

United States Senate

WASHINGTON, DC 20510

COMMITTEES:
APPROPRIATIONS
BANKING, HOUSING,
AND URBAN AFFAIRS
BUDGET
ENVIRONMENT AND
PUBLIC WORKS

April 29, 2014

Hon. Mary Jo White
Chair, Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: SEC Rule Proposal on Regulation Crowdfunding (File No. S7-09-13-Release Nos. 33-9470, 34-70741)

Dear Chair White:

I write to urge the Securities and Exchange Commission (the Commission) to move forward with the proposed Regulation Crowdfunding (CF) (the Proposal). As you know, the CROWDFUND Act (the Act), which became Title III of the JOBS Act through a bipartisan amendment that secured 65 votes on the floor of the U.S. Senate, forms the legal basis for the Proposal. The Act's intent was to facilitate access to capital for small businesses and start-up enterprises through the new technologies and community innovations of crowdfunding, while protecting ordinary investors from fraud, deception, and the risks of large losses.

As has been noted repeatedly and as the various members of the Commission have highlighted, securities-based crowdfunding is inherently experimental in nature.¹ Whether it will succeed or fail depends on whether regulators, industry, and investors can take an experimental, but appropriately cautious, approach. I emphasize both experimentation and caution because failure on either front will doom the securities-based crowdfunding marketplace quickly. For small businesses to utilize it, the system must be both simple and easy; yet investors must also have confidence in what crowdfunding provides, or else they will not provide the capital into the market. I urge the Commission to keep this important lesson in mind on all issues related to crowdfunding.

I now offer several comments on the Proposal.

¹ Statement for the Record of Senator Jeff Merkley Regarding Crowdfunding in Title III of H.R. 3606, July 26, 2012, available at <http://www.gpo.gov/fdsys/pkg/CREC-2012-07-26/html/CREC-2012-07-26-pt1-PgS5474-3.htm>; Statement Regarding the Proposing Release on Crowdfunding by Commissioner Kara M. Stein, October 23, 2013, available at <http://www.sec.gov/News/Speech/Detail/Speech/1370540008723#.Uz8UAPldXjU>.

INVESTMENT CAPS MUST BE TIGHTENED SIGNIFICANTLY

Caps on the amount any individual investor can put at risk form the foundation of the caution and experimentation that are necessary for crowdfunding to work. The more effective the investment caps are, the more room the Commission has to be flexible on other matters.

I have serious concerns with the Commission's approach to investor caps in the Proposal. Permitting a funding portal² to rely on the investor's representations concerning compliance with investment limits above \$2,000 is a recipe for disaster for vulnerable investors, like senior citizens, and contrary to the statutory design. It must be changed.

Self-certification would permit a single investor to be easily over-exposed to crowdfunding – which are inherently high risk investments – through what could easily be check-the-box style agreements like consumers see when they update software. A self-certification approach opens the door to investors being defrauded across one or more platforms, an especially serious risk in affinity fraud cases.³ Again, these are precisely the risks that the Act was intended to prevent. Yet the Proposal ignores the plain intent of the Act and instead adopts the least investor-protective approach available. Moreover, it would be incredible if the verification requirements for *ordinary investors* in crowdfunding were permitting to be less than for accredited investors under Rule 506(c).

Accordingly, as an initial matter, the Commission should take the strongest possible approach for verification of qualifications to invest beyond \$2,000. After crowdfunding develops a successful track record over its first few years, the Commission could reconsider possible options for relaxing any strict initial approach.

In addition, to best protect investors in this new market, the statute specifically applies the investment caps across all platforms. In doing so, it contemplates the development of a central data repository, perhaps located at the relevant national securities association, where platforms can check whether investors are safely within the scope set out in the Act across the marketplace. Unfortunately, the Proposal does not establish such a repository or set forth any path towards its establishment and thus fails to implement the plain meaning of the statutory language. Testing, supervisory oversight, and other mechanisms to ensure investors are protected should also be more fully considered.

² Unless otherwise noted or is clear from context, references to funding portals also includes broker-dealers acting as crowdfunding intermediaries.

³ Securities and Exchange Commission, *What is an Affinity Fraud*, available at <https://www.sec.gov/investor/pubs/affinity.htm>.

The Proposal's approach with respect to net worth and annual income is also unacceptable, as it would put the most vulnerable investors at risk. The Act was designed to favor investor protections, and the statutory language gives the Commission a choice of how to interpret it. Unfortunately, the Proposal has chosen to interpret the statute in the least investor friendly approach, meaning that investors may choose between the greater of their net worth or annual income for their cap calculation. That is not consistent with the overall approach of the Act. As *The New York Times* editorialized on March 30, 2014, a retiree with \$25,000 in annual Social Security income and a nest egg of \$100,000 should not be allowed to put \$10,000 a year into crowdfunding.

In order to protect the nascent mechanism of crowdfunding from the reputation of decimating the savings of vulnerable investors and remain true to the intent of Congress, I urge the Commission to reconsider its interpretations regarding investment caps. One of the worst things that could happen to the crowdfunding marketplace would be if ordinary investors lost large amounts on securities-based crowdfunding in its early days.

