SECURITIES AND EXCHANGE COMMISSION

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Comment in Response to Proposal to Implement Regulation Crowdfunding

Comment submitted by:

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Comment submitted to:

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I. Introduction and Background

My name is Chad Odhner, and I would like to offer a few comments on the Securities and Exchange Commission's ("Commission") notice of proposed rulemaking and request for comment on Regulation Crowdfunding, published in the Federal Register on November 5, 2013. I am familiar with the crowdfunding process because I have participated in several non-equity fundraising endeavors in the past through Kickstarter.com. As a musician, I personally used Kickstarter to support fellow artists and raise money for my own musical projects. I have seen how beneficial this type of crowd-based fundraising can be for projects at their beginning stages.

In addition to my background in music, I am a third-year law student at Villanova University School of Law, interested in the capital formation process and federal securities regulation. I have taken two courses on the Securities Act of 1933 and the Securities Exchange Act of 1934. Given my past experiences, I became interested in the exemption for Regulatory Crowdfunding mandated by Title III of the Jumpstart Our

Business Startups (JOBS) Act.[1] The potential for economic development through this exemption is immediately apparent to anyone who has seen crowdfunding in action, because it allows so much interaction between startups and potential investors.

II. Overview of Comments

I appreciate this chance to offer suggestions in response to a few of the Commission's specific requests for comment, and I submit the following comments solely on my own behalf. I submit the following comments to encourage the Commission to implement the crowdfunding exemption in a way that creates a capital boost for creative startup entrepreneurs, while preserving an open line of communication between issuers and the online crowd.

For many provisions of Title III, Congress did not leave the Commission much flexibility with regard to implementation. Thus, I will not focus either on what Congress should have done,[2] or on what the Commission has no authority to do under the Act.[3] Instead, my comments focus on provisions in the proposed rules that fall within the Commission's discretionary authority. I will comment on three provisions of the proposed rules, and my comments directly or indirectly support the goal of fostering an open communication between startups and potential investors.

In Part III, I summarize the intended purpose of and the regulatory context for the Crowdfunding Exemption. In Part IV, I discuss the proposed prohibition on advertising the terms of the offering. Overall, I believe that the Commission implemented this prohibition in a way that leaves an open line of communication between businesses and investors, and I offer my support for the Commission's approach. In Part V, I recommend that the Commission allow issuers to file disclosures in languages other than English. Allowing foreign language disclosures would ensure that the exemption is a viable option for all of America's diverse small businesses, regardless of their English proficiency. Finally, in Part VI, I recommend that the Commission calculate the $1 million limit, and other limits on funds raised under the exemption, as net proceeds after deducting intermediary fees and certain fixed compliance costs. Allowing issuers to deduct these costs will limit their compliance burden while encouraging a higher quality of disclosures by incentivizing startups to hire skilled legal and financial professionals to draft and audit disclosures.

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[1] Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in various sections of 15 U.S.C.).
[2] For example, many critics have argued that Title III's disclosure requirements for issuers will be costly enough to significantly limit the number of businesses that will use the exemption.
[3] For example, some commenters have suggested that the Commission should raise the exemption's $1 million limit, but the statute clearly does not give the Commission authority to do so.

III. Regulatory Background and Context for the Crowdfunding Exemption

On October 23, 2013, the Commission proposed a set of rules[4] designed to let startup companies and other small businesses sell securities through limited crowdfunding transactions for the first time (the "proposed rules"). The proposed rules—implementing Title III of the JOBS Act—are designed to make it less costly and complicated for these businesses to raise modest startup funds. Traditionally, the complex and expensive registration process under the U.S. securities laws made it prohibitive for small businesses to raise capital through public offerings of stock. Thus, small businesses have been unable to raise capital except through a limited population of "accredited investors," such as banks, wealthy people, and venture capital firms.[5]

Some creative businesses and organizations turned to crowdfunding through platforms like Kickstarter and IndieGoGo. Entrepreneurs used these websites to appeal to the online "crowd" for funding, by promoting their ideas to potential contributors through creative video presentations and other media. Individual pledges would be charged to the donor only when a project reached its stated fundraising goal. Rewards for contributions ranged from receiving the first run of a product under development, to being named in film credits.

