



**Americans for Financial Reform**  
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March 5, 2014

Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F St., N.E.  
Washington, D.C. 20549-1090

Re: Crowdfunding (File Number S7-09-13)

Dear Secretary Murphy:

Americans for Financial Reform (AFR) appreciates the opportunity to respond to the Commission's request for comment on its proposed rules to create a regulatory framework for crowdfunding. AFR is a coalition of more than 250 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.

AFR was active during the legislative debate that led to passage of the JOBS Act. Our focus was on trying to ensure that steps promoted as encouraging capital formation did not come at the expense of reasonable protections for investors. While we were disappointed by the lack of balance in the final legislation, we appreciated the fact that the crowdfunding title had been revised in the Senate to incorporate a few modest but important protections for investors. In including these protections Congress took steps to recognize the risk inherent in a market that enables unsophisticated investors to invest based on limited information in the highly risk stock of early stage start-up companies seeking seed capital.

We are therefore deeply concerned that the rules proposed by the Commission fail to deliver the key investor protections that Congress sought to provide. By proposing rules that fail to protect against the most significant risks investors face, the Commission greatly magnifies the likelihood that most investors will lose some or all of the money that they invest through crowdfunding. And, if investors burned by painful experience then shy away from this market, legitimate companies seeking to raise capital through crowdfunding will also suffer the consequences. As a result, in addition to being bad for investors, the Commission's inadequate rule proposals are also likely to undermine the ability of crowdfunding to promote small company capital formation.

While there are many aspects of the rule proposal that we believe could and should be strengthened, our comments will focus on just a few issues with the greatest potential impact on investor protection:

- The need to strengthen the investment limits and enforcement of those limits in order to reduce the risk of unaffordable losses;
- The need to impose meaningful obligations on crowdfunding intermediaries to ensure compliance by issuers;
- The need to prevent issuers from evading regulatory restrictions by conducting side-by-side offerings under different exemptions; and
- The need to better ensure that investors actually receive and understand the materials necessary to make an informed investment decision.

The Commission has clear statutory authority to adopt a more pro-investor approach in each of these areas. The remainder of this letter discusses the specific changes the Commission should make both to fulfill its statutory mandate and to meet its regulatory responsibilities to protect investors, maintain market integrity, and promote capital formation.

### **1) The proposed investment limits expose investors to risks of unaffordable losses.**

Investing in early stage start-up companies poses significant risks, as the Commission acknowledges in its economic analysis of the proposed rules. Experience teaches us that half or more of the early stage start-up companies that are expected to raise capital through crowdfunding will likely fail, with their investors losing their entire investment. In addition, early stage start-ups are notoriously difficult to value, and crowdfunding investors will likely lack both the expertise and information necessary to determine whether the valuation of any particular offering is fair. They will also lack the ability to negotiate the kind of protections against dilution that institutional investors routinely require in return for funding start-up companies. Thus, even if crowdfunding avoids becoming a mecca for fraud, the risks to investors are enormous. And it is naïve to suppose that the “wisdom of the crowd” will be sufficient to address all those risks.

Indeed, it is precisely because it recognized those risks that Congress included investment limits in the crowdfunding title. The purpose of the limits is to ensure that investors do not lose more than they can afford to when investing through crowdfunding. Unfortunately, the legislative language is ambiguous, allowing for several legally defensible approaches to setting the limit. In implementing this provision, the Commission has chosen the approach that maximizes potential investor losses. While this approach is one of several alternatives that would be consistent with the statutory language, we do not believe it is consistent with congressional intent to minimize the risks that investors would suffer damaging losses as a result of crowdfunding. It is worth noting that Congress required use of the accredited investor definition’s approach to calculating net worth precisely because it will in many instances considerably reduce the amount of money that investors can put at risk.

The Commission seeks to justify its proposed approach by arguing that maximizing the amount of money that investors can put at risk actually improves investor protection by increasing the ability of investors to be adequately diversified through investment in multiple crowdfunding offerings. In reality, any possible benefits of diversification within crowdfunding are far outweighed by the risks associated with over-investing in crowdfunding. The percentage of the

population for whom an investment of ten or even five percent of their net worth in individual stocks of start-up companies would be deemed suitable or prudent is extremely small. Far from protecting investors, the result of the Commission's proposed approach will be to maximize the number of investors who can invest a dangerously large percentage of their net worth in highly speculative investments.

