

attracting investors who are motivated more by mission impact of the offering than by any potential outsized financial return.⁷

- *Privacy Protection Requirement:* Like all crowdfunding portals, CDFI Jobs Portals will collect sensitive personal financial information. Because CDFI Jobs Portals must be controlled by regulated financial institutions, they will be subject to Gramm-Leach-Bliley privacy rules, thereby easily meeting the privacy protection mandate in the Crowdfunding Act.

Permission for CDFI Jobs Portals

We believe this series of requirements, taken together, creates an investor protection regime stronger than that required under the Crowdfunding Act. Specifically, we recommend that the SEC:

- *Consider a CDFI Jobs Portal to have satisfied the burden of proof under (c)(2)(B), creating a safe harbor; or*
- *Not be deemed an issuer.*

a) Relevant Precedent for Exemptive Relief

Since their inception, the federal securities laws and the SEC have provided broad exemptions for public charities and benevolent organizations because they serve the public interest.⁸ These broad exemptions make it simpler for individuals to invest for the public good. They also make it easier and less costly for resource-limited charitable enterprises to access capital for mission impact. This proposal enables the SEC to apply to the Title III rulemaking its long-standing recognition of the unique nature of offerings that serve the public interest.

A. Proposed Investor Protections: Stronger Protections That Will Not Inhibit Mission Investor Participation

The proposed solution involves introducing strong investor protections administered by a specific type of crowdfunding portal, referred to as a CDFI Jobs Portal, through which mission investors can co-invest in CDFI-funded projects and businesses. Crowdfunded debt securities co-invested alongside CDFIs through CDFI Jobs Portals will typically fill financing gaps, which frequently prevent CDFI transactions from coming together.⁹

1. CDFI Jobs Portal: Investor Protections Overview

In seeking to reduce barriers to mission investors, a central objective of our proposal is to supplement the relaxation of these protections with a series of alternative investor protections that are more stringent than those required by law but that do not present barriers for mission capital formation. The table below outlines the investor protections extended through the CDFI Jobs Portal and compares them to the proposed rules for standard portals.

⁷ Offering annual interest rates no higher than 5%.

⁸ Securities Act of 1933, Section 3(a)(4).

⁹ Using CDFI Jobs Portals, crowdfunding investors could also potentially lend directly to CDFIs, so long as the CDFI-issuer itself has been invested (and underwritten by) a separate qualified CDFI. In this case, crowdfunded capital would most typically be on-lent to the CDFI-issuer's low-income community borrowers.

B. The CDFI Jobs Portal: Investor Protections Detail

<i>Investor Protections</i>	Jobs Portal	Standard Portal
Sophisticated co-investor "skin in the game"	Yes	No
Strict standards & ongoing quality control of co-investors	Yes	No
Issuer "skin in the game"	Yes	No
Restricted to lower-risk loans with low rates of return	Yes	No
Proven financial strength overseen by federal regulators	Yes	No
Subject to Gramm-Leach-Bliley privacy rules ensuring investor privacy protection	Yes	No ¹⁰
Investor personal data disclosure for tracking maximum aggregate investment	Over \$500: Yes \$500 or less: No	Yes

As summarized above, the CDFI Jobs Portal solution contains a number of supplementary investor protections that go beyond those required in the law. This section details each.

1. CDFI Co-Investor "Skin in the Game" Requirement

Every transaction posted on a CDFI Jobs Portal must have a co-investment ("skin in the game") from a CDFI.¹¹ The co-investment structure, which was also proposed in the report resulting from the Milken Institute's 2012 crowdfunding roundtable, "would allow the crowdfunded businesses and crowdfunding investors to benefit from the due diligence and management expertise of sophisticated investors," helping ensure legitimacy of issuers and the soundness of investment.¹²

The SEC has also cited the participation of a sophisticated financial intermediary as a source of protection against fraud. Most recently, this compelling reasoning appeared in the text introducing the proposed rule that would eliminate the ban on general solicitation in offerings under Rule 506 of Regulations D and in Rule 144A offerings. In suggesting that instances of fraud would be less likely in the case of generally solicited 144A offerings, the proposing release noted:

"We expect that there would be fewer occurrences of general solicitation facilitated fraud in Rule 144A offerings, as compared to Rule 506(c) transactions.... Rule 144A offerings always include a

¹⁰ While participating broker dealers will be subject to Gramm-Leach-Bliley rules (GLB), and while the SEC may find GLB a valuable standard for enforcing Title III's privacy protection mandate, it is not clear that any approximation of this pre-established and separately enforced standard could be applied effectively to otherwise unregulated funding portals.

¹¹ See Appendix A, Rule XX01 (b)(ii)(C). Note that the qualified CDFI co-investment is not in the same crowdfunded security, but does support the same transaction. This co-investment may be a bank loan or credit facility or securities that are offered in a registered offering or pursuant to an exemption from registration such as Section 4(a)(2) or Regulation D.

¹² Gorfine, Daniel S., Bradley Belt, and Chris Brummer. "Crowdfunding: Promoting the Promise and Minimizing the Peril." *Milken Institute*, Aug. 2012. Web. Page 6. See also Gorfine, Daniel S., and Chris Brummer. "Crowdfunding: The Next Big Thing" *The Milken Institute Review*. First Quarter, 2013. Which urges the SEC to "consider a 'green-light' model that reduces the regulatory burden on portal-based transactions that couple the crowd with accredited investors" including CDFIs. Page 71.

financial intermediary. The due diligence conducted by these intermediaries is an additional layer of protection against fraud.^{13, 14}

2. CDFI Co-Investor Performance Standards Requirement

As a further measure to ensure investment soundness, the co-investing CDFIs themselves would be required to meet high performance standards (loan loss rates, reserves, capitalization). These standards would be established and enforced by the CDFI Jobs Portal, ensuring that only financially strong CDFI co-investors are able to participate.¹⁵ In a sector with very low loss rates, participation would be limited such that any poor loan performance outliers or the rare at-risk institution would be excluded.

CDFI sector expertise, combined with these co-investor quality control standards, provides substantial assurance that issuers will not be fraudulent enterprises. Beyond simply weeding out fraud, the standards also will enhance the likelihood that issuances are of good quality, with a higher likelihood of repayment, as they will have been competently reviewed by stable CDFI co-investors with strong track records.

3. Requirement of Issuer First-Loss Co-Investment

In addition to the requirement of a qualifying CDFI co-investor, each issuer must also invest or put at risk its own resources in order to be eligible for a crowdfunding investment through a CDFI Jobs Portal. This issuer "skin-in-the-game" will be equity or equity-equivalent resources that serve as "first-loss" funds in the event of default.¹⁶ The CDFI Jobs Portal will be responsible for affirming (with the assistance of the CDFI co-investor) that issuer resources have been committed before an offering can post on the site.

4. Low-Return Debt: Emphasizing Charitable Nature of Investment, Removing Enticement of High Returns

Securities offered on the CDFI Jobs Portal will be restricted to low-yield debt investments, attracting investors who are motivated more by the mission impact of the offering than by any high financial return.¹⁷ Before investing, each investor will also be required to affirm a simple, easy-to-read statement

¹³ In this report, the SEC staff further states: "Also, Rule 144A investors are generally large institutions, which are better able to identify fraudulent activities than smaller institutions and retail investors." "SECURITIES AND EXCHANGE COMMISSION 17 CFR PARTS 230 and 239 [Release No. 33-9354; File No. 57-07-12] RIN 3235-AL34 ELIMINATING THE PROHIBITION AGAINST GENERAL SOLICITATION AND GENERAL ADVERTISING IN RULE 506 AND RULE 144A OFFERINGS." Securities and Exchange Commission, 27 Aug. 2012. Web. Page 53.

¹⁴ While many CDFIs are smaller institutions, it is broadly recognized in the banking sector that in the case of community development finance, these smaller, community-based financial intermediaries better perform the thorough due diligence necessary for investment success because of their deep knowledge of local markets and market players and close ties to the community. Recognition of this expertise is a primary reason that the banking industry is the largest investor in the CDFI sector, providing roughly 40% of the sector's capital. Larger banks find that CDFIs can more effectively and reliably provide this type of smaller scale, less-systematized finance than can larger institutions.

¹⁵ See Appendix A, Rule XX01 (b)(i)(A)&(B).

¹⁶ See Appendix A, Rule XX01 (b)(i)(C).

¹⁷ The limitation of these offerings to debt securities will likely be attractive to issuers on CDFI Jobs Portals. Small businesses in low-income communities, most of which have never offered equity securities before, would likely not find appealing the ongoing costs of offering equity. In particular, it has also been noted that the complexities and costs of ongoing services and reporting to large numbers of equity investors as well as related compliance costs will be difficult to manage and/or generally unappealing for small businesses unaccustomed to this work. See Graham, Stephen M. "The JOBS Act Represents An Important Step In the Right Direction." Fenwick & West LLP, 2012. Web. Graham notes that "the administrative costs involved in managing hundreds of shareholders could be significant." Page 1. In addition, nonprofit organizations, which constitute a large portion of CDFI borrowers, are non-stock corporations that are unable to offer equity to investors.

acknowledging that they are making a mission investment that offers below-market rates of return and that all funds are at risk of loss.¹⁸ The rate-of-return limitation,¹⁹ restriction to debt, and acknowledgement of mission investment help make clear the non-profit-maximizing, mission-impact nature of the investment. Further, to the extent the “get-rich-quick” temptation is one aspect of securities investing that leads investors to take on greater risk than perhaps they can afford, these mechanisms are intended as a form of investor protection dissuading investors from any inclination to take on significant exposure through CDFI Jobs Portals for the sake of prospective financial return.

5. Regulated Financial Institution Requirement

Senator Merkley’s Statement for the Record references federally regulated, 501(c)(3) CDFIs.²⁰ The proposed rule requires that CDFI Jobs Portals be controlled or operated by such entities: regulated financial institutions that are also both public charities and certified CDFIs. The requirement that the entity be controlled or operated by a federal banking agency will help ensure investor privacy protection as well as successful execution of the investor protections summarized above. Relevant federal financial institution regulators include the Office of the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation. These regulators, also known as “federal banking agencies” regulate national banks, state-chartered banks, bank holding companies, and credit unions. These regulators also oversee any 501(c)(3) CDFI affiliates their regulated financial institutions may control.

The requirement of an additional regulator beyond the SEC is not to regulate CDFI Jobs Portals for securities law compliance, as this is the role of the SEC (and FINRA). Rather, it is intended as an additional and important layer of oversight to ensure the stability and responsibility of CDFI Jobs Portals and the institutions that operate them. These regulators regularly and thoroughly review financial institutions for financial strength and stability as well as operational and reputational risk, *inter alia*. This additional non-securities regulatory oversight helps ensure that operators of CDFI Jobs Portals are well established and responsible financial enterprises.

These regulators ensure strong and responsible financial management and will manage CDFI Jobs Portals with high standards of quality control. They will likely focus on ensuring that CDFI Jobs Portals work with responsible issuers and co-investing CDFIs. Furthermore, since status as a regulated financial institution is difficult to attain, it ensures “fly-by-night,”²¹ and high-risk enterprises will not be able to operate CDFI Jobs Portals. From the SEC’s regulatory cost perspective, this provision also effectively restricts the number of

¹⁸ This statement, in addition to the requirement as prescribed in Title III that each investor “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” as reflected in Securities Act of 1933, Section 4A(a)(4)(B).

¹⁹ We propose that the maximum annual rate of return of 5%.

²⁰ Senator Jeff Merkley (OR). “Crowdfunding,” *Congressional Record* 158:113 (26 July 2012) page 55474.

²¹ In early conversations in which we suggested all CDFIs be able to operate “low-barrier to entry” crowdfunding portals, it was pointed out in conversations with policy makers that a bad actor could theoretically operate as a legitimate mission lender for several months in order to attain CDFI status, with a long-term intent to defraud investors. While this would be conceivable for the attainment of CDFI certification, the standard for becoming a federally regulated financial institution is much higher. Such a scheme would not be possible in the context of the proposed financial institution requirement for operating CDFI Jobs Portals. Furthermore, because CDFI Jobs Portals would have higher standards for participating CDFI co-investors than the standard for becoming a CDFI (see item 2 in this Section), the portals would effectively weed-out any potential bad actors.

entities that can operate a CDFI Jobs Portal, limiting the number of portals subject to this special SEC rule while opening the market up to broad participation in the CDFI sector through CDFI co-investing.

There is also strong precedent for the SEC providing exemptive relief to regulated financial institutions in the distinct but related context of securities issued by these entities. Section 3(a)(5)(A) of the Securities Act of 1933 exempts from regulation “any security issued (A) by a savings and loan association...cooperative bank...or similar institution, which is supervised and examined by State or Federal authority having supervision over any such association.” While these financial institutions are not issuers when operating CDFI Jobs Portals, we believe that the long-standing precedent in federal securities law recognizing the unique role and supplementary supervision of regulated financial institutions as supportive justification for exemptive relief from securities regulation is relevant in this context.

The requirement that CDFI Jobs Portals be subject to regulation by federal banking agencies also helps to ensure strong privacy protection for its investors. Federally regulated financial institutions are governed by Gramm-Leach-Bliley privacy rules, and these privacy protection rules would also apply to any funding portal they control. As a result of this fact, CDFI Jobs Portals will be legally bound to protect the confidentiality of customer data and additional federal banking regulator oversight will ensure that they do so. The Crowdfunding Act’s requirement that the SEC develop and enforce privacy requirements for funding portals²² should be comfortably met by this standard.

6. Public Charity Requirement

As mentioned above, federal securities law and the SEC have long supported the exemption of charities from many aspects of securities regulation. Since its inception, the SEC has provided broad exemptions for public charities and benevolent organizations because they serve the public interest. The intent of these exemptions is both to make it easier for the broader public to invest for the public good and also to make it less costly for entities serving the public good – which typically lack the resources to engage in the securities registration process – to access capital. The proposed CDFI Jobs Portal rules are designed to apply this well-established exemptive charitable precedent to the crowdfunding rulemaking now before the Commission.

The proposed rules require that CDFI Job Portals be operated or controlled by public charities.²³ As 501(c)(3) public charities, operators of CDFI Jobs Portals will be legally bound to pursue charitable purposes, providing an additional layer of assurance of charitable activity as well as accountability to the IRS for achieving charitable purpose. Federal securities law and the SEC have an established history of accommodating securities regimes that responsibly achieve charitable purpose goals.²⁴ While a CDFI Jobs Portal would not be the direct issuer, in purpose and design the proposal is consistent with Congress’s exemptive intent for charitable purposes.

²² Securities Act of 1933, Section 4A(a)(9).

²³ See Appendix A, DEFINITIONS, (b)(ii).

²⁴ Section 3(a)(4) of the Securities Act of 1933 outlines the exemption from registration for “[a]ny security issued by a person organized and operated exclusively for religious, education, benevolent, fraternal, charitable, or reformatory purposes and not for the pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual.”

In addition, we contemplate that a substantial portion of co-investors and issuers of these crowdfunded securities will be public charities as well. While not all issuers would be public charities, all will have positive community impact either directly through their work or indirectly through their community impact, as all will have been co-funded by federally accredited CDFI mission investors and approved for posting based on their charitable impact by the public charity CDFI Jobs Portal.

It is important to note that neither the Securities Act of 1933 nor the Philanthropy Protection Act of 1995 provides any exemption for public charities from the anti-fraud provisions.²⁵ The CDFI Jobs Portal will be subject to the same anti-fraud provisions.

7. Cost Benefit Analysis of Regulatory Change

We encourage the SEC to review City First Enterprises' Letter of Comment from July 4th, 2013 in order to include the estimated economic impact of enabling this type of mission-driven community development financing via Regulation Crowdfunding. We believe these economic benefits would be significantly reduced should the Funding Portal be subject to the liabilities and costs currently outlined in the Proposed Rules.

III. Safe Harbor for Fulfilled Obligations Under Statute

Should the SEC determine that it must impute issuer liability to all Funding Portals and cannot create a distinct exemption for a non-profit CDFI Jobs Portal focused on mission-driven debt for the purpose of community development, we believe it would be appropriate to create a safe harbor providing that an intermediary that satisfies its obligations under Section 4A(a) and under the rules under Regulation Crowdfunding that apply to intermediaries will be presumed to have satisfied the burden of proof under Section 4A(c)(2)(B) that it did not know, and in the exercise of reasonable care, could not have known of an untruth or omission. This safe harbor would cabin the potential liability to which the mission-oriented Funding Portal is exposed, as well as provide the valuable guidance in order for a Funding Portal to develop its internal policies and processes to be certain they are complying with the final rules, while providing significant investor protection.

IV. Conclusion

Lack of sufficient capital is a primary impediment to job creation in low-income communities. Access to crowdfunded capital from mission investors through CDFI Jobs Portals would allow CDFIs to channel substantially more capital towards job creation in these disinvested communities. We write in support of a solution that would facilitate the deployment of mission investor dollars towards job creation in low-income communities through the unrivaled capacities and proven impact of CDFIs, while providing very robust investor protections and promoting an orderly market.

²⁵ For further details on public charities and securities regulation, we encourage the rulemaking staff to read "Securities Regulation of Fundraising Activities of Religious and Other Nonprofit Organizations." Horner, Timothy L. and Makens, Hugh H., *Stetson Law Review*, (1996).

We commend the SEC for taking the next step of proposing rules to implement this new tool for smaller enterprises to finance their operations and growth through the support of a community of funders while continuing vigorous protection of investors. We believe this has the opportunity to create a new source of mission capital across the United States, promoting considerable economic growth and a more efficient market for individual funders seeking to align their investments with their values.

The SEC's rulemaking will be critical in determining the extent to which the legislation achieves its objective of creating jobs while protecting investors. We urge the SEC to reconsider imposing liability on Funding Portals, or additional costs or burdens on issuers not required by the statute, and we ask the SEC carefully and explicitly to consider the mission-driven investment space to ensure that the implementation of Title III serves all communities. We strongly encourage that the law's core intended outcome of job creation be responsibly inclusive of the underinvested, low-income communities where unemployment is high and jobs are needed most. At the same time, like the SEC, we want to ensure that investors, including especially those in the vulnerable communities CDFIs serve, are protected.

We ask the SEC to adopt our proposed CDFI Jobs Portal rules, which will enhance both investor protection and mission capital formation. CDFIs are uniquely well positioned responsibly to channel crowdfunded investment toward the socially valuable purpose of creating jobs in areas that need it most. To make possible implementing rules that encourage greater mission investor participation, CDFI Jobs Portals and their participants will be subject to a series of new investor protections that are more stringent than those required by law but that do not present barriers for mission capital formation. In adopting the proposals we have outlined, the SEC will ensure that the crowdfunding rules reflect its own longstanding policy of providing responsible exemptive relief in service of the public interest.

In his Statement for the Record, JOBS Act co-author, Senator Merkley encouraged the SEC staff developing the regulations to consult with the Treasury Department's CDFI Fund.²⁶ We also encourage the Commission to again contact and discuss the proposed rules and their alternatives with the CDFI Fund, which can provide insight on CDFI sector performance, scale, capital needs, and expertise in channeling capital to underinvested communities.

Thank you for your consideration. If you have any questions regarding the contents of this letter, or would like to contact us, please do not hesitate to do so at info@cfenterprises.org or (202) 745-4486.

Sincerely,



John Hamilton
President, City First Enterprises

²⁶ Senator Jeff Merkley (OR). "Crowdfunding." *Congressional Record* 158:113 (July 26, 2012) page S5474.