i.e. “participation in any profit-sharing agreement”), and is expected to have a positive effect on the overall industry.

With harmonization, this simpler, lower-risk, easy to understand security, that is ripe for an intermediary to innovate upon, will never see the proverbial light of day among Reg CF intermediaries.

On the Proposed Prohibition of SAFEs

If there are inherent problems with SAFEs, then they should be dealt with specifically. As mentioned above, it's our contention and read of file no S7-05-20 that the dramatic shift from a market able to innovate with multiple security types to the stringency of harmonization initiated from a one-page SEC bulletin whose prognostication of investor confusion and anger over SAFEs has not materialized. This is absolutely not to impugn the intent of the bulletin, which is to protect investors, or suggest SAFEs should be offered without restriction. Quite the opposite, they're still relatively new instruments we'd ask the SEC to further evaluate. But there is no evidence to suggest that they're problematic to Regulation Crowdfunding or, in the three years since the bulletin was published, have had an iota of an adverse impact on the meteoric growth of Regulation Crowdfunding.

These are two examples whereby specific security types have had a tremendous negative impact on our economy, and unaccredited and accredited investors alike.

- 1) Mortgage-backed securities wreaked havoc on our financial system in 2008.¹¹ Investors around the country were severely hurt, dissatisfied and financially devastated. However, these securities continue to be freely traded, and have not been banned.

⁹ <https://www.nytimes.com/2019/01/11/technology/start-ups-rejecting-venture-capital.html>

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<https://www.gamesindustry.biz/articles/2018-04-10-new-altered-ventures-fund-has-usd36m-to-invest-in-projects-for-emerging-markets>

¹¹ <https://irle.berkeley.edu/what-really-caused-the-great-recession/>

- 2) Having been personally involved in the libel suit involving MMAR Group v. Wall Street Journal (1994-2000) as a valuation analyst, one of this document's authors is familiar with the effect derivatives had on municipal funds, and more specifically, the bankruptcy filing on behalf of Orange County, CA as a result of failures in the markets relating to this type of investment.¹²

"Warren Buffett referred to derivatives as 'time bombs' and financial 'weapons of mass destruction.' Recently a complex derivatives trade caused over \$5 billion in losses at J.P. Morgan."¹³

Yet, derivatives continue to be freely traded.

This is an indication that wisdom has been exercised in these particular cases. It is not always the investment vehicle that is the issue, but rather the use of said vehicle. Since those situations occurred, the use of those securities has been reined in, so to speak. We believe the same discretion should apply to SAFEs and other "non-traditional" security types in conjunction with raising capital for asset purchases, project/product creation or company formation.

Proposed Solutions

- The creation of a working committee among SEC staff and senior leaders of crowdfunding intermediaries who offer securities other than equity or debt. Said intermediaries would report to the SEC on issues they observe, author case studies for public review, provide and share data on investor satisfaction, and propose regulations based on the marketplace experiences for the SEC to evaluate—all with the express intent of refining regulations to permit security types to drive innovation.
- Address issues with less frequent security types if and as they arise.

We thank you for your time and attention in reviewing this response to the proposed changes in Reg CF, and greatly look forward to hearing your feedback.

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¹² <https://www.latimes.com/archives/la-xpm-1994-12-08-mn-6548-story.html>

¹³ <https://www.usnews.com/opinion/blogs/economic-intelligence/2012/07/16/derivatives-should-be-banned-from-financial-markets>