But "investment crowdfunding"[6] was not feasible; that is, entrepreneurs previously could not offer a share of the business they were promoting, because doing so would have triggered costly federal registration requirements under Section 5 of the Securities Act. Because most small businesses and entrepreneurs seek only modest funding, it would not have been economically feasible to comply with rigorous federal reporting and disclosure requirements.

Title III attempts to address this problem by creating a crowdfunding exemption from Section 5 registration. Under the crowdfunding exemption, companies will be able to raise up to $1 million during a twelve-month period through crowdfunding, provided they meet certain requirements.

To summarize those requirements:

• The statute limits the amount that individual investors may invest, depending on their economic status, and requires investors to hold their shares for a year.

• The statute also requires issuers to make the offering through an authorized crowdfunding intermediary or "funding portal," and to make certain disclosures to

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[4] Regulation Crowdfunding, 78 Fed. Reg. 66427 (Nov. 5, 2013) (available at: http://www.sec.gov/rules/proposed/2013/33-9470.pdf).

[5] See 17 C.F.R. § 230.501(a), Rule 501(a) of Regulation D.

[6] I use the term "investment crowdfunding" rather than "equity crowdfunding" because the exemption appears also to allow for the sale of non-equity securities, such as bonds and other debt instruments.

investors and the Commission, including yearly financial reports that must be independently audited if the company raises over $500,000.

The hope is that the exemption—which relaxes the onerous disclosure requirements under federal securities regulations—will boost the economy by generating a new capital stream for creative, startup entrepreneurs. Startups will be able to connect for the first time with a class of small, collaborative investors that have previously been excluded from the venture capital process due to their "unaccredited" status.

IV. Comment on the Prohibition on Advertising the Terms of the Offering

Summary of comment: The Commission clarified this prohibition in several important ways and I support the proposed approach.

Title III of the JOBS Act imposes a limitation on advertising the offering as follows. Under Section 4A(b)(2), an issuer is prohibited from "advertis[ing] the terms of the offering, except for notices which direct investors to the funding portal or broker."[7] The scope of this prohibition is not clear from the text of the statute, which does not define "advertise" or "terms of the offering" or "notice." Crowdfunding depends on an open and candid line of communication between issuers and potential investors.[8] The statute's ambiguous prohibition on advertising, if implemented improperly, threatens to severely limit this beneficial communication.

In the absence of clear statutory guidelines, the Commission clarified this prohibition in two important ways. First, Rule 204 of the proposed rules states:

> Notwithstanding the prohibition on advertising the terms of the offering, an issuer may communicate with investors and potential investors about the terms of the offering through communication channels provided by the intermediary on the intermediary's platform, provided that an issuer identifies itself as the issuer in all communications.[9]

The Commission seeks feedback on whether this approach is appropriate,[10] and I believe it is. Early proponents of the Crowdfunding exemption based the crowdfunding model on websites like Kickstarter and IndieGoGo, which allow artists and entrepreneurs

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[7] Section 4A(b)(2).
[8] The Commission appears to share this conception of crowdfunding. The proposed rules refer to the "original concept of crowdfunding, in which the public – or the crowd – is presented with an opportunity to invest in an idea or business and individuals decide whether or not to invest after sharing information about the idea or business with, and learning from, other members of the crowd." 78 Fed. Reg. 66430.
[9] 78 Fed. Reg. 66555 (Proposed Section 227.204).
[10] 78 Fed. Reg. 66455 (Question 103).

to market their projects through creative, multi-media campaigns. These crowdfunding platforms harnessed the "wisdom of the crowd" by allowing potential contributors to ask questions about and comment on the project. Thus, the members of the crowd would decide whether they wanted to support a venture only after they had shared information with each other about the venture's merit. This crowdfunding model moves beyond simple product marketing—relying heavily on social awareness, aesthetic, and other emphases to appeal to passionate small investors interested in supporting startup projects.[11]

I interpret the Commission's approach to mean that issuer's will be permitted to engage in these types of promotional activities, and communicate with the crowd about the business or idea being funded, as long as they do so through the intermediary site. I also interpret the proposed rules to mean that crowdfunding intermediary sites could continue to host issuers' videos and other promotional content, similar to the marketing content found on websites like Kickstarter. This approach will allow the issuer to communicate freely and creatively about the offering and the project, while giving the crowd a forum to ask questions or offer criticism. Issuers will be able to respond to such questions and concerns as long they identify themselves to potential investors at all times.

