Cornell University
Law School

Lawyers in the Best Sense

WILLIAM A. JACOBSON
Clinical Professor of Law

154 Myron Taylor Hall
Ithaca, New York 14853-4901
T: 607.255.6293
F: 607.255.3269
E: waj24@cornell.edu

February 3, 2014

Via Electronic Filing

Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: Release Nos. 33-9470; 34-70741; File No. S7-09-13 (Proposed Rule to Govern the Offer and Sale of Certain Securities Under the Jumpstart Our Business Startups Act)

Dear Secretary Murphy:

The Cornell Securities Law Clinic (the "Clinic") submits this comment to support some and critique other components of the proposal (the "Rules Proposal") of the Securities and Exchange Commission (the "Commission") to implement Title III of the Jumpstart Our Business Startups Act (the "JOBS Act"). The Clinic is a Cornell Law School curricular offering in which students provide representation to public investors and public education regarding investment fraud to the largely rural "Southern Tier" region of upstate New York. For more information, please see: http://securities.lawschool.cornell.edu.

The Proposed Rules Need to Protect Investors Without Excessively Burdening the Issuers or Intermediaries

The fundamental challenge with any piece of securities regulation is the need to balance the sometimes-conflicting goals of investor protection and cost efficiencies for issuers. Many crowdfunding investors will likely be unsophisticated, and since offerings are capped at $1 million, with some investors being capped as low as $2,000, there is a substantial need to ensure investor protection.

Regulatory compliance, however, burdens both the issuer and the intermediary with additional costs. Since the capital amounts raised by these offerings will be relatively small, there is greater risk that transaction costs, like regulatory compliance, will make this avenue prohibitively expensive. While many some may argue that the costs imposed by Title III of the JOBS Act will deter issuers and intermediaries from participating in crowdfunding offerings,[1] others believe that Title III's success depends on the rules the Commission decides to adopt.[2]

Therefore, the Clinic supports the proposed rules that simplify compliance while still protecting the investor and does not accept proposals that either unnecessarily complicate offerings or weaken important investor protections. While investor protection remains our primary focus, we realize that prohibitively costly requirements may discourage issuers and intermediaries from participating in crowdfunding, contrary to congressional intent.

[1] *See, e.g.*, David Mashburn, *The Anti-Crowd Pleaser: Fixing the Crowdfund Act's Hidden Risks and Inadequate Remedies*, 63 EMORY L.J. 127, 147–49 (2013).
[2] Jeffrey W. Rubin, *The JOBS Act: An Overview—What Every Business Lawyer Should Know*, BUS. L. TODAY, May 2012.

I. ISSUER CONSIDERATIONS

a. The Commission Should Allow Issuers to Exceed Their Target Amount If Properly Disclosed.

Section 4A(b)(1)(F) of the Securities Act of 1933 requires an issuer to disclose its target offering amount and the deadline for reaching that target. Depending on the size of the target, Section 4A(b)(1)(D) subjects the issuer to disclosure standards that increase in thoroughness and cost as the size of the target increases. For example, an issuer's disclosure obligations are much less for an offering below $500,000 than for an offering above $500,000. If an issuer fails to reach its target by the deadline, the offering ends, and the money is returned to the investors.

Mimicking reward crowdfunding sites like Kickstarter, the Commission proposes to let issuers raise money in excess of its target. The offering cannot exceed the $1 million statutory limit, and the issuer must disclose, at the start of the offering, the purpose for the additional funds and the "maximum amount [it] will accept and whether oversubscriptions will be allocated on a pro-rata, first come-first served, or other basis."[3] Moreover, the Commission sees no need to establish a limit on an issuer's oversubscription so long as it properly discloses it to its investors.[4]

(i) The Commission's Oversubscription Proposal Draws A Fair Balance (Request for Comment 35)

The Clinic agrees with the Commission that issuers should be allowed to accept oversubscriptions and answers Request for Comment 35 in the affirmative.