As a first step in restoring the investor protections intended by Congress, therefore, we urge the Commission to adopt a "lesser of" rather than a "greater of" approach to setting the investment limits. While it would still allow investors to take out-sized risks, this one change has the potential to significantly reduce the number of investors who would suffer losses through crowdfunding that would threaten their basic financial well-being. It would therefore much better align with the congressional intent to protect investors from such serious harm.

In addition to this change, investors will only receive the full benefits of this important investor protection if the Commission adopts a more effective approach to *enforcement* of the investment limits. The Commission's proposed approach, which relies entirely on self-certification, is not adequate to enforce the individual investment limits, let alone the thornier problem of aggregate investment limits. As a result, it renders meaningless one of the most important provisions Congress adopted to ensure that the experimental effort to promote small company capital formation through crowdfunding doesn't result in devastating injury to individual investors.

At an absolute minimum, the Commission should require crowdfunding portals to collect enough data from investors to avoid the most likely errors in calculating the investment limit and to prevent evasion of those limits. For example, most investors asked to provide their net worth would include the value of their house in that number. But the statute requires that the net worth calculation be based on the accredited investor definition, which excludes the value of the home. The difference in the resulting investment limit would in many cases be dramatic, doubling or more the amount that an investor could invest in crowdfunding. It would be a simple matter to require portals to collect information from investors that would prevent this error. The Commission should require that they do so. In addition, requiring portals to collect a Social Security number would help to prevent individuals from evading limits by opening multiple accounts under false names. Neither of these requirements would significantly increase the cost of compliance, but they would significantly improve investor protection.

Enforcing aggregate limits is more challenging, but that does not justify the Commission's proposed approach, which falls well short of what Congress intended. As Sen. Jeff Merkley, a key author of the crowdfunding title stated, "Without aggregate caps, someone could in theory max out a per-company investment in a single company and then repeat that bet ten, a hundred, or a thousand times, perhaps unintentionally wiping out their entire savings."<sup>1</sup> Given the seriousness of the risk, the Commission has an obligation to propose a serious solution, and not just rely on self certification. At the very least, the Commission should require intermediaries to avail themselves of readily available information to satisfy their verification obligations. That way, if a central database were developed, portals would be more likely to use it. The Commission also could and should increase the incentive for the industry to develop a solution to this problem by sunseting their ability to rely on self-certification. This would make it easier for

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<sup>1</sup> See 158 Cong. Rec. S5476 (July 26, 2012)

a private vendor to develop a trade reporting database that could be used for verification of aggregate limits across portals. Alternatively, the portals could work with FINRA to develop such a database. But portals are only likely to support this sort of technological solution to the enforcement of aggregate investment limits if they have an incentive to do so. As long as they are permitted to rely on self-certification, they will have no such incentive.

## **2) The proposal promotes a meaningless check-the-box approach to issuer compliance.**

Many of the issuers that seek to raise capital through crowdfunding are likely to have no prior securities market experience and no legal counsel to guide them through the process. Thus, there is a high risk of compliance violations by even the best intentioned of crowdfunding issuers. Congress sought to address that problem by making intermediaries responsible for ensuring issuer compliance. The Commission rules fall short in several vitally important ways.

First and foremost, the Commission's proposal to allow intermediaries to rely on self-certification by issuers makes a mockery of its proposed requirement that intermediaries have "a reasonable basis for believing that an issuer seeking to offer and sell securities in reliance on Section 4(a)(6), through the intermediary's platform, complies with the requirements in Securities Act Section 4A(b) and the related requirements in Regulation Crowdfunding." In an online marketplace, this will quite literally promote a check-the-box approach to compliance, in which issuers are required to click a box indicating that they understand their legal obligations under the securities laws and are in compliance with those requirements. There is no reason to believe that this will do anything to prevent either fraud or the unintentional compliance errors that are likely to occur routinely among inexperienced crowdfunding issuers.

