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February 11, 2014

Via Electronic Mail at rule-comments@sec.gov

Honorable Mary Jo White, Chair
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Comments on SEC Proposed Rule: Crowdfunding; Release Nos. 33.9470, 34-70741; File Number S7-09-13

Dear Chair White:

The following comment addresses a number of key areas where SEC's proposed rulemaking has either exacerbated the inherent cost and complexity inherent in the Title III structure created by Congress, or threatens to make investment crowdfunding a less viable market. This comment also suggests alternative approaches as the SEC undertakes to finalize Title III rules.

The issues discussed are generally described as follows:

- The Requirement of Audited Financial Statements for Raises over $500,000.
- The Form of Non-Financial Offering Disclosure
- The Form and Substance of Annual Ongoing Disclosure
- Investor Education- The Role of the SEC in Investor Education
- Unnecessary Liability for Funding Portals
- The Prohibition Against "Curation" by Funding Portals
- Limitations on Intermediary Compensation
- The Retroactive Application of the "Bad Actor" Provisions

Though the SEC's request for comment is limited to issues raised under the proposed rules, I thought it might be helpful as a point of reference to initially address Title III of the JOBS Act and the proposed rules as part of a broader picture, both from an historical and regulatory point of view - as investment crowdfunding represents a new, complex and controversial market, and is especially challenging from a regulatory point of view.

I. INTRODUCTION AND BACKGROUND

Crowdfunding may very well have its roots in communities thousands of years before the passage of the JOBS Act of 2012, garnering small donations from large groups of people to finance the construction of community projects, such as temples of worship. Crowdfunding took on a new dynamic in the 21st Century, however, with the advent of the Internet. Chair White aptly took note of these forces in her address to the 41st Annual Securities Regulation Institute on January 27, 2014, in Coronado, California, *"The SEC in 2014."* Speaking in part to the Title III initiative under the JOBS Act, she noted:

> "It is not only our job to keep pace with this rapidly changing environment, but, where possible, also to harness and leverage advances in technology to better carry out our mission."
>
> "Just as we have seen market technology and products evolve over time, we also have seen massive change in the ease and speed with which information and capital flows. This, in turn, has led companies, investors, Congress, the SEC and others to reconsider how companies can seek capital and communicate with potential investors. Indeed, we are at the start of what promises to be a period of transformative change in capital formation."[1]

Despite the legions of prognosticators of doom, many of whom are my colleagues in the securities bar, investment crowdfunding is upon us – and is here to stay.[2] The only thing that stands in its way is burdensome or ineffective government regulation – something squarely on the shoulders of Congress, and currently the SEC, through the Title III rulemaking process – at the federal level. The SEC cannot meet this challenge alone. Hence, both the benefit of the open rulemaking process, and the necessity that all constituencies come to the table to air their views and opinions – openly, honestly and thoughtfully.

In a few short years crowdfunding has grown into a multi-billion dollar "industry," and has become the focal point of concerted academic research at major U.S. institutions, including the University of California, Berkeley, and The Wharton School at The University of Pennsylvania. Thus far, crowdfunding has managed to not only exist, but thrive, in an environment largely free of outside regulation and with minimal instances of fraud. It has done so largely through *self-regulation* by industry gatekeepers, or portals - Kickstarter, RocketHub and IndieGoGo to name but a few – against a backdrop of state laws regulating fraudulent, unfair or deceptive business practices applicable to financial activities generally.

When the "rewards" offered by crowdfunded projects included an economic interest in the funded enterprise, crowdfunding found itself on a collision course with a decades old federal regulatory scheme, *The Securities Act of 1933.* Congress attempted to meet this challenge by passing Title III of the JOBS

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[1] *"The SEC in 2014"* Speech by SEC Chair Mary Jo White before the 41st Annual Securities Regulation Institute, January 27, 2014. https://www.sec.gov/servlet/Satellite/News/Speech/Detail/Speech/1370540677500#.UvnT7rTl-70.

[2] *Will Crowdfunding Kickstart an Investment Revolution? Policy and Political Implications of Peer-to-Peer Financing.* Policy Note: Georgia Levenson Keohane, September 5, 2013, Fellow, Roosevelt Institute. http://rooseveltinstitute.org/policy-and-ideas/big-ideas/policy-note-will-crowdfunding-kickstart-investment-revolution.

Act in April 2012. Unfortunately, the legislative process was flawed – and so too was the final legislation. The result – an end product with unnecessary cost and complexity – something which some states have seemingly managed to avoid through thoughtful, targeted regulation. [3]

A. Cost and Complexity – Where is the Congressional Cost-Benefit Analysis?

There are three major flaws in Title III of the JOBS Act which infuse unnecessary cost and complexity, which have been extended by the SEC into the proposed rules:

- Financial Disclosure in the Offering Process
- Non-Financial Disclosure in the Offering Process
- Ongoing Post-Offering Disclosure

All of these flaws were avoidable to a large degree, if not entirely, if Congress used, as a starting point, a cost-benefit analysis. Congress did not do so – and the resulting cost-benefit equation has been exacerbated by proposed SEC rules addressing these three areas. Fortunately, the SEC, through rulemaking, retains the power to mitigate some unnecessary costs which threaten to choke out investment crowdfunding.

B. Less Burdensome State Solutions

As a starting point, in order to develop an appropriate reference point for less burdensome alternatives to provisions in the proposed rule, the Commission ought to first look to state legislatures and state securities regulators who have been guided by a cost-benefit analysis *at the outset of the legislative or rulemaking process* – their ultimate goal not "investor democracy," or leveraging the "wisdom of the crowd" **-** but rather to create jobs and to encourage investment by their residents in local businesses.

1. **Kansas** – Lets begin with Kansas, the first state in the U.S. to implement a comprehensive blue sky merit review process in 1911 – and also, ironically, the first state to enact by regulation an exemption from state registration which is adaptable to crowdfunding. Unlike the JOBS Act, their proposed regulation, ultimately adopted on August 12, 2011, contained the following preamble to the proposed regulations:

> "The proposed exemption will allow Kansas companies to raise capital without going through the registration process. A company could spend approximately $15,000 to $25,000 to properly register a $1 million securities offering. The costs would include a filing fee of $500, legal and accounting fees, due diligence costs, and other expenses associated with a securities offering. *Most of these costs could be avoided if the company takes advantage of the new exemption, which has no filing fee and is designed to be used with minimal legal assistance*. ***Because of the high expenses associated with registration, few companies actually use the registration process for small offerings."*** [Emphasis added.]

Notably, the Kansas regulations, ultimately adopted under the title "Invest Kansas Act ("IKE"), contained no specific disclosure requirements, financial or otherwise, either at the time of the offering or

[3] *See Equity Crowdfunding and The Road Not Taken – What Congress Could Learn From Kansas*, Samuel S. Guzik, The Corporate Securities Lawyer Blog, August 6, 2013. http://corporatesecuritieslawyerblog.com/?p=268.

otherwise. Liability for material misstatements and omissions was instead addressed by the state's securities anti-fraud statute.

2. **Georgia.** Through a series of rulemaking initiatives, the State of Georgia adopted its own investment crowdfunding statute. As with Kansas, Georgia's crowdfunding regulations contained no explicit disclosure requirements, financial or otherwise, either at the time of the offering or otherwise. As with Kansas, investor protection was embedded in the state's securities anti-fraud statute.