First, the proposal accounts for the potential abuses that could accompany allowing oversubscriptions. The risk of a failed offering not only requires an issuer to realistically evaluate its financial needs before posting an offering; it encourages the issuer to select a more conservative target amount. But should an issuer have legitimate financial needs in excess of its target, the proposed rule provides the issuer the flexibility to set a "stretch goal," avoiding the costs associated with a second offering and reducing the likelihood of a failed offering. This flexibility should encourage small businesses and startups with legitimate business needs to participate in crowdfunding.

[3] Proposed Rule 201(h) of Regulation Crowdfunding.
[4] Crowdfunding, 78 Fed. Reg. 66,428, 66,457 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pt. 200, 227, 232, 239, 240, 249).

The rule also ensures that issuers have a valid need for the additional funds and have put thought into how they will use the money since it requires all this information in a disclosure at the outset of the offering. Again, the proposal forces the issuer to evaluate its financial needs.

Additionally, the proposal prevents issuers from using oversubscriptions as a way to avoid heightened disclosure requirements. This requirement eliminates the main danger of allowing oversubscriptions. Congress determined that investors need more detailed information as the size of the offering increases to better protect themselves. Congress also decided that this information should be subject to greater scrutiny by mandating the use of public accountants and auditors for larger offerings. By requiring issuers to include the maximum oversubscription they will accept in their target offering amounts for purposes of 4A(b)(1)(D), the Commission has preempted the possibility of issuers undermining Congress's intent.

Second, much of U.S. securities regulation is premised on meaningful disclosure, and the proposed rule ensures that investors are fully informed from the outset of the offering. Investors are therefore aware of the possibility that their percentage of ownership may be less than expected. Investors can also read the disclosures associated with the additional funding request and determine for themselves if the issuer's plans are reasonable and attainable. Lastly, requiring disclosure at the outset prevents investors who had already committed to the offering from being pressured into maintaining their investment commitment after an issuer posts a request for additional funds late in the offering process.

(ii) Limiting the Amount of Oversubscriptions Does Not Serve the Purpose of the JOBS Act (Request for Comment 110)

The Clinic also agrees with the Commission that there is no need to limit the maximum oversubscription so long as it does not exceed $1 million statutory limit. The Clinic therefore answers Request for Comment 110 in the negative. Such a limit would be arbitrary because it (1) eliminates flexibility to the Issuer (2) without affording any additional protection to the investors. The limitation therefore fails to serve the two main goals of securities regulation (investor protection and cost efficiencies for issuers).

Proposed rule 201(h) already requires a number of disclosures if the issuer decides at the outset to accept oversubscriptions. The Commission also prevents the issuer from using oversubscription as a means to avoid heightened disclosure requirements. The risk of fraud here is no greater than in any other crowdfunding offering. The only additional protection such a limitation could provide would be to minimize the total monetary loss realized should the small business fail. But the JOBS Act already provides that protection by setting a $1,000,000 ceiling for offerings.

There is therefore no need to restrict an issuer that decided to pursue a modest offering to ensure the offering's success, but provided a detailed plan with what it could do with additional funding should its business model appeal to many investors. It would also prevent informed investors from investing in a business they believe in. Such restrictions would cut against Title III's purpose: assisting small businesses and startups in bridging the funding gaps they often face.

b. The Requirements For an Issuer's "Financial Condition" Discussion Are Unclear and Appear Optional (Request for Comment 47).

Section 4A(b)(1)(D) of the Securities Act of 1933 requires an issuer to disclose a description of its "financial condition," and the Commission has interpreted this requirement in its instructions to proposed rule 201(s). Per the Commission, "financial condition" should include, to the extent material, the results of historical operations, liquidity, and capital resources. Such "discussion should focus on whether historical earnings and cash flows are representative" of future performance. The Commissions continues on with a number of additional items the issuer should discuss and concludes that the "financial condition" description should be a simplified and shorter version of what's required under Item 303 of Regulation S-K for registered offerings. The Commission, however, declines to impose a specific format.[5]

The Clinic acknowledges the need for flexibility here. However, the Clinic does not think that the Commission's proposal provides a clear enough standard. The Clinic therefore answers Request for Comment 47 in the negative. The proposed "requirements" are all tempered by the word "should." We believe that "focus[ing] on whether historical earnings . . .are representative of what investors should expect in the future" is a mandatory requirement not a mere aspirational goal.