While we understand the Commission's desire to be sensitive to the compliance costs associated with its proposed rules, these do not justify ignoring both its obligation to protect investors and a clear congressional mandate to impose meaningful compliance obligations on intermediaries. After all, Congress clearly understood that there would be a cost associated with imposing this gatekeeper function on intermediaries. The Commission has an obligation to propose rules that implement that requirement in a manner that considers effectiveness as well as costs.

A key component of an effective system is an obligation for intermediaries to evaluate issuers and their offerings with an eye toward identifying compliance failures. They should be required to perform these compliance reviews before the issuer begins to raise capital. And they should have an on-going obligation to monitor communications by issuers during the course of the offering to detect and prevent violations. Intermediaries should be free to develop these compliance procedures as an in-house function or to hire an independent third party to perform compliance functions. The Commission should set appropriate standards both for in-house compliance departments and for third parties that provide these services to intermediaries, with a particular focus on independence and accountability. These reviews would be in addition to the background checks required by the statute.

The Commission's approach to the required background checks is also seriously flawed, since it does not set even the most basic standards for such checks. By failing to do so, the Commission all but ensures that some funding portals will give short shrift to this responsibility. Moreover, it

fails to provide a clear standard that the Commission can enforce against, thus limiting its ability to act to address inadequate practices. By failing to require that the background checks be made public, the Commission fails even to take advantage of the “wisdom of the crowd” in vetting those background checks. Requiring the publication of the background checks would increase the incentive for intermediaries to be thorough in their approach and to deny listings to issuers that pose a significant risk to investors. We urge the Commission to fix both these problems, by establishing basic standards and guidance for background checks and by requiring the results of the background checks to be posted on the website along with other offering documents.

One way the Commission could address cost concerns associated with this compliance requirement would be to scale the compliance obligations of intermediaries to match the size and risks of the offerings. For offerings that accept only very small investments – less rigorous reviews might be required than for offerings that allow investments up to the \$100,000 maximum. On the other hand, offerings by issuers who would be precluded from participating in crowdfunding but for the forward-looking definition of “bad actors” would need to be subject to more intensive up-front and on-going compliance reviews. Indeed, intermediaries should be free to refuse to list such offerings on the grounds that they pose an inherent investor protection risk.

### **3) The proposal creates an easy mechanism to evade regulatory requirements.**

The Commission proposes to allow crowdfunding offerings to be conducted side-by-side with offerings under other exemptions, thus providing an easy mechanism for issuers to evade regulatory restrictions. One likely result is that issuers would evade crowdfunding’s strict advertising limits by conducting a simultaneous offering under Regulation D using general solicitation. The proposed restrictions are entirely inadequate to prevent that offering from being used to condition the market for the crowdfunding offering or, alternatively, to prevent crowdfunding from indirectly promoting a Regulation D offering that does not include general solicitation. Moreover, we support the arguments from our colleagues that the proposal in this area is based on a false reading of the statute<sup>2</sup> and is inconsistent with the Commission’s prevailing policy on integration of offerings.

To prevent this and similar evasion of regulatory restrictions, the Commission should require integration of crowdfunding offerings with offerings by the same issuer under separate exemptions. To limit the ability of one offering to be used to condition the market for a separate offering, the Commission should require that offerings be separated by at least one month and preferably two months. This would create a clear standard for issuers to follow and would help to ensure that other pro-investor provisions of the Commission proposed rules – with regard to advertising restrictions, for example, and requiring crowdfunding offerings to be conducted exclusively through funding portals – are not rendered moot.

### **4) The proposal fails to ensure the investors will see, let alone review, crucial disclosures and educational material.**

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<sup>2</sup> AFR agrees with the reading of the JOBS Act rule of construction as described in comment letters from Mercer Bullard of Fund Democracy, University of Denver Law School Professor J. Robert Brown, and from Barbara Roper of Consumer Federation of America.

The Commission appropriately proposes to require that crowdfunding investors agree to accept electronic delivery of disclosures as a condition of participating in a crowdfunding offering. In doing so, however, it proposes a new definition of electronic delivery that could be satisfied by delivery of notice through an electronic message (including email or a text message, for example) that the disclosure document is available on the website of the funding intermediary. Crucial information, including warnings about the risks of crowdfunding and the risks of a particular offering, could be “delivered” through this entirely inadequate means. Given the ease of providing an actual link to disclosures in any electronic message, this is not justified.