3. **Wisconsin** – Likewise, Wisconsin's legislators placed cost reduction at the forefront of its signature crowdfunding regulation, known by the acronym "CASE." The statute mandated a number of basic categories of disclosure, plus "Any additional information material to the offering". No financial statements are required, nor are there any required disclosures following completion of the offering.

Notable were the remarks contained in a Press Release issued by the principal sponsor of the Wisconsin legislation, State Representative David Craig, on November 7, 2013, the former attributable to Governor Scott Walker, the latter Rep. Craig, upon the passage of the CASE for Jobs Act:

> "no longer will our state treat its job creators like they are located on Wall Street instead of Main Street." . . . .
>
> "Wisconsin's CASE for Jobs Act is a securities registration exemption bill that alters and creates Wisconsin registration exemptions *to free Wisconsin small businesses from the expensive and cumbersome registration process* that can cost small businesses tens of thousands of dollars."[4] [Emphasis added]

In sum, simplicity and cost reduction were the touchstones of the Kansas, Georgia and Wisconsin investment crowdfunding statutes – recognizing that unnecessary cost and complexity would render any regulatory solution essentially dead on arrival. The Commission ought to take heed of these approaches, as a reference point, to the extent allowable by Congress under Title III – lest it be left with a market structure which is dead on arrival.

C. Lessons to be Learned from Down Under.

Long before investment crowdfunding was a gleam in the eyes of U.S. crowdfunding advocates, a different crowdfunding experiment was launched in Australia by crowdfunding pioneer Paul M. Niederer – The Australian Small Scale Offering Board Equity Platform ("ASSOB").[5] A great deal can be learned from the Australian ASSOB model.

Absence of Fraud and Failure – One of the more notable lessons to be learned from ASSOB is the relative absence of fraud. Perhaps even more surprising is the relatively low attrition rate of startups and small, emerging companies which have adopted the ASSOB model.

> "Our best indication of how equity-based crowdfunding will work is to look at the places it already exists. We track the Australian platform ASSOB that was founded in 2005, so we have

[4] Press Release dated November 5, 2013, "*Governor Walker Signs Craig Crowdfunding/CASE for Jobs Act into Law.*"

[5] Australian Small Scale Offerings Board, https://assob.com.au/.

6-7 years of data to look at. Through their platform, they've helped fund 176 companies so far. Nearly 6% have gone on to register on traditional securities exchanges and forty percent have exited through trade sales. But here is the real clincher: 86% of these companies are still in operation. Clearly, ASSOB has a long-enough history of successful funding to demonstrate that it can work."[6]

The Cost-Benefit Reality – The ASSOB model also provides a useful reference point in any cost-benefit analysis of investment crowdfunding for small business. There is always a cost for money – and the higher the risk, the higher the cost. There is also a certain amount of unavoidable cost "friction" generated by the pursuit of capital at the lower end of the capital formation food chain – simply in terms of positioning a company seeking to raise capital. The ASSOB model appears to reflect this economic reality – its entry point for small, emerging companies is a minimum raise of $500,000.

This "price point" suggests that raises below this amount which depend upon going out to a wide group of investors, may simply not be cost-effective under Title III absent a dramatic shift in the regulatory paradigm inherent in the Securities Act of 1933 in general, and Title III in particular. The answer may lie in a new regulatory paradigm for raises below $500,000, free of the web of securities regulation other than the securities anti-fraud statutes (Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934) – in effect, a "demilitarized zone" for small offerings. Further discussion of a new investment paradigm for small business is outside the scope of this comment.

D. The SEC Cost-Benefit Analysis

In one sense, the Commission has taken a different approach in Title III rulemaking – as it must – given the prescripts of Title III. However, in some important instances the SEC is proposing burdensome regulations not *mandated* by statute, and then attempting to minimize the economic impact of these costs through estimates which, according to some third party analyses, may fairly be characterized as "fuzzy math."[7]

Regardless of one's views on quantifying compliance costs, and recognizing that in many instances cost estimates are no more than educated guesses, this letter instead focuses on unnecessary complexities which go hand in hand with unnecessary costs – and therefore threaten to undermine the Title III crowdfunding market.

II. TITLE III - AUDITED FINANCIAL STATEMENTS FOR RAISES OVER $500,000

Though Congress in Title III has given the Commission, through the rulemaking process, the express power to limit or eliminate the requirement of audited financial statements for raises over $500,000, the Commission has expressly declined to do so. Instead, the proposed rules require two years of audited financial statements for all raises over $500,000. The Commission reasons:

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[6] "*An Interview With Carl Esposti, Crowdfunding Industry Research*,, by Alan Hall, Forbes Magazine, May 14, 2012. http://www.forbes.com/sites/alanhall/2012/05/14/an-interview-with-carl-esposti-crowdfunding-industry-research/.

[7] *See, e.g.* SEC Comment Letter of Kiran Lingam, General Counsel, SeedInvest, dated January 21, 2014, https://www.sec.gov/comments/s7-09-13/s70913-134.pdf.

> While Congress authorized the Commission to establish a different threshold, we are not proposing at this time to raise the threshold at which an issuer would be required to provide audited financial statements, as some commenters suggested.191 We note that Congress specifically selected $500,000 as the threshold at which to require audited financial statements. . . . Leaving the $500,000 threshold unchanged also would provide the Commission, investors and issuers an opportunity to become familiar with the new offering exemption before considering possible changes to the threshold.[8]

For the reasons discussed below, I find this reasoning to be unpersuasive. Congress *expressly* authorized the SEC to increase the dollar limits for audited financials – it ought to exercise this discretion.

A. Regulation A – Another Reference Point for the Commission

Since the inception of SEC Regulation A, an exemption from registration rarely used due to burdensome costs, ***Commission rules have required that issuers wishing to avail themselves of this exemption need only provide "reviewed" financials*** unless audited financial statements are available. Regulation A permits offerings up to $5 million, through a "mini-registration" process.

The Commission revisited these rules on December 18, 2013, when it issued proposed rules to implement Title IV of the JOBS Act (Regulation A+), and included proposed revisions to what it designated as "Tier I" offerings," those under $5 million.[9] ***In the proposed Title IV rules, the Commission neither proposed to change the requirement for reviewed financial statements, nor did it even solicit comments on whether audited financial statements ought to be required for Tier I companies.***

The longstanding requirement of "reviewed" financial statements for Regulation A offerings stands in sharp contrast to the Commission's proposed rules for Title III raises over $500,000, requiring audited financial statements. Clearly, not only do less burdensome alternatives exist, these alternatives have found favor in the eyes of the SEC for decades. This glaring incongruity is perplexing – and one that ought to have been addressed, and summarily disposed of, in the legislative process. Not having done so, it is now incumbent upon the Commission to either follow its own precedents, or provide a cogent analysis as to why Title III crowdfunding requires a higher, more costly level of financial disclosure, albeit for smaller capital raises.[10]

As the Small Business Administration Office of Advocacy has advised the Commission pursuant to its Comment Letter of January 16, 2014, it is incumbent upon the Commission under the Regulatory Flexibility Act of 1980, as amended ("RFA"),[11] to consider less burdensome alternatives to these and

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[8] SEC Release No. 33-9470, dated October 23, 2013, p. 77. https://www.sec.gov/rules/proposed/2013/33-9470.pdf.

[9] SEC Release No. 33-9497, dated December 18, 2013. https://www.sec.gov/rules/proposed/2013/33-9497.pdf.

10 *See "Regulation A+ Offerings—A New Era at the SEC,* by Samuel S. Guzik, The Harvard Law School Forum on Corporate Governance and Financial Regulation, January 15, 2014. https://blogs.law.harvard.edu/corpgov/2014/01/15/regulation-a-offerings-a-new-era-at-the-sec/.