The Commission likely realizes that crowdfunding issuers will have been in business for various lengths of time. Some issuers may have no operating history at all. However, the Clinic thinks that the Commission should change the language in the proposal to account for this difference but then set certain requirements for issuers depending on the length of their operating history. For example, if issuers have prior operating history, a discussion on whether historical earnings are a good indication of future performance should be a requirement, a "must," not a "should."

[5] *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,444 (proposed Nov. 5, 2013).

c. Issuers Should Be Able to Post Their Annual Reports on Their Websites so Long as the Reports Are Easy to Find (Request for Comment 80).

Section 4A(b)(4) requires issuers to, at least annually, provide its investors and the Commission "reports of the results of operations and financial statements" as the Commission deems appropriate.

In response, the Commission has made two proposals to satisfy these mandates. First, the Commission proposes to require issuers to file their reports annually with EDGAR "no later than 120 days after the end of the most recent fiscal year covered by the report." Second, the Commission proposes to require issuers to post the annual report on the issuer's website.

The Clinic agrees with the Commission that "investors in this type of Internet-based offering would be familiar with obtaining information on the Internet" and that it "would be cost-effective for the issuer." There is no need for a physical delivery. However, the Clinic would like the Commission to clarify where on an issuer's website the issuer has to post the report. The Clinic also believes that requiring the issuer to provide the annual report to the Intermediary (in addition to posting it on the issuer's website) would be another cost-effect alternative, especially if the issuer does not maintain a website. Therefore, we answer Request for Comment 80 in the affirmative but recommend two additions to the proposal.

The Clinic believes in the goal of meaningful disclosure and views an issuer's continuing reporting obligations as a crucial tool in achieving that goal. But for disclosure to be meaningful, the Commission must ensure that investors can easily obtain the information. The Clinic therefore asks the Commission to consider implementing two additional—and low-cost—requirements to its proposal. First, mandate that issuers create an easy-to-access "Investor Relations" page on its website. This would prevent an issuer from intentionally hiding its annual reports in a seldom visited area of its website. Second, also require the issuer to provide its report to the intermediary. Intermediaries could then post the report in the community where the issuer's investors gather to discuss the issuer's performance and their investments. Both of these additions make it more likely that investors will access the annual report, facilitating meaningful disclosure. Moreover, neither option imposes any significant cost on the issuer.

d. Issuers Should Disclose Material Risk Factors (Request for Comment 41).

Section 4A(b)(1) of the 1933 Act imposes several disclosure requirements on issuers of stock, and the Commission's Proposed Rule 201 of Regulation Crowdfunding reflects these disclosure requirements. While proposed rules 201(a)–(e) reiterate the statutory disclosure requirements, the Commission also seeks to add several disclosure items that would provide more information to a prospective investor.

Rule 201(f), among others, would require issuers to disclose the material factors that make an investment in the issuer speculative or risky. The Commission believes that knowledge of this risk factor would help investors better understand more of the risks associated with a particular issuer.

Because crowdfunding issuers will likely be companies that do not have long operating histories, the potential risks associated with such a company would not necessarily be apparent to crowdfunding investors. Therefore, the Clinic answers Request For Comment 41 in the affirmative. The Clinic believes that these disclosure requirements would help investors better understand the nature of crowdfunding investments and further assist them with assessing and comparing various crowdfunding issuers.

(i) The Commission Should Provide Examples of Material Risk Factors.

Moreover, the Clinic believes that providing issuers with a sample list of material risk factors would enhance investor protection and also benefit the issuers. Including examples in the rules would ensure that issuers do not leave out information crucial to risk assessment. Moreover, these examples can serve as clear guidelines for issuers, especially for startups that lack the resources and expertise to prepare such disclosures. Examples will help avoid unnecessary regulatory burdens.