The Commission’s own research demonstrates the challenge involved in getting investors to read and understand the disclosures they receive.<sup>3</sup> Recent research by the Consumer Federation of America discusses ways in which the Internet can be used to help overcome these barriers to effective disclosure.<sup>4</sup> In a context in which unsophisticated investors will be investing based on limited information in highly speculative securities of start-up companies, the Commission should be looking for ways to better ensure that investors actually review the required disclosures, not eroding well-conceived, decades-old requirements regarding the electronic delivery of disclosures. At an absolute minimum, the Commission must remove the portion of its definition of electronic delivery that permits delivery of a notice that does not include direct access (through a link or attachment) to the disclosures required to be provided.

The Commission could and should take several additional steps to improve the effectiveness of its disclosure requirements. It should, for example, require intermediaries to monitor whether crowdfunding investors actually access the disclosures and educational materials they receive and use those delivery methods that produce the best results. The Commission, or alternatively FINRA and the state securities regulators, should develop model educational materials, including a model interactive risk questionnaire, that funding portals could either use or use as a model in designing their own materials. This would both decrease costs for portals in developing such materials and better ensure that a basic level of quality is met in providing the required disclosures. The mandatory interactive risk questionnaire should be expanded to include additional important risks and should be designed to educate investors about, as well as test their knowledge of, key risks associated with crowdfunding. And, even if it adopts these strengthening amendments, the Commission will need to carefully monitor practices in this area to ensure that they operate effectively.

## **Conclusion**

While there will doubtless be successful businesses started and worthy projects supported through equity crowdfunding, we are extremely concerned that the public and regulators will look back on crowdfunding in five to ten years’ time as a failed experiment in which the harm to investors far outweighed any benefits to small company capital formation. The Commission’s proposed rules make that unfortunate outcome more likely, not less.

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<sup>3</sup> Staff of the Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors (As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act)*, August 2012.

<sup>4</sup> Roper, Barbara, Director of Investor Protection, Consumer Federation of America, *Can the Internet be Used to Transform Disclosure for the Better?*, January 2014.

A pervasive problem with the proposal is the Commission's prioritization of reducing the costs of compliance above seeking effective investor protections in accord with the statute and its mandate. The economic analysis accompanying the proposed rules does not give any indication that the Commission considered the investor protection impact of alternative regulatory approaches. (The one exception is its specious "investor protection" justification for an approach to investment limits that maximizes the potential for investor losses.) A second pervasive problem is the Commission's unwillingness to use its regulatory authority to address profound risks to investors even where it clearly understands the nature and extent of those risks. A prime example of this is its failure to adopt any requirements to reduce the risk that crowdfunding investors will see their investments diluted, a risk that the Commission discusses in some detail in the economic analysis. These are disturbing failures from an agency that has investor protection as its central mission.

A significant rewriting of the proposed rules will be necessary in order to provide adequate investor protections, and in some areas simply to meet the consumer protection mandates created by the statute. We have suggested several high priority areas in need of revision. While we recognize that the Commission has already fallen behind the implementation schedule set in the statute, that is a problem that is hardly unique. Rules to implement Dodd-Frank Wall Street Reform and Consumer Protection Act provisions addressing core financial security issues are even further behind schedule. The Commission must not use the rush to complete the rulemaking to justify adopting regulations that fall so startlingly short of providing the most basic provisions necessary to protect investors. Ironically, over time the result of such weak and ineffective rules would also be to undermine crowdfunding as a viable capital formation option for small start-up companies. The Commission can and must do better.

Respectfully submitted,

Americans for Financial Reform

## **Following are the partners of Americans for Financial Reform.**

*All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.*

- AARP
- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Center for Effective Government
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Green America
- Greenlining Institute
- Good Business International

- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Home Defender's League
- Information Press
- Institute for Agriculture and Trade Policy
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lawyers' Committee for Civil Rights Under Law
- Main Street Alliance
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Council of Women's Organizations
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Urban League
- Next Step
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club

- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

*List of State and Local Partners*

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC

- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- New Economy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending

- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

***Small Businesses***

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- UNET