[11] Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164 (codified at 5 U.S.C. § 601).

other requirements.[12] Even absent any Congressional mandate under the RFA, the failure of the Commission to exercise its discretion by eliminating the need for two years of audited financial statements could be characterized as both unfair and arbitrary – based upon long-standing Commission practices, recently reaffirmed in Title IV rulemaking. [13] [14]

Perhaps more importantly, it is questionable what benefit, if any, audited financial statements would provide over reviewed financial statements, particularly for companies with minimal revenues – often the case with startups and development stage companies. The Commission has yet to cite what benefit, if any, audited financials provide over reviewed financial statements, particularly when weighed against the incremental cost to a small business, in money, time and managerial resources.

It is doubtful that the large majority of crowdfunding investors, regardless of their level of financial sophistication, would find much in the way of meaningful information in audited financial statements, especially when compared to reviewed financial statements. I find the observations of one commentator more attuned to the reality of the startup world to be persuasive:

> As an investor, I do not believe that audited financial statements would give me significantly more confidence in an issuer than financial statements reviewed by a CPA. The reason is that, first and foremost, when evaluating a startup or early-stage company, I just don't pay that much attention to financial statements in the first place, beyond basic revenue-related figures, production or acquisition costs, and margins. The financial statements of startups and early-stage companies, which are often contrived for the sole purpose of raising capital, don't help me evaluate those companies chances for success as reliably as several other factors, including: the quality of the management team the uniqueness, innovativeness, and competitive advantage of their product or service the potential size of their market and the valuation and price of equity shares they are offering.[15]

Though Congress has not given the Commission the latitude to dispose of financial statements entirely, as has been done in a number of states, it ought to exercise its discretion and eliminate entirely the requirement for audited financial statements as both unnecessary and costly – instead requiring

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[12] SEC Comment Letter of Small Business Administration Office of Advocacy, dated January 16, 2014. https://www.sec.gov/comments/s7-09-13/s70913-121.pdf

[13] *See* SEC Release No. 33-9497, dated December 18, 2013, *supra*. https://www.sec.gov/rules/proposed/2013/33-9497.pdf.

[14] For further discussion of the disparities between Title III and other SEC exemptions from registration, including Regulation A, *see "Regulation A+ Offerings—A New Era at the SEC*, by Samuel S. Guzik, The Harvard Law School Forum on Corporate Governance and Financial Regulation, January 15, 2014. https://blogs.law.harvard.edu/corpgov/2014/01/15/regulation-a-offerings-a-new-era-at-the-sec/.

[15] *See* SEC Comment Letter of David M. Freedman, dated January 15, 2014. https://www.sec.gov/comments/s7-09-13/s70913-120.htm.

reviewed financial statements, as has been done for decades under Regulation A, the chorus from the American Institute of Certified Public Accountants notwithstanding.[16]

III. NON-FINANCIAL OFFERING DISCLOSURE

Title III of the JOBS Act delineates the disclosure obligations of an issuer in a crowdfunded offering. Pursuant to the SEC's rulemaking powers, the Commission has transformed less than a page of statutory disclosure into 10 pages of proposed rules.

What is most problematic about the SEC's disclosure rules is not the substance of the rules themselves – rather what is *not* in the rules: an optional, simplified disclosure format which issuers may consider when crafting the statutory disclosure.

Perhaps even more problematic, indeed perplexing, is the failure to even submit the issue of the form of disclosure to the public in the rulemaking process. Though the SEC asks *a* question, it asks the *wrong* question. Rather than asking whether the SEC should provide an *optional* form of disclosure for crowdfunding issuers, it pre-empts this question entirely, and instead poses the following question:

> **Request for Comment**
>
> 92. Should we require a specific format that issuers ***must use*** to disclose the information required by Section 4A(b)(1) and the related rules? [17] [Emphasis added].

The question, and the supporting discussion, glosses over the importance of providing an issuer with the *option* of selecting a form based disclosure – one prepared and provided by the SEC. It does so with an analysis which is not only analytically deficient, but which begs the question/comment posed by the Small Business Administration Office of Advocacy – one which the Commission is statutorily obligated to not only analyze – but answer – under another act of Congress, the Regulatory Flexibility Act of 1980:

> Further, small business stakeholders expressed concerns about the potential costs and burdens associated with the proposal's nonfinancial disclosures . . . . Small business representatives at Advocacy's roundtables proposed alternatives to the nonfinancial disclosure requirements that may minimize costs . One alternative to the proposed rule's nonfinancial disclosures suggested by

[16] I note the position of the American Institute of Certified Public Accountants on this issue as expressed to the SEC in its Title III Comment Letter: "We believe that the threshold selected by Congress for which an issuer would be required to provide audited financial statements is appropriate" and "startups frequently have their financial statements reviewed or audited." SEC Comment Letter of the AICPA dated February 3, 2014. https://www.sec.gov/comments/s7-09-13/s70913-232.pdf feb 3, 2014. I do not find this position to be persuasive – neither should the Commission. The Commission's judgment on this issue ought to be guided by common sense, with a view towards making a new market function efficiently – Title III of the JOBS Act was intended to create jobs through growth of small business – *not professionals* – whether they be accountants, securities attorneys or otherwise. *Contra*, SEC Comment Letter of Paul M. Niederer, ASSOB Equity Platform, dated October 25, 2013. https://www.sec.gov/comments/s7-09-13/s70913-20.htm , at Para. 53, 55, 58.

[17] SEC Release No. 33-9470, dated October 23, 2013, *supra*. https://www.sec.gov/rules/proposed/2013/33-9470.pdf.

> a small business owner is that the SEC could adopt a simple "question and answer" format for nonfinancial disclosures similar to the format used in disclosures for Regulation A offerings.
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> The question and answer format would be less burdensome for small business issuers while still providing the SEC with the information it is seeking under the proposed rule. Another potential alternative suggested by a small business representative is that the SEC could develop standard , boilerplate disclosures for some of the more complicated nonfinancial disclosures, such as risk factors.
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> Permitting small business issuers to use standard disclosures would serve as a less burdensome alternative that still accomplishes the purposes of this rulemaking. Because the [form of the] proposed rule's nonfinancial disclosures are not required by the JOBS Act, Advocacy encourages the SEC to develop alternatives that would be less burdensome for small business .[18]

Indeed, the prefatory discussion to Request for Comment No. 92, lays out alternatives suggested by commentators in the prior, preliminary request for comments by the SEC.

> Section 4A(b)(1) [of the JOBS Act] does not specify a format that issuers must use to present the required disclosures and file these disclosures with the Commission. Several commenters stated that the Commission should require the disclosure on a form modeled after, or require the use of NASAA's Small Company Offering Registration Form (U-7).236 One commenter suggested using Form 1-A, which is used for securities offerings made pursuant to Regulation A, as a model. One commenter requested that we create a form for issuers that "simplifies the process and provides legal certainty for investors, intermediaries and issuers," while another commenter suggested that we adopt a "simple, uniform, easy-to-understand yet comprehensive template prospectus that is similar in principle to the mutual fund industry's summary prospectus." Another commenter recommended that disclosure be simple, allow for standardization and take into account the size and stage of development of the issuer. One commenter suggested we create a disclosure template that would allow issuers to complete certain fields by inserting the required disclosure.[19] [Footnotes intentionally omitted]

Not only did the Commission *not* submit for comment the question as to whether the Commission should provide, as an alternate method of disclosure, a simple, easy to understand format, it failed to provide any cogent reason for this omission. It simply stated: "We believe this flexibility is important given that we expect that issuers engaged in crowdfunding transactions in reliance on Section 4(a)(6) would encompass a wide variety of industries at different stages of business development."[20]. Simply stating that "flexibility is important," a disclosure principal with which I concur, simply begs the question one more time: Why has the SEC not provided a simplified disclosure format as an optional form of disclosure? The SEC is unable to cite any authority, either by way of preliminary public comments or otherwise, for the failure to craft a simple, *optional* form of disclosure.