CORPORATE GOVERNANCE AND ANTIDILUTION PROTECTIONS SHOULD BE STRENGTHENED

I remain very concerned regarding the lack of robust mandatory corporate governance provisions in the Proposal. The Commission must do more to ensure fairness, and not simply disclosure, with respect to the rights investors have in securities. Crowdfunding is not like investing in other contexts. It involves investments in risky early-stage or small companies, investments that are usually only made by sophisticated investors that know how to and can protect their interests. Crowdfunding investors, on the other hand, are likely not to have the experience or market power to negotiate or in some cases even understand the complicated provisions that might leave them entirely diluted or otherwise shut out from corporate decision-making. As *The New York Times* also noted in its March 30, 2014 editorial, it would be unacceptable if securities-based crowdfunding investors were treated no better than the 9,500 people who donated \$2.4 million via donation-based crowdfunding to Oculus but who received no share in the \$2 billion acquisition by Facebook.

While it may not be possible to ensure that crowdfunding investors will never be diluted, they should not be denied up front the basic rights and options that sophisticated angel and venture investors insist up routinely. These might include protections against fundamental changes in a business, anti-dilution agreements, standards to ensure shares are fairly valued, and prohibitions of practices such as non-voting preferred stock that may be difficult for the investor to understand.

At the same time, small companies may find it unwieldy to deal with hundreds of scattered crowdfunding investors without some orderly process. I believe that both small businesses and investors can obtain significant benefits from being able to have simple, standard options for taking in and managing crowdfunding investors. This could include, for example, ways to ensure that they vote together and are treated the same as a class.

If the Commission is unwilling to mandate these provisions itself (directly or through safe harbors from tougher disclosure requirements), it should direct the relevant national securities association to develop those options for the marketplace. This type of approach was expressly contemplated in the Act by the exceptionally robust disclosure mandates of the statute on these areas, which I have explained before were included in the Act in the hopes that they would both protect investors and allow the Commission or the national securities association the opportunity to provide streamlined safe harbors for standardized, investor-friendly approaches.⁴

TIMELINESS OF FINANCIAL STATEMENTS SHOULD BE TIGHTENED

I am very concerned about the timeliness of financial statements and the relevant review or audit by auditors. Under the Proposal, an issuer may use financial statements for the year *prior* to the most recently completed fiscal year, provided that the issuer was not otherwise already required to update the financial statements and updated financial statements are not otherwise available. If more than 120 days have passed since the end of the issuer's most recently completed fiscal year, the issuer must use financial statements for its most recently completed fiscal year. While the issuer would be required to include a discussion of any material changes in the financial condition of the issuer, this could allow issuers to submit financial statements that are more than a year out of date and that cover only a very limited portion of the issuer's existence, leaving out what could be critical information for investors.

Because it contemplates permitting ordinary investors to take part in relatively high-risk investments, crowdfunding rules should reflect best practices in the securities marketplace and not permit financial information (and the relevant audit or review) to be so thoroughly out of date.

⁴ Statement for the Record of Senator Jeff Merkley Regarding Crowdfunding in Title III of H.R. 3606, July 26, 2012, available at <http://www.gpo.gov/fdsys/pkg/CREC-2012-07-26/html/CREC-2012-07-26-pt1-PgS5474-3.htm>

THE COMMISSION'S SAFE HARBOR ON INVESTMENT ADVICE SHOULD BE MAINTAINED

Under the Act, funding portals (as opposed to broker-dealers) have a streamlined set of regulatory obligations in exchange for a more limited set of powers. This is perhaps most pronounced in the prohibition on a funding portal's ability to offer investment advice, which we included both because crowdfunding advocates wanted crowdfunding to rely on the "wisdom of the crowd" and because investment advice necessitates a range of obligations to protect the investor from fraud and bad advice.

The Proposal provides a safe harbor relating to the prohibition on investment advice to ensure that funding portals may engage in certain common sense business strategies and investor services, such as searches on objective terms and denial of offerings on concerns about fraud. In general, I endorse the approach taken by the Commission as it strikes the right balance between forcing a funding portal to be a "want ads" bulletin board of any issuer under the sun, while not permitting funding portals to become unregulated investment advisors.

FUNDING PORTALS MUST ENSURE COMPLIANCE WITH CROWDFUNDING RULES

Under the Proposal, the Proposal permits a funding portal to rely on the representations of the issuer concerning compliance with the Act's requirements unless the intermediary has reason to question the reliability of those representations.

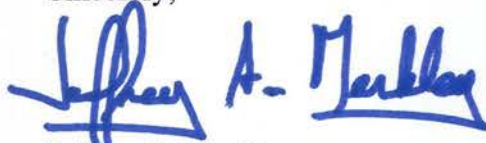
I have concerns about the Proposal's approach on these issues. One of the fundamental ways that the Act seeks to achieve streamlined access to capital for small business while also protecting investors is by placing the burden of protecting investors on the funding portals that stand between the two. Permitting a funding portal to rely on the representations of an issuer upends that statutory design, and in doing so potentially exposes small businesses and start-ups to increased costs of having to figure out how to comply and also potentially exposes investors to serious risks from the failure of those small businesses and start-ups to adequately comply. Such an approach also exposes the entire crowdfunding marketplace if a reputation for weak compliance or fraud develops. Instead, the Commission should adopt standards and guidance for what funding portals must do to ensure that an issuer has satisfied the fairly simple requirements of the Act.

THE COMMISSION SHOULD MONITOR THE MARKET AND ADJUST QUICKLY IF PROBLEMS EMERGE

The Commission should evaluate any initial framework over the first few years of its operation and adjust it quickly should problems emerge.

In conclusion, I acknowledge the hard work of the Commission staff and encourage you to move forward with a final rule soon that protects investors and facilitates the development of a new, healthy capital-raising marketplace.

Sincerely,

A handwritten signature in blue ink, appearing to read "Jeffrey A. Merkley". The signature is stylized with a large initial "J" and a long horizontal stroke at the end.

Jeffrey A. Merkley
United States Senator

cc: FINRA