In creating a list of examples, the Commission should consider the risk factors set forth in Item 503 of Regulation S-K, e.g., the issuer's lack of an operating history, the issuer's financial position, and the issuer's business or proposed business.[6] Given that many crowdfunding issuers will have no more than a business plan for which they are seeking investors to help fund, the issuer's proposed business would be particularly useful for investors.

e. The Commission Should Require Financial Statement Certification For the Middle- and Upper-Tier Issuers.

Section 4A(b)(1)(D) of the 1933 Act pertains to financial statement disclosure requirements for the issuers and provides a three-tiered structure that is dependant on the aggregate target offering amount. As the target amount increases, the statute applies stricter disclosure requirements. Lower-tier issuers are offering, in aggregate, $100,000 or less. Middle-

[6] *See* 17 C.F.R. 229.503(c).

tier issuers are offering, in aggregate, more than $100,000 but not more than $500,000. Upper-tier issuers are offering, in aggregate, amounts more than $500,000.

The Commission seeks to adopt these statutory requirements under Proposed rule 201(t). Proposed Rule 201(t)(1) requires lower-tier issuers to disclose their most recent annual income tax returns and financial statements. The issuer's principal executive officer must also certify that these disclosures are true and complete in all material aspects. Proposed Rule 201(t)(2) requires middle-tier issuers to have their financial statements reviewed by independent public accountants. Proposed rule 201(t)(3) requires upper-tier issuers to have their financial statements audited by independent public accountants.

The Commission states, and the Clinic agrees, that the tiered disclosure requirements provide investors with more confidence regarding the reliability of the issuer's financial statements. The Clinic also believes that these differential certification requirements help lower- and middle-tier issuers avoid excessive regulatory burdens.

The Clinic believes that requiring the principal executive officer's certification for middle- and upper-tier issuers would result in the production of more reliable financial statements. This additional requirement would not burden the issuers because Instruction 4 to the proposed Rule 201(t) provides clear guidance for the substance of the certification. Furthermore, requiring the principal executive officer's certification of financial statements is consistent with other federal regulations relating to certification of an issuer's financial disclosure.[7] Therefore, in addition to the proposed Rule 201(t)(2) and (t)(3), the Commission should require middle- and upper-tier issuers to provide financial statements certified by the principal executive officer.

II. <u>INTERMEDIARY CONCERNS</u>

The proper regulation of intermediaries is important in protecting the interests of investors.

The Clinic is commenting on four intermediary regulation issues; a) verifying and disseminating information on issuers, b) obtaining and verifying information from investors, c) providing educational information to investors, and d) preventing intermediary conflicts of interest. The focus will be on ensuring that these functions are done in a consistent, robust, and

[7] *See, e.g.*, 15 U.S.C. § 7241 (2012); 18 U.S.C. § 1350 (2012) (requiring periodic financial disclosure to be accompanied by a written certification by the issuer's principal executive officer).

cost-effective way so that investors are informed and protected from nefarious actors without eating up the value of their investment in regulatory and transactional costs.

a. Intermediaries Should Have Strong Rules Governing Verification and Display of Issuer Information (Requests for Comment 134 and 157).

The potential for fraud and negligent misrepresentation in crowdfunding is high. The safeguards and regulatory scrutiny found in registered public offerings are more stringent than what is provided under Regulation Crowdfunding, leaving investors to make decisions with information that is less complete and less vetted. These investors may not have the experience to recognize unusual or outlandish claims and will be less likely to pay for due diligence than wealthier investors negotiating large investments in private equity offerings. The ability to verify that issuers meet the required qualifications and are not involved with disqualified individuals, as well as ensuring the information they provide is readily available to both potential and current investors is essential to protecting investors from fraud. Intermediaries are in the best position to ensure these requirements are met because they have the most direct interaction with issuers and will be the "repeat players" in this industry.