This approach also adds a layer of investor protection. When the crowd is allowed to comment and share information, it is more likely that red flags will be spotted about potential fraud, a poor business track record, or excessive risks associated with a venture. The whole crowd gets information from commenters with specialized knowledge about particular elements of the project. This broad crowd participation benefits the whole crowdfunding movement by giving a voice to investors that have not had the opportunity to be heard in the traditional venture capital model, helping to alleviate traditional problems in venture capitalism, such as tunnel vision resulting from a non-diverse investor base.

V. Comment on Foreign Language Electronic Filings

Summary of comment: The English-only requirement for electronic filings places a disproportionate, and potentially prohibitive, burden on minority businesses and should be removed from the final rules.

Hispanic and other immigrant businesses constitute a vital piece of the American economy, but already have a difficult time accessing credit.[12] The crowdfunding

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[11] As a hypothetical example, people with a chronic disease like diabetes might be drawn to support a company that is developing a more convenient and reliable blood glucose testing device.

[12] See LatinoMagazine.com, "Special Report" http://www.latinomagazine.com/special_report/special_report.htm (survey of Latino businesses revealed that top concern was gaining better access to credit).

exemption has the potential to provide a much-needed boost to this population by empowering entrepreneurs to raise money for projects that benefit their local communities. Section 4(a)(6) requires numerous and complicated disclosures about the issuer's business and finances to be made to the public and filed electronically with the Commission. But proposed Rule 306 requires that these electronic filings be made in English. The Commission seeks comment as follows:

> Should we amend Rule 306 to permit filings by issuers under the proposed rules to be filed in the other language?[13]

I urge the Commission to amend Rule 306 in this way. I believe the current approach is undesirable for three reasons. First, the proposed English-only requirement places a disproportionate, and potentially prohibitive, burden on issuers who principally communicate in languages other than English. In turn, potential investors who do not speak English primarily will have fewer opportunities to participate in crowdfunding venture capitalism. Second, the current approach is inconsistent with the rest of the proposed disclosure regime, which emphasizes that issuers and intermediary sites will be able to "determine the format that best conveys the required disclosures" to potential investors. This flexibility should include determining which language or languages disclosures should be made in. Finally, the current approach does not add any protection against fraud because investors who only speak English can simply ignore offerings in other languages. On the other hand, there is actually a greater risk of misstatements being made about an offering and its terms if the issuer is forced to attempt to make disclosures in less than proficient English.

One potential difficulty for the Commission in permitting electronic filings in languages other than English is that the Commission will need to employ translators to complete the review process for these filings. However, other aspects of the proposed rules will already require this. For example, the Commission states:

> The proposed rules would not, however, prevent an issuer from providing to the relevant intermediary both an English and a foreign language version of the information for the intermediary to make publicly available through its platform.[14]

The Commission will already be required to monitor foreign language disclosures made through intermediaries. Thus, allowing electronic filings to be made in languages other than English would not impose a significant administrative burden on the Commission. Conversely, requiring English disclosures would place a significant, and potentially prohibitive, burden on some small businesses.

[13] 78 Fed. Reg. 66438 (Question 22).
[14] 78 Fed. Reg. 66438, No. 90.

All these reasons support allowing issuers to make electronic filings and disclosures in foreign languages. The crowdfunding exemption has the potential to be a lifeline to small businesses, and it should be implemented in a way that makes it a viable option for all of America's diverse small businesses, regardless of their English proficiency.

VI. Comment on Calculating the $1 Million Limit

Summary of Comment: To incentivize high quality disclosures, the $1 million limit should be calculated as net proceeds after intermediary fees and certain fixed regulatory compliance costs.

Title III imposes a clear $1 million dollar limit on how much a company can raise during a twelve-month period under Section 4(a)(6). The statute does not appear to provide the Commission with authority to change this limit,[15] but it leaves the Commission room to determine what funds should be counted toward that limit. For example, the proposed rules do not require funds raised under other federal exemptions to be counted toward the limit.[16] The Commission could similarly propose rules that let issuers deduct certain regulatory compliