February 3, 2014

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission,
100 F Street N.E.
Washington, DC 20549–1090

Via email to rule-comments@sec.gov

Re: File No. S7-09-13, "Crowdfunding"

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[redacted]

Dear Ms. Murphy:

On behalf of the Competitive Enterprise Institute, I am pleased to provide these comments on the proposed rule regarding equity crowdfunding.[1] Founded in 1984, CEI is a non-profit research and advocacy organization with a strong focus on regulatory barriers affecting access to capital. In addition, before I came to CEI, I had written about both capital formation and investor protection as a journalist for publications such as Investor's Business Daily and the Washington Times. Over the past two years, I have testified before the House Energy and Commerce Committee and the House Financial Services Committee on the link between startups and job growth. Many of the policy solutions CEI has put forward over the years were incorporated into the Jumpstart Our Business Startups (JOBS) Act of 2012.

Introduction

Title III of the JOBS Act[2] provides a specific exception to the registration requirements of the Securities Act of 1933. This exemption should allow individual firms to raise up to $1 million a year in small increments from ordinary investors through a registered funding portal via the

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[1] Proposed Rule, "Crowdfunding," *Federal Register,* Vol. 78, No. 214, November 5, 2013, p. 66428. Release Nos. 33-9470 and 34-70741; File No. S7-09-13 [hereinafter "Proposed Rule"]. "Equity crowdfunding" refers to firms raising money from a variety of individuals with the promise of a share of the venture's proceeds and/or a specified return on investment.
[2] Jumpstart Our Business Startups Act, Public Law 112–106, Apr. 5, 2012.

internet. Some state laws regarding registration and qualification are preempted, but states and the SEC still have full authority to prosecute fraud.

In signing the JOBS Act in April 2012, President Barack Obama described how securities "laws that are nearly eight decades old make it impossible for [ordinary Americans] to invest" in small startups. Noting that "a lot has changed in 80 years," President Obama then explained: "Because of this bill, start-ups and small business will now have access to a big, new pool of potential investors -- namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in."[3]

The President is right. A lot has changed in 80 years. When President Franklin D. Roosevelt signed the Securities Act of 1933, many Americans did not have electricity or a single telephone. Now, many American pay their electricity bills on their phones. And from a phone or a laptop, investors can access information from all over the world on industries and firms.

Yet unfortunately, the proposed rule is still mired in the archaic regulations of the 1930s, when an investor would be limited to mail or physical travel to study the particulars of a given firm. By the SEC's own estimate, the proposed rule may cost an entrepreneur as much as $39,000 to raise $100,000 through crowdfunding.[4]

The burdensome proposed rule is no doubt influenced by scores of comments that the SEC received about how "radical" equity crowdfunding would be. Yet crowdfunding only seems that way because so many of the SEC rules have remained static. To put the risks – and the benefits – of crowdfunding in perspective, it is necessary to compare it to the many economic transactions that take place every day which could put individuals in far greater peril, but which are guarded by an evolving series of branding methods and best practices

Comparative Risk Analysis

Every day on the Internet, not just products, but businesses, are bought and sold. On eBay, for instance, it is possible to buy retail stores. In 2012, a gas station and convenience store in North Carolina exchanged hands on eBay for about $1.2 million.[5] Yet as large as it was, this transaction was governed by a fraction of the rules for a $500 investment in a publicly–traded company.

And this illustrates a fundamental contradiction of our securities laws and policies impeding capital formation that the JOBS Act sought to address. Buying an entire business requires much more due diligence on the part of the purchaser than investing in a portion of a business. Yet investors buying the smallest portions of the smallest businesses face more "protections" than if

[3] "Remarks by the President at JOBS Act Bill Signing," The White House, April 05, 2012, http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing

[4] Sherwood Neiss, "It might cost you $39K to crowdfund $100K under the SEC's new rules," Jan. 2, 2012, http://venturebeat.com/2014/01/02/it-might-cost-you-39k-to-crowdfund-100k-under-the-secs-new-rules/

[5] Timothy P. Carney, "Entrepreneurs win half a loaf with the JOBS Act," Washington Examiner, April 1, 2012, http://washingtonexaminer.com/entrepreneurs-win-half-a-loaf-with-the-jobs-act/article/1208256

they pay thousands more for a business outright. This paradox harms the well being of both small investors and small entrepreneurs.

As an illustration, suppose the gas station and convenience store owner did not wish to completely relinquish control over his business and wanted to seek investors. Instead of selling his or her entire business on eBay for $1.2 million, he or she might decide to sell 50 percent of the business on the site for $550,000 or possibly units representing one-thousandths of the business for $1,200.

But this isn't permissible on eBay or on just about any other Internet venue that isn't a licensed broker-dealer. This is because selling a piece of a business is considered a "securities transaction" and thus subject to the plethora of securities laws.

Such outdated rules aren't just limiting opportunities for small entrepreneurs like the gas station owners in the example. They are also impeding economic mobility for ordinary American investors. By utilizing crowdfunding primarily with a donations model – albeit frequently buffered with trinkets such as T-shirts and other memorabilia -- many artists are raising funds from thousands of ordinary Americans for their next motion pictures or album.

For instance, actor and director Zach Braff recently raised $3.1 million for his film "Wish You Was Here" through more than 45,000 fan donations from the popular crowdfunding web site Kickstarter. Upon the film's premiere at the 2014 Sundance Film Festival in January, it picked up distribution rights for $2.75 millions, recouping more than 90 percent of the funds raised on Kickstarter before any theatrical release.

As explained by the news and entertainment web site Buzzfeed, "Traditionally, in the indie film world, that acquisition fee would be used to pay back the budget of the film" and all of the film's investors who had contributed to that budget.[6] But in this case, the film's backers were not investors, so all they will be getting is T-shirts, posters, and/or invitations to screenings. "As those who have donated to Kickstarter or other crowdfunding sites know, those 'rewards' are the only way to financially remunerate backers for their contribution." Buzzfeed adds. Though the Kickstarter crowdfunders know what they are getting, many would like the ability to get more if the venture turns out to be successful.

Conclusion: Let "portals" make their own rules, with the SEC as backup against fraud

The successes of electronic marketplaces from eBay to Kickstarter shows that the SEC need not "reinvent the wheel" – though don't be surprised if equity crowdfunding produces innovation in wheels and many other products – in making rules for crowdfunding "portals." To gain trust, online venues have developed their own simple but effective set of rules for participants. eBay has received high marks from law enforcement for its fraud detection efforts and anti-fraud

[6] Adam B. Vary, "Why Zach Braff's 'Wish I Was Here' Won't Be Refunding Its Kickstarter Backers," Buzzfeed, January 21, 2014, http://www.buzzfeed.com/adambvary/zach-braff-wish-i-was-here-sundance-kickstarter

technology.[7] High seller ratings and past successes also lead to enhanced reputations and repeat business.

If equity crowdfunding were allowed to exist with minimal government regulation, much online business activity would be similar to that which exists now, with new tailoring for equity ventures. A filmmaker could now offer T-shirts and/or a share of the profits. But the film's backers would still know that it is a speculative venture. Local businesses and their communities would also benefit. Instead of going online to find a buyer with $1.2 million, a gas station owner could crowdfund by selling stakes to his regular customers.

When there is fraud on online market venues, the government – usually the Federal Trade Commission and its counterparts at the state level – does step in to apprehend and punish the perpetrators. But it is able to do so without "precautionary" requirements that cripple the buying and selling. The SEC should utilize this as a model by punishing fraud in equity crowdfunding when it occurs, but otherwise largely relying on the private rules that have and will continue to evolve for online marketplaces.

In signing the JOBS Act, President Obama bemoaned that for startup entrepreneurs, "Right now, you can only turn to a limited group of investors -- including banks and wealthy individuals -- to get funding." The SEC must avoid costly, paternalistic requirements on crowdfunding that have the effect of keeping the status quo and locking ordinary investors out of startup capital.

Respectfully submitted,

John Berlau

[7] Scott Kirsner, "How eBay Fights Fraud," Fast Company, August 1, 2003, http://www.fastcompany.com/46858/how-ebay-fights-fraud