The Commission requested comments on whether they should require intermediaries to conduct specific checks or other actions to verify whether an issuer is subject to disqualification and if there should be a minimum level of due diligence specified to help establish a reasonable basis for belief that the issuer is subject to disqualification in Request for Comment 134, 78 Fed. Reg. 66,464 Nov. 5, 2013.

The Clinic supports the promulgation of rules requiring specific steps and implementing a due diligence standard for intermediaries to establish a reasonable basis that an issuer is not subject to disqualification. The Clinic believes that promulgating specific steps will clarify how intermediaries should conduct background checks and will ultimately create efficiencies. Intermediaries would not need to expend resources analyzing and interpreting ambiguous guidelines. Specifying steps will also help prevent intermediaries from competing for issuer business by reducing the thoroughness of their background checks in a sphere where investors are less likely to be familiar with intermediary reputation. Specifying a minimum level of due diligence in conducting investigations will ensure a proper backstop against any lack of clarity or novel situations that might arise as issuers conduct their investigations.

The Commission also requested comment on how long after an issuance an intermediary should be required to make an issuer's offering information available on its platform in Request for Comment 157, 78 Fed. Reg. 66,469 Nov. 5, 2013. The Clinic recommends requiring intermediaries to make offering information available for a period of at least six years after an offering closes. Many disputes arising out of crowdfunding issuances will likely be dealt with in arbitration proceedings through the Financial Industry Regulatory Authority (FINRA), which has a six year claim window under FINRA Rule 12206. At a minimum, Intermediaries should be required to keep offering information easily accessible during that period to ensure potential claims are not hindered. Relatedly, the Clinic supports Proposed Rule 303(a)(2)'s, 78 Fed. Reg. 66,557, requirement that offering information be made available through the intermediary's platform 21 days prior to the close of an offering.

b. Intermediaries Should Take Affirmative Steps to Ensure Investor Compliance (Requests for Comment 139 and 159).

The crowdfunding rule will open new opportunities to investors who may not have the experience or the resources to properly evaluate and bare the risks involved. Intermediaries must understand the investors they serve in order to properly protect them. The potential for investor confusion about rules is also high, and intermediaries are in the best position to ensure investors aren't violating rules that limit the risks they take.

The Commission requested comments on whether they should specify the type of information that intermediaries collected from investors in Request for Comment 139, 78 Fed. Reg. 66,465. The Clinic answers the request in the affirmative. The goal of these rules should be to provide a clear framework that intermediaries must follow to ensure that they do not have to expend resources attempting to interpret ambiguous standards. Specifying the information intermediaries must collect accomplishes that goal. It also prevents intermediaries from using an unintended interpretation of an ambiguous standard to justify their failure to collect information that would require them to prevent investors from being involved in an offering.

Among other things, intermediaries should be required to collect identifying information to prevent duplicate or fraudulent accounts as well as information regarding other intermediary accounts and investments. Intermediaries should be required to make it clear that this information is being collected for regulatory compliance reasons rather than for marketing or other commercial uses to ensure investors are more forthcoming.

The Commission also requested comment on the portion of Proposed Rule 303(b)(1) that allows intermediaries to rely on investor representations in Request for Comment #159, 78 Fed. Reg. 66,470. The Clinic opposes the Commission's Proposed Rule allowing intermediaries to rely on the representations of investors. While the Clinic recognizes that intermediaries must rely on investor representations for some information related to investment limit compliance, intermediaries should be required to take certain affirmative steps to verify investor representations. Intermediaries should check the identifying information of account-holders against public databases to ensure they know their customers, and then check to see if they hold multiple accounts. The intermediaries should also be required to check account-holder representations for internal consistency and plausibility, with questionable representations prompting greater requirements for verification.

c. The Commission Should Give Intermediaries Options for Compliance with Investor Education Requirements (Requests for Comment 143 and 145).