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[18] SEC Comment Letter of Small Business Administration Office of Advocacy, dated January 16, 2014. https://www.sec.gov/comments/s7-09-13/s70913-121.pdf .

[19] SEC Release No. 33-9470, dated October 23, 2013, *supra*, p. 102, https://www.sec.gov/rules/proposed/2013/33-9470.pdf.

[20] *Id,* at p. 103.

Certainly, the Commission's hands were not tied by Congress. There is nothing in Title III of the JOBS Act which precludes the Commission from crafting a simplified form of optional disclosure. Indeed, in footnote 612 to the Proposed Rules, the Commission cites to a statement made by Sen. Scott Brown, which would allow *funding portals* to provide or make available "basic standardized templates, models and checklists." *A fortiori*, ought not the Commission be providing "basic standardized templates"? rather than leaving this to chance to be developed by newly invented creatures of statute, "funding portals." Why is it not the Commission, in the first instance, taking on this important task.

Moreover, there is ample precedent for the Commission to provide optional, simplified form disclosure. For many years the SEC has provided an optional "question and answer disclosure format" for Regulation A offerings up to $5 million. Analogous formats have been developed and successfully utilized for "SCOR offerings" at the state level since the late 1990's – carefully developed by a joint partnership between the North American Securities Administrators Association ("NASAA") and the American Bar Association – which remain in use today in over 30 states (Form U-7). Though these formats may not be a perfect fit for crowdfunded offerings, they certainly are a useful starting point for crafting simplified disclosure formats.

And the concept of simplified disclosure, or right-sized disclosure, is not an idea whose time has come and gone, as suggested by other recent proposed rulemaking.[21] Indeed, it was the subject of a major policy initiative undertaken by the SEC in 2008, ultimately to be temporarily set aside, apparently overcome by issues arising out of the "Great Recession" and The Dodd-Frank Act. And "scaled disclosure", or "right sized disclosure" has been a frequent topic of public statements at the Commission level in recent months, most notably by Chair White and Commissioner Gallagher.[22] Indeed, as recently as two weeks ago, in a speech delivered before the Forum for Corporate Directors, Commissioner Daniel M. Gallagher discussed the importance of simplified disclosure, incorporating modern technology[23] – resurrecting analyses and proposals of a former SEC Commissioner and a former Director of Corporation Finance. [24]

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[21] *See* SEC Release No. 33-9497, dated December 18, 2013, proposing to eliminate optional question and answer format for Regulation A offerings. https://www.sec.gov/rules/proposed/2013/33-9497.pdf.

[22] *See, e.g. "On the Proposed SEC Regulations & Crowdfunding – A Postscript: Is SEC Commissioner Gallagher a Friend of the Crowd?"*, by Samuel S. Guzik, dated November 11, 2013, The Corporate Securities Lawyer Blog, http://corporatesecuritieslawyerblog.com/?p=399.

[23] Speech by SEC Commissioner Daniel M. Gallagher, "Remarks to the Forum on Corporate Directors," January 24, 2014. https://www.sec.gov/servlet/Satellite/News/Speech/Detail/Speech/1370540680363#.UvnwU7Tl-70. *See, also, "On the Proposed SEC Regulations & Crowdfunding – A Postscript: Is SEC Commissioner Gallagher a Friend of the Crowd?,"* by Samuel S. Guzik, dated November 11, 2013, The Corporate Securities Lawyer Blog, http://corporatesecuritieslawyerblog.com/?p=399

[24] Professor (and former SEC Commissioner) Joe Grundfest and former SEC Director of Corporation Finance Alan Beller, "Reinventing the Securities Disclosure Regime: Online Questionnaires as Substitutes for Form-Based

If there were ever a *place* for the Commission to facilitate non-burdensome, scaled disclosure, it would be the sub-$1 million crowdfunding market – the very bottom of the capital formation pool. If there were ever a *time* for the SEC to undertake this initiative – it is NOW – on the eve of the creation of a new and challenging market for capital formation which cries out for scaled disclosure.

Instead, the Proposed Rules are testimony to the fact that the Commission has stood silent in the face of a new and controversial crowdfunding market, precluding comment on this subject, and according to the Office of Advocacy, failing to comply with a 33 year old act of Congress, the RFA.[25]

One need not speculate as to the reason the Commission has taken this "hands off" approach in the investment crowdfunding arena – whether it be a matter of institutional complacency, internal priorities or otherwise. Nonetheless, the Commission's inaction in this area is inexplicable: whether from a policy point of view; a practical point of view (*i.e.* making a new market work well), or a legal point of view.

And simply relying on independent, largely unregulated third party service providers to fill this void, rather than the Commission itself, with its objectives of investor protection and obligation to facilitate capital formation, is an abdication of responsibility which is both unprecedented and unacceptable.[26]

Perhaps the biggest disappointment in this area is not even the proposed rules themselves – but what has preceded it. On November 15, 2012, the Commission convened the annual 2012 SEC Government-Business Forum on Small Business Capital Formation as mandated by the Small Business Investment Incentive Act of 1980. Among the attendees were four SEC Commissioners. Notably, this was the first Small Business Capital Formation Forum following the passage of the JOBS Act in April 2012. What emerged from this Forum was a series of recommendations of the participants relating to suggested legislative and regulatory reforms for the Commission to consider in future rulemaking impacting small business.

Of the many recommendations that emerged from the Forum, the following recommendation was ranked as number one:

1 Required disclosure for crowdfunding issuers should be simple and allow for

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Filings," Rock Center for Corporate Governance, Stanford University, Working Paper Series No. 2 (Aug. 4, 2008). Available at: http://ssrn.com/abstract=1235082.

[25] SEC Comment Letter of Small Business Administration Office of Advocacy, dated January 16, 2014. https://www.sec.gov/comments/s7-09-13/s70913-121.pdf .

[26] *See, e.g.* Statement of Andrea Seidt, President of The North American Securities Administrators Association (NASAA), contained in a NASAA Release dated October 15, 2013, entitled *"NASAA Expands Annual Top Investor Threat List,"* "Whether a crowdfunding portal or an accredited investor aggregator, it is important to do your due diligence and to understand that use of an unregulated third party to provide such services does not change your obligations under federal and state securities laws," Seidt said. "Investors are not alone in their potential to be scammed. Using a fraudulent portal means both the business and the investor stand to lose." http://www.nasaa.org/27012/nasaa-expands-annual-top-investor-threats-list/.

> standardization, and take into account the size and stage of development of the issuer (including, specifically, whether the issuer is a start-up). [27]

This recommendation has not been heeded by the Commission – the recommendation has not even been submitted to the public for comment – it has barely been given lip service. And unfortunately, this single recommendation, and the apparent short shrift given to it in the rulemaking process, is not an isolated example – judging by the scores of recommendations made by Small Business Forum participants over the past three decades, the large majority of which recommendations have died an uneventful death – often simply repeated in Forums year after year after year.

To place a fine point on the analyses and conclusions of this commentator, the undersigned urges the Commission to give further consideration to the issue of the form of non-financial disclosure and the important role which the Commission is eminently best qualified to undertake in the first instance, in view of:

- Stated policy objectives of the Commission regarding non-financial "scaled disclosure' over the past five years;
- The vast human resources and expertise at the disposal of the Commission.
- The relative expertise of the Commission, compared to those of newly formed "funding portals," in developing and implementing optional simplified disclosure format.
- Recommendations made by the 2012 SEC Government-Business Forum, note 29, cited by the Commission in the Proposing Release (note 241, at p. 102), and consensus recommendations of one of the Forum's Working Groups: "New regulations should provide for scaled disclosure based on, among other factors, size of offering, including unaudited financial statements for smaller offerings; *and encourage user-friendly techniques such as Q&A*."[28] [Emphasis added]
- Limited resources, and undue costs, associated with smaller offerings by small issuers.
- The opinions expressed by the SBA Office of Advocacy in this rulemaking process.

Clearly, the Commission has the power and resources to reduce the costs and burdens of issuer disclosure. It ought to exercise that power, and marshal those resources, in a manner which will more effectively protect investors and reduce costs and burdens on small business issuers.

IV. **ONGOING ANNUAL DISCLOSURE**

One of the most burdensome requirements in the SEC's proposed rule is the requirement that every year after a company successfully concludes a crowdfunded offering it must file detailed disclosure reports, including financial statements, essentially as long as the crowdfunded securities are outstanding.

Under Title III of the JOBS Act, Congress required the SEC to promulgate rules requiring:

[27] U.S. Securities and Exchange Commission, 2012 Government-Business Forum on Small Business Capital Formation, p. 23, http://www.sec.gov/info/smallbus/gbfor31.pdf.
[28] *Id*, at p. 25.

"[annual] reports of the results of operations and financial statements, as the Commission shall, by rule, determine appropriate, *subject to such exceptions or termination dates as the Commission shall establish by rule."* [emphasis added]

The proposed rules, as promulgated, go far beyond anything that the SEC is *required* to do under the JOBS Act – essentially requiring *the same detailed financial and non-financial disclosures* provided to investors when the offering is conducted, *year after year* – less only information regarding the terms of the original offering itself. On the financial side, the same burdensome requirement of audited financial statements for raises over $500,000 is continued in perpetuity (as is the requirement of reviewed financial statements for raises between $100,000 -$500,000). And once again, the SEC has failed to provide any form of an *optional*, simplified disclosure format.

And not only is the extensive (as in expensive) SEC-proposed ongoing disclosure *not* mandated by Congress, it directly conflicts with requirements of the SEC for other types of offerings to unsophisticated investors allowing raises up to $5 million. Specifically, under Regulation A, which allows offerings up to $5 million ***there is absolutely no ongoing disclosure requirement whatsoever.*** Thus, in an area where Congress gave the SEC express rulemaking power to *reduce* the scope of ongoing, annual disclosure, it has inexplicably failed to consider any alternatives – even though there is ample precedent for doing so.

Essentially, even if a small issuer considering a crowdfunding offering is open to taking on significant up front out-of-pocket costs to *attempt* a successful crowdfunded offering, its certain reward is extensive, expensive continuing ongoing disclosure - in perpetuity.

Clearly, there are more appropriate, less burdensome alternatives which the Commission can and should consider, and implement, in the final rules. Failure to do so is at odds with not only past (and current) precedent for offerings up to $5 million to unsophisticated investors (*i.e.* Regulation A), but once again is in direct conflict with the mandate of the Regulatory Flexibility Act – to weigh less burdensome alternatives.[29]

V. INVESTOR EDUCATION – A PROACTIVE ROLE FOR THE SEC IN INVESTOR PROTECTION

Section 4A(a)(3) [of the JOBS Act] states that an intermediary must "provide such disclosures, including disclosures related to risks and other investor education materials, as the Commission shall, by rule, determine appropriate." The Commission, in its Request for Comment, asks the following:

> 143. Should we prescribe the text or content of educational materials for intermediaries to use? Why or why not? Should we provide models that intermediaries could use? Why or why not?[30]

As appears to be the case with the issue of providing an alternate option for simplified, non-financial disclosure, the SEC has simply failed to ask the right question: What can *the SEC do*, through

[29] SEC Comment Letter of Small Business Administration Office of Advocacy, dated January 16, 2014. https://www.sec.gov/comments/s7-09-13/s70913-121.pdf .
[30] SEC Release No. 33-9470, dated October 23, 2013, *supra*, p. 152, https://www.sec.gov/rules/proposed/2013/33-9470.pdf.

investor education, to assist “ordinary” investors in understanding and evaluating investment opportunities, particularly for high risk ventures?

The SEC Fails to Leverage the Power of the Crowd

What crowdfunding brings to the investment process is allowing the crowd to ask questions directly to the crowdfunding company, and to allow investors to discuss the merits and risks of an investment, all in an open and transparent forum. Though the SEC’s proposed rules certainly open up these channels of communication – and create a permanent electronic record of the information provided, the SEC has stopped short of leveraging the power of the crowd, many of whom will be relatively unsophisticated.

Though the proposed rules provide for *intermediaries* to provide educational materials to an investor when they open an account on the platform, the SEC has missed an opportunity to think outside of its regulatory box – and provide effective guidance to investors.

In the first instance, it ought to be the responsibility of *the SEC* to educate investors on the risks of investing. The SEC has avoided taking on this responsibility and left this to chance – adding to the casino type atmosphere that many believe will define equity crowdfunding. The SEC is more than capable of coming up with educational materials which will explain to an investor, in plain English, not only what are the risks in investing, *but how to evaluate and minimize these risks.*

The SEC can, and should, take investor education one step further and explain to investors in plain English what questions to ask of a crowdfunding issuer, and why it is important for an investor to ask these questions. This simple step will not only effectively unleash the power of the crowd to vet an investment opportunity – thereby leveraging a benefit of the crowdfunding model – but will go a long way towards the SEC meeting its responsibility to protect investors in a meaningful way – particularly in a new, high risk market. After all, isn’t this exactly what the SEC does when it reviews a full blown registration statement – ask questions of the issuer of the securities? Let the crowd ask the questions in a transparent setting, and arm the crowd with information which will assist them in determining what questions to ask and why they should ask them.

Frankly, I find it mindboggling that there appears to have been no thought given whatsoever by the Commission to leveraging the power of the Internet to assist investors to fend for themselves. Instead, it appears content to leave this entirely to “intermediaries”, including the newly created “funding portal” a creature of statute with no apparent investment education expertise.

The Securities Act of 1933 is premised upon the principle that registration of the sale of securities with the SEC is necessary to protect unsophisticated investors, and other groups who cannot afford the risk of loss – groups that are unable to “fend for themselves.” The Internet, generally, and Title III crowdfunding, in particular, present an opportunity of enormous proportions to educate literally millions of investors as to how to analyze an investment opportunity – when millions of “eyeballs” will land on the platforms of broker-dealers and funding portals – with a pocket full of cash and stars in their eyes – and help them *fend for themselves*. Even our major Las Vegas casinos, though not required by law to do so, will educate new players as to the rules of the game, and even the odds. Why is the SEC not stepping up to this opportunity to help the investing public fend for itself – let alone even talking about it?

Certainly, it is not a function of limited resources or expertise. Rather, it seems to be a product of institutional complacency.