Many of the investors participating in crowdfunding offerings are likely to be unfamiliar with investing in unregistered securities because they are a novel product offering for unaccredited investors and can often be complex. The caps on investment amounts will limit the incentive for investors to pay a professional to evaluate the suitability of these products for their investment strategy. Providing meaningful educational information to investors is essential to ensuring they have the opportunity to make an informed investment decision. The internet contains a myriad of educational resources, some credible, most not, and it may be difficult for investors to discriminate between the two. It is essential that intermediaries act as a source of credible, comprehensive information about this investing environment and ensure that their clients have understood it.

The Commission has requested comments on whether; 1) they should prescribe the text or content of educational materials and 2) whether they should create models of educational materials for intermediaries to use in Request for Comment 143, 78. Fed. Reg. 66,467. The Clinic answers the first part in the affirmative and supports Proposed Rule 302(b). Section 4A(a)(3) of the Securities Act of 1933 requires intermediaries to provide educational materials to crowdfunding investors because Congress has recognized that intermediaries are in the best position to educate investors. The Commission's Proposed Rule 302(b) presents an adequate minimum of information that intermediaries must provide to investors.

The Clinic answers the second part in the affirmative as well. The rules should seek to impose as little interpretive burden on intermediaries as possible to ensure that regulatory compliance costs do not make crowdfunding prohibitively expensive or unnecessarily burdensome for the issuers. Providing models for intermediaries to use allows for an economical option to comply with the educational requirement, lowering costs that would be passed on to issuers and ultimately investors.

The Commission requested comment on whether intermediaries should be required to submit educational material to either themselves or a relevant self-regulatory organization (SRO) for review, and if so, what the submission and approval timeline should look like in Request for Comment #145, 78 Fed. Reg. 66,467. The Clinic supports requiring intermediaries to submit their non-model educational material to either the Commission or a relevant SRO for review at the time such material is displayed on the intermediary's platform.

The Clinic recognizes that specialized intermediaries will have a unique understanding of the investors they cater to and may be able to create more approachable and digestible educational materials tailored to their target market. Intermediaries may also offer novel products that wouldn't be appropriately covered by model educational materials.

While the Clinic supports giving intermediaries flexibility in this arena, at a minimum, review by regulatory authorities is necessary to protect unsophisticated investors from misleading or confusing materials and prevent problems farther down the road. The Clinic does not believe the added burden of requiring prior approval will produce justifying benefits. Intermediaries should only be required to submit their educational material at the time they place it on their platform, and the relevant regulator can then create internal criteria for review based on factors such as, *inter alia*, intermediary history, substantial variation from past material and novelty of underlying product.

d. Intermediaries Having a Financial Interest in Issuers Creates Unnecessary Complications (Requests for Comment 122 and 124).

The position of intermediaries as gatekeeper between issuers and investors requires that their fidelity to neutrality not be compromised by an interest in the issuer. The primary reason intermediaries are the ideal entity to perform functions such as issuer verification, investor education, and investor limit compliance, is precisely because they do not benefit as much as those with financial interests in the issuer from a nefarious approach to those functions. It is essential to the protection of investors that this wall between interests is maintained.

The Commission requested comment on Proposed Rule 300(b) prohibiting intermediaries from, among other things, receiving a financial interest in an issuer as compensation for services in Request for Comment 122, 78 Fed. Reg. 66,461. The Clinic supports Proposed Rule 300(b) in its entirety. The purpose of an intermediary is to have a detached third party sit in the middle of a transaction as a gatekeeper and ensure that each party gets what they are expecting to get. They are given a variety of powers and trusted to execute that duty. The incentive of an intermediary that has a financial interest in an issuer or is receiving such an interest as compensation is drawn towards protecting and enhancing the value of that particular interest, not the integrity of the transaction.

Intermediaries have an unequal position in terms of familiarity with the issuer and power over the issuer and transactions, and the potential for abuse of that position increases when the intermediary controls or is promised a financial interest in the issuer.

The Clinic supports the Commission's Proposed Rule against intermediaries receiving a financial interest in an issuer as compensation for services. The Clinic also supports prohibiting intermediaries that have received an interest in an issue from providing future services so long as it retains the interest for the same reasons. Intermediaries have an unequal position in terms of familiarity with the issuer and power over the issuer and transactions, and the potential for abuse of that power and familiarity for the benefit of a financial interest in the issuer is incompatible with the services intermediaries provide.

The Commission requested comment on a comment letter suggestion that intermediaries should be allowed to receive financial interests in issuers if they do so on the same terms as is offered to the general public in Request for Comment 124, 78 Fed. Reg. 66,461. The Clinic disagrees with the commenter that argues an intermediary should be able to receive a financial interest in issuers on the same terms as other investors participating in the offering.[8] An interest in the issuer, even on the same terms as other investors, would draw the incentives of the intermediary away from the integrity of the transaction and towards benefiting their specific interest. Rules requiring disclosure would be insufficient to alleviate conflict of interest concerns, particularly given that many of the investors are expected to be relatively unsophisticated and may not know how to seek out or evaluate such a disclosure. Allowing intermediaries to obtain an interest creates the potential for abuse and comes at the cost of rule simplicity.

III. <u>INVESTOR ISSUES</u>

Regulation Crowdfunding provides a novel way for unaccredited investors to make limited investments in new ventures that aren't at a stage where going public makes sense. Historically, these types of investments have been primarily restricted to accredited investors that have the experience to evaluate the inherent risks and the resources to endure them. In opening this door, Congress provided limits to ensure that investors could bear the risks involved and provided a scheme that was simplistic enough for unaccredited investors to understand. It is important for the Commission to keep the goals of simplicity and investor protection in mind as it builds a workable process from the framework Congress provided.

[8] *See* EarlyShares Letter 2.

a. The Commission Should Interpret Ambiguous Investment Caps in a Rational but Conservative Way (Request for Comment 6).

Caps on investment amounts provide an important backstop on investor risk. The lower an investor's income and wealth, the less loss they are able to tolerate from the inherent risks of small business investing, even when viewing loss as a percentage of an investor's income. It is in recognition of this magnified risk that Congress included two tiers of investment caps in Section 302(a) of the JOBS Act. Keeping these limits strong and unambiguous will ensure that the final rules include the full protection Congress intended.

The Commission requested comment on how to interpret the ambiguous language in the investment limits set forth in Section 302(a) of the JOBS Act and whether their proposed interpretation is appropriate in Request for Comment 6 at 78. Fed. Reg. 66,434. The Clinic disagrees with the current proposed interpretation. The Commission proposes that investors can use either their income or net worth, whichever is higher. If either income or net worth is above the tier threshold of $100,000, the higher percentage cap will apply, with the caveat that the limit has a floor of $2,000. The Commission's approach would allow an investor with no income and as little as $100,000 in net worth to put a full 10% of their wealth into this risky environment, whereas someone with $90,000 of both income and net worth would remain at the 5% despite being in a clearly more stable economic position.

The Clinic proposes that the Commission interpret the statutory ambiguity to mean that within tiers, the higher of the relevant percentage of net worth, income and $2,000 be the applicable limit, and that among tiers, if annual income and net worth are on opposite sides of the tier threshold of $100,000, both tiers should be calculated, and the lower between the two should be used. This is the most logical interpretation of the statute, as it gives effect to the "and" at the end of the new Section 4(a)(6)(B)(i) of the Securities Act of 1933. When annual income and net worth straddle the $100,000 threshold, both (i) and (ii) apply. Since the aggregate investment amount must "not exceed" (i) and (ii) under such a scenario, the lower tier is the only relevant one. Both must be calculated, as it is conceivable that (ii) will be the lower since it contains the hard upper investment limit of $100,000. The Clinic believes this is the most rational interpretation of the statute, and that this will provide more comprehensive protection for investors.

b. The Commission Should Not Allow Using Joint Income or Joint Net Worth for Investment Limits (Request for Comment 7).