There are those who say crowdfunding, whether investment crowdfunding or otherwise, can be a powerful force to change the world. Long before the Internet, an iconic leader by the name of Nelson Mandela remarked:

"Education is the most powerful weapon which you can use to change the world."

The SEC should take note: through the Internet the SEC has the power and resources to educate the "crowd."- it should seize the opportunity to do so.

It is time for the SEC, in the name of investor protection, and in the context of an Internet driven investment paradigm, to be proactive and think outside the box.[31] Certainly, it is well within its expertise to educate investors, in plain English, what questions to ask an issuer, and why these questions ought to be asked. This simple step ought to also assist the SEC toward effectively crafting *simplified* disclosure rules for crowdfunding companies and allow them to provide this information in a more simplified format – in effect, shifting some of the disclosure burden to the crowd – with a corresponding benefit to both the crowdfunding company and the crowd.

VI. UNNECESSARY LIABILITY FOR FUNDING PORTALS – BASED UPON A TENUOUS READ OF THE JOBS ACT

Section 4A(c)(1)(A) and (B) of the JOBS Act impose liability for misstatements or omissions for an "issuer described in paragraph (2)" of such section. Subsection 4A(c)(3) defines "issuer" as "any person who is a director or partner of the issuer, and the principal executive officer or officers, principal financial officer, and controller or principal accounting officer of the issuer (and any person occupying a similar status or performing a similar function) that offers or sells a security [in a Title III transaction] ***and any person who offers or sells the security in such offering****."* [Emphasis added]

The statute imposes liability on an issuer, the specified officers and directors, and *any other person who offers or sells the security*. Thus, there is no statutory liability for any intermediary *unless* the intermediary (or its agents) is engaged in the offer or sale of the Title III security.

The problem for intermediaries who are not broker-dealers is created not necessarily by any proposed rule, but in *dicta* which the SEC has gratuitously (and wrongly, in my opinion) included in the Proposing Release – at page 280. Section 4A of the JOBS Act provides that an "issuer" is liable for the refund of the purchase price of the security to the purchaser if in connection with the offer and sale of a crowdfunded security it makes a material misstatement or a material omission, and is unable to sustain the

[31] "The public must have faith that the SEC and other institutions are aggressively working to protect the integrity of the securities market. And, for that faith to return, *the SEC must be pro-active in demonstrating that it is pro-investor*." [Emphasis added]. *"Taking a No-Nonsense Approach to Enforcing the Federal Securities Laws"* Statement by SEC Commissioner Luis Aguilar at the Securities Enforcement Forum 2012, October 12, 2013.

burden of showing that it could not have known of such untruth or omission even if it had exercised reasonable care.

In Section II.A.5 of the Release, entitled "Scope of Statutory Liability" the Commission states:

> Section 4A(c)(3) defines, for purposes of the liability provisions of Section 4A, an issuer as including "any person who offers or sells the security in such offering." *On the basis of this definition, it appears likely that intermediaries, including funding portals, would be considered issuers for purposes of this liability provision. We believe that steps intermediaries could take in exercising reasonable care in light of this liability provision would include establishing policies and procedures that are reasonably designed to achieve compliance with the requirements of Regulation Crowdfunding, and that include the intermediary conducting a review of the issuer's offering documents, before posting them to the platform, to evaluate whether they contain materially false or misleading information.* [Emphasis added]

By the SEC making this statement, in effect saying that all intermediaries are "likely" engaged in the offer or sale of Title III securities within the meaning of statutory liability provisions, it has opened the door wide open to an investor bringing an action against an intermediary as a an "offeror" or "seller." And to prevail the intermediary must meet the statutory burden of proof of a "due diligence" defense. This position by the SEC is problematic on a number of levels, with the biggest impact falling on intermediaries who are not broker-dealers.

What the SEC has done, in my opinion, based upon a faulty reading of the JOBS Act, is to take a position which would impose statutory seller liability on a funding portal where there is no basis to impose such liability on a funding portal – as (in my opinion) it is not correct to state that a funding portal will be engaging in activities arising to the level of offering or selling securities, as intended by Congress – they are simply a conduit with limited duties under the JOBS Act.

According to the SEC's release regarding the proposed rules, what follows from this perceived statutory liability on funding platforms is further *dicta* suggesting that funding portals must affirmatively conduct due diligence on an issuer's offering materials. This also appears to be contrary to the express obligations which Congress imposed on intermediaries in Section 4A(a).

The net result of the SEC's position is that in order for a funding portal to avoid liability to a purchaser on the basis of an issuer's false or misleading offering materials, the funding portal would be well advised to conduct due diligence on the issuer's offering materials. This seems at odds with the passive role to which a funding portal is limited.

A broker-dealer which operates as an intermediary, on the other hand, should (and would) face liability if it were actively engaged in the offer and sale of the security, which is normally the case. Accordingly, FINRA rules affirmatively require a broker-dealer (in any private placement) to conduct due diligence on an issuer and the offering materials, and to have proper procedures and controls in place in regard to due diligence. FINRA imposes similar duties on the broker-dealer to evaluate suitability of the investment for the specific investor.

Thus, if the SEC's expansive *dicta* is not qualified (better yet, a safe harbor provided for a funding portal not acting as a broker-dealer), not only will newly established funding portals have the burden and expense of creating internal due diligence *procedures*, but they will be required to perform additional due diligence for each and every issuer to effectively establish a “due diligence” defense.

These initial and transaction specific costs in and of themselves are burdensome, and may serve as an unnecessary barrier by non-broker-dealer intermediaries (*i.e.* funding portals) to enter this industry. Also, consider that to the extent imposing unnecessary liability may not deter funding portals from entering the business, the heightened risk and additional due diligence costs will of necessity require a funding portal to charge higher fees to issuers than would otherwise be necessary, a cost ultimately borne by investors.

A broker-dealer will already have due diligence procedures in place under FINRA rules, as they offer and sell securities in the ordinary course of their business – so they will not have this initial cost of doing business. Funding portals, on the other hand, have no businesses other than Title III crowdfunding to spread these internal control costs – as would a broker-dealer. Moreover, a broker-dealer would, in theory, have an opportunity to engage in other business transactions with a Title III issuer outside the Title III offering, including future private placements and market-making activity. These opportunities would *not* be available to a funding portal, as they are not a fully licensed broker-dealer. So as to the opportunity of a funding portal to earn fees in a Title III transaction, it would not be on a level playing field with licensed broker-dealers.

This issue is a potential “industry killer”, with small business being the victim – especially if broker-dealers shun the Title III market as too small relative to the risks and rewards – which many, including this commentator, believe will occur.

Note the SEC’s request for comment, Paragraph 120, appearing at page 131 of the release:

> 120. No intermediary can engage in crowdfunding activities without being registered with the Commission and becoming a member of FINRA or another registered national securities association. We recognize that while there is an established framework for brokers to register with the Commission and become members of FINRA, no such framework is yet in place for funding portals. *We do not intend to create a regulatory imbalance that would unduly favor either brokers or funding portals. Are there steps we should take to ensure that we do not create a regulatory imbalance?337 Please explain*. [Emphasis added]

In this regard:

- There is a “regulatory imbalance” as between funding portals and broker-dealers, as noted above.
- The SEC, in footnote 336 to Paragraph 120 (see below), even acknowledges this regulatory imbalance.
- *The SEC highlights in footnote 336 that a broker-dealer, but not a funding portal, may “engage in solicitations” in a crowdfunded offering – the precise activity that should trigger liability as an “offeror” or “seller under the 1933 Act and Title III liability provisions for persons who “offer” or “sell”.*

Footnote 336 states the following:

> 336/ We note, however, that a registered broker could nonetheless have a competitive advantage to the extent *it would be able to provide a wider range of services* than a registered funding portal could provide in connection with crowdfunding transactions made in reliance on Section 4(a)(6). Unlike a funding portal, a registered broker-dealer could make recommendations, *engage in solicitations* and handle investor funds and securities. In addition, a registered broker-dealer, but not a funding portal, could potentially facilitate a secondary market for securities sold pursuant to Section 4(a)(6). *See* Exchange Act Section 3(a)(80) [15 U.S.C. 78c(a)(80)] (providing that a funding portal may act as an intermediary solely in securities transactions effected pursuant to Securities Act Section 4(a)(6), which are offerings by issuers and not resales). [Emphasis added]

I point out, for the sake of completeness, that funding portals are allowed (but not required) to assist an issuer in preparing offering materials. However, this activity ought not arise to the level of a solicitation – it is analogous to the services an issuer's securities counsel might perform – an activity which clearly would not trigger statutory liability as an offeror or seller.

This potential, unnecessary liability to a funding portal is further complicated in view of two other factors discussed in this comment. First, as discussed below, under the SEC's proposed rules all intermediaries are prohibiting from mitigating this financial risk by taking an equity stake in the issuer. And second, as discussed below, according to the SEC in the proposed rules, an intermediary which is not a broker-dealer is prohibited from excluding companies from its platform based upon subjective factors, such as quality of management, valuation of the company, market size, need for additional capital, pending litigation, or other subjective factors which increase the risk to an investor. Not so for a licensed broker-dealer.

As I stated in an earlier commentary published less than two weeks after the Proposed Rules were issued:

> The Commission, in effect, has created a schizophrenic business paradigm for funding platforms – a business model which imposes the risks/liability attendant to being a broker-dealer – but without the ability to use the broker-dealer compensation model – or even to create value for a different compensation model by being able to screen issuers.[32]

The Solution

In my opinion, what the SEC needs to do, going forward, given that it has hung every funding portal out to dry with (in my opinion) erroneous *dicta*, is to create a *safe harbor rule* for funding portals that do no more than conduct their business in the ordinary course, and do *not* otherwise engage in activities that could be deemed solicitations. If not, this gratuitous imposition of guarantor-like liability

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[32] See *"ON THE PROPOSED SEC REGULATIONS AND CROWDFUNDING: LET'S GET IT RIGHT, CHAIRMAN WHITE,"* by Samuel S. Guzik, dated November 5, 2013, The Corporate Securities Lawyer Blog, http://corporatesecuritieslawyerblog.com/?p=393

on a funding portal may very well kill Title III crowdfunding before it can get off the ground – or force funding portals to impose needlessly high fees.

VII. THE PROHIBITION AGAINST CURATION BY NON-BROKER-DEALER INTERMEDIARIES

Congress dictated that funding portals (*i.e.* non broker-dealer intermediaries) could not offer investment advice or recommendations – unlike licensed broker-dealers, who may offer investment advice and recommend securities. The SEC has taken this one step further in the Release, by prohibiting funding portals from excluding companies on the basis of subjective or qualitative factors, Under the proposed rules an intermediary which is not a broker-dealer is prohibited from excluding companies from its platform based upon qualitative factors, such as quality of management, valuation of the company, market size, need for additional capital, pending litigation, or other qualitative factors which increase the risk to an investor.

As I noted in a previous article**,** why would someone bother going to a portal that reads more like an unfiltered Craig's List bulletin board, as opposed to a menu of carefully curated investment opportunities.[33] This gives broker-dealers a major competitive advantage over funding portals, both from the company (issuer) perspective and the investor perspective. Though, in my opinion, Title III of the JOBS Act does *not* preclude funding portals from presenting a list of carefully curated investments (so long as there is a disclaimer by the funding portal that they are not recommending any security, and a statement that all of the listed investments carry significant risks), the SEC in in the proposing Release has clearly precluded funding portals from doing so – even if they have on *their staff* a licensed broker-dealer, certified public accountant, or Certified Financial Planner. And given the position of the SEC in the proposed rules that an intermediary has an affirmative obligation to review offering materials, and will face statutory liability as a seller of the security, the inability of a funding portal to screen issuers based upon qualitative factors becomes a significant deterrent to conducting business – even with higher fees.

What is at stake for the Title III crowdfunding industry is the vitality of the investment crowdfunding market itself. This writer believes that most players in the broker-dealer community will avoid the Title III markets, due to its cost, complexity and more attractive and efficient alternative capital raising tools available under Rule 506 of Regulation D. Thus, if the Title III market is left largely to funding portals, rather than broker-dealers, not only will investors not be well served by portals who have no "quality filter" on investments, they may not be served at all. And the problem is compounded further by an unnecessarily expansive view of intermediary liability (discussed above), and prohibitions imposed by the SEC's proposed rule prohibiting any intermediary from obtaining a financial interest in an issuer (discussed below).

Adding to this conundrum, the Commission's own proposed rules appear to **REQUIRE** an intermediary, including a funding portal, to deny access to its platform, or cancel an ongoing offering, if the funding portal believes that the offering "presents the potential for fraud *or otherwise raises concerns regarding investor protection*." Proposed Rule 301(c)(2). [Emphasis added]. Presumably factors such as

[33] *Id.*

"valuation" would appear to be a prohibited factor for funding portals to screen issuers, yet if a funding portal believes an issuer's security is overvalued, thus raising investor protection concerns, the portal would be required to ban the offering from its platform.

Not only does proposed Rule 301(c)(2) directly conflict with the Commission's ban on curation by funding portals, but it also undercuts the vitality of any argument by the Commission that somehow it is precluded by Title III or any other federal securities law from allowing "funding portals" to curate issuers and transactions "off line" before they are listed on the funding portal.

VIII. LIMITATIONS ON INTERMEDIARY COMPENSATION – THE LAW OF UNINTENDED CONSEQUENCES

Restrictions on Compensation Paid to Crowdfunding Platforms

This is another potential "industry killer" – *not* required by the JOBS Act. The JOBS Act prohibits officers and directors of the intermediary (platform) from having any economic interest in the crowdfunded company. In the proposed rules the SEC has expanded this requirement to prohibit *intermediaries* from having any economic interest, in addition to officers and directors. The principal reason given by the SEC for this expansion of the statutory requirement – it seemed like a "logical" extension of the Congressional mandate. However, if the vitality of the crowdfunding market is a concern to the Commission, this "logic" will have unintended consequences, making it deeply flawed logic.

Economic interests, such as warrants or "carried interests" in future profits, are commonplace on Wall Street, especially with high risk transactions. It is a way to increase the potential financial reward – but without cash flow drain to the company it is funding. So too, with crowdfunding and portals. If intermediaries are limited to cash compensation, that will translate into higher up front and backend costs to crowdfunded companies. This will come initially out of the pocket of the crowdfunder, and if the offering is successful, will indirectly come out of the pocket of investors – leaving less money available for working capital.

By all accounts crowdfunding is a high risk proposition – indeed one of the riskiest possible investments. And the dollars involved are small, by financing standards – a maximum of $1 million over 12 months. If the potential reward is out of line with the risks to an intermediary and other costs of doing business – one of two things will happen. First, many intermediaries will not enter this arena at all, and those that do may ultimately fold their tents if business is not profitable. *Second, It also ensures that a licensed broker-dealer, who is free to engage in any type of financing transaction (not so with a non-broker dealer "funding portal"), will eschew the crowdfunding route for an otherwise fundable company – and instead will go another route such as a Regulation D private placement – which carries no SEC restrictions on equity compensation.*

In sum, this "logical" extension of a JOBS Act requirement will ensure that most broker-dealers will ignore the investment crowdfunding route – and it will increase costs to companies in need of funding. And for non-broker-dealer portals, this is an unnecessary variable in their cost-benefit analysis – particularly problematic for them (versus broker-dealers) as their only revenue will be derived from crowdfunded offerings – and not from other avenues such as private placements.

IX. CURTAIN CALL FOR BAD ACTORS?

In the Proposed Rules, the SEC proposes to exclude "bad actors" from participating in crowdfunded offerings, but proposes to apply this rule only to misconduct which occurs *after* the effective date of the final Title III rules – leaving prior misconduct an item of disclosure:

SEC Request for Comment No. 277.

> 277. The proposed rules would specify that disqualification under Section 4(a)(6) would not arise as a result of events occurring before the effective date of proposed Regulation Crowdfunding. Should we limit disqualification to events occurring after the enactment of the JOBS Act instead? Why or why not?[34]

The Commission states in the Proposed Rules:

> In lieu of imposing disqualification for pre-existing events, the proposed rules would require disclosure in the offering materials of matters that would have triggered disqualification had they occurred after the effective date of proposed Regulation Crowdfunding. We believe this disclosure would put investors on notice of events that would, but for the timing of such events, disqualify offerings under Section 4(a)(6) that they are evaluating as potential investments.[35] [footnotes omitted.]

One would think that this ought to be a "no-brainer" for the Commission. Unfortunately, it is not, much to the chagrin not only of the undersigned, but others outside the Commission who have visited this issue.

Logic and common sense alone ought to carry the day on this issue. There simply is no good reason to allow known "bad actors" to actively participate in U.S. securities markets, particularly markets such as investment crowdfunding which many believe are unusually susceptible to fraud. Simply wearing a "scarlet letter" in the form of issuer disclosure of prior misdeeds ought not to suffice, when more effective avenues are available.

Separate and apart from common sense, as Commissioner Luis Aguilar has noted in public statements, recidivists play an outsized role in the SEC's own enforcement efforts.[36] Thus, if the mission of the SEC is investor protection, while at the same time conserving the Commission's resources, it ought to lock the door on the investment crowdfunding market to known fraudsters – something it declined to do in the realm of the larger Title II market –duly noted by me in my comment letter to the SEC on the

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[34] SEC Release No. 33-9470, dated October 23, 2013, *supra*, p. 311, https://www.sec.gov/rules/proposed/2013/33-9470.pdf.

[35] SEC Release No. 33-9470, dated October 23, 2013, *supra*, p. 310, https://www.sec.gov/rules/proposed/2013/33-9470.pdf.

[36] *"Taking a No-Nonsense Approach to Enforcing the Federal Securities Laws."* Statement by SEC Commissioner Luis Aguilar at the Securities Enforcement Forum 2012, October 12, 2013.
https://www.sec.gov/servlet/Satellite/News/Speech/Detail/Speech/1365171491510#.UvnpVbTl-70

Title II proposed rules issued in July 2013.[37] And should there be any individual cases which demand an exception to this policy, the SEC maintains a simple, easily accessible procedure to apply for and obtain a *waiver* of the bad actor ban on a case-by-case basis.

Columbia Law School Professor John C. Coffee, Jr. nailed this issue, in the context of Title II rulemaking, in his commentary entitled *"'Bad Actors' and Worse Policy"* The introduction to his commentary says it all:

> Is the SEC capable of blushing? Increasingly, there are occasions in which the Securities and Exchange Commission takes positions so inconsistent with the protection of investors and its own history and so deferential to the industry that one has to ask: What were they thinking? How can a federal agency be that tone deaf?[38]

Professor Coffee follows with an insightful and irrefutable analysis, albeit too late for Title II. Should the SEC be keen on protecting *investors* in the Title III market, I suggest that final Title III rules provide that known offenders not be given the opportunity to "case the joint," even if they are wearing an easily discernable badge of fraud, as currently required by the SEC's proposed rules.

Though the SEC has already spoken to the issue of retroactivity of the "bad actor" provisions in Title II rulemaking, and proposes to go down a similar path in Title III, the SEC should resist temptation to be a "recidivist", and apply the "bad actor" provisions retroactively – covering proscribed activity which occurred *before* the implementation of the final rules.

X. CONCLUSION

The United States Congress, and now the U.S. Securities and Exchange Commission, are at an historic crossroad – between Main Street and Wall Street – and at a time and place in history where the Internet offers new opportunities, albeit with challenges, to revolutionize the way in which capital resources are allocated to small business, the engine of job creation in the United States. We find ourselves at this crossroad at a time when this country is faced by record joblessness and economic stagnation.

These challenges and opportunities come against a backdrop of a securities regulation framework borne out of the Great Depression, at a time when modes of communication were limited – both in terms of time and expense. The time has come to revisit this regulatory framework, and for both Congress and the SEC to become more proactive – and think outside of an 80 year old box.

The first area of capital formation to meet these challenges and opportunities head on is the area known as investment crowdfunding, which presents its own unique challenges – especially in terms of investor protection. Though this area is the subject of much controversy, it also presents a number of economic and regulatory opportunities.

[37] SEC Comment Letter of Samuel S. Guzik, dated August 28, 2013. https://www.sec.gov/comments/s7-06-13/s70613-312.pdf

[38] John C. Coffee, Jr., *"Bad Actors' and Worse Policy,"* The CLS Blue Sky Blog, September 23, 2013. http://clsbluesky.law.columbia.edu/2013/09/23/bad-actors-and-worse-policy/,

On the economic front, investment crowdfunding, in its purest economic form, is potentially a powerful magnet for entrepreneurial activity. Though some business models may never come to fruition, and others will be ill-conceived, there can be no doubt that investment crowdfunding offers the promise of rekindling the entrepreneurial spirit in this country - upon which this country's economy depends – as well as the future of millions of Americans entering the labor force for the first time. It may very well be that investment crowdfunding, though not suitable for many types of businesses, may provide the spark for an entrepreneurial spirit which leads businesses down other, more traditional methods of capital formation.

On the regulatory front, investment crowdfunding challenges the SEC in a number of areas which have broad policy implications for other areas of capital formation – including ongoing policy initiatives geared towards creating more efficient capital markets – such as scaled disclosure and more innovative means of investor protection – such as investor education, rather than well intentioned regulatory strangulation.

With this in mind, investment crowdfunding, though riddled with innumerable costs and complexities, ought to be carefully nurtured and developed, both by Congress and the SEC, with a view towards implementing broader policy objectives aimed at more efficient means of capital formation and smart regulation – policy considerations which cut across a variety of capital markets.

Much as the country of Spain partnered with private individuals and businesses, such as Leonardo da Vinci, in the 15th Century in search of new global trade routes, it is the responsibility of this government to partner with private individuals and businesses in search of new mediums of capital formation, facilitated by the modern wonder known as the Internet.

The time has come to combine smart technology with smart government regulation. Oddly, the place to start may be investment crowdfunding.

I would be pleased to discuss these matters further at your convenience.

Respectfully submitted,

Samuel S. Guzik
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cc: Dillon Taylor, Assistant Chief Counsel
U. S. Small Business Administration
Office of Advocacy