In Request for Comment 7 at 78 Fed. Reg. 66,434, the Commission requested comment on its proposal to allow investors to calculate annual income and net worth jointly with the investor's spouse for purposes of determining an investment limit. The Clinic opposes instruction 2 to paragraph (a)(2) of Proposed Rule Section 100, which allows for this aggregation of income and net worth. The enabling legislation for Regulation Crowdfunding, the JOBS Act, makes no mention of allowing for aggregation of income or net worth in meeting the statutorily defined investment limits. The statute only mentions the calculation of income and net worth for a natural person, and does not appear to contemplate the use of joint income and net worth.

The JOBS Act instructs that income and net worth should be calculated for a natural person in accordance with the rules of calculation for an accredited investor. As proposed, the Commission's calculation of joint income and net worth does not match how the current regulations on calculating joint income and net worth for an accredited investor are dealt with. Accredited investors wishing to use joint annual income of a spouse must meet a higher threshold than investors using the annual income of a single natural person.[9] While the calculation of net worth for purposes of accredited investor status is the same regardless of if the investor uses individual or joint net worth,[10] net worth as a category is set at a value five times higher than the annual income requirement, whereas annual income and net worth are treated equally under Title III of the JOBS Act.

Allowing for the use of joint annual income and joint net worth in calculating the investment limit under Regulation Crowdfunding exposes married investors to greater risks than Congress may have intended, particularly under the Commission's proposed interpretation of Section 4(a)(6)(B)(i) of the Securities Act of 1933. Aggregation of income and net worth under Regulation Crowdfunding poses a unique problem not present in the calculation of accredited investor status. Married investors with no income and a joint net worth of $100,000 could end up with as much as $10,000 of their wealth at risk in this new and untested environment in a single investment. This is of particular concern for elderly, retired investors as they are often the targets of high-pressure, abusive, and even fraudulent sales tactics.[11] To properly protect the financial well-being of these individuals, investment limits should be calculated on an individual basis.

---

[9] 17 C.F.R. 230.501(a)(6).

[10] 17 C.F.R. 230.501(a)(5).

[11] Susan Wyderko, Statement to the Senate, Special Committee on Aging, Not Born Yesterday: How Seniors Can Stop Investment Fraud, Hearing, March 29, 2006 (Serial 109-20), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-109shrg28187/html/CHRG-109shrg28187.htm.

c. Investment Limits Should Remain Simple and Focused on Unaccredited Investors (Request for Comment 9)

Title III of the JOBS Act and the regulations promulgated under it remove the requirement that investors be accredited before being offered a wide variety of investments formerly reserved only for accredited investors. The focus is on opening up small business and startup investing to unaccredited investors, with an eye towards doing so in as uncomplicated a manner as possible. Adding in exemptions and special rules that do not serve this goal only increase complexity and impose both interpretation risk and compliance burdens on crowdfunding's various actors.

The Commission sought feedback on whether institutional and accredited investors should be subject to the statutory investment limits or if they should have a special exemption in Request for Comment 9 at 78. Fed. Reg. 66,435. The Clinic opposes allowing accredited and institutional investors to receive any exemption from Title III's investment limits. The primary function of Title III of the JOBS Act and Regulation Crowdfunding is to provide unaccredited investors an avenue to invest in new ventures. To the extent that the JOBS Act does contemplate investment by accredited investors, it works to limit the ability of individual accredited investors by putting a hard maximum aggregate amount sold at $100,000. Given that all individual investors who could surpass that maximum under the annual income or net worth calculations would qualify as accredited investors, the maximum must be meant to limit accredited investors, or else it would have no effect at all. The statute limits the ability of accredited investors to use this method of investing, providing an exemption would nullify important aspects of the statute.

Conclusion

We respectfully request that the Commission take our comments into consideration in addressing the Proposed Rules.

Respectfully submitted,

William A. Jacobson
Clinical Professor of Law and Director,
Cornell Securities Law Clinic

Antony Vita ('14)
Alexander Wingate ('14)
Paul Kang ('15)
Hyesoo Jang ('15)
JeongHyun Baak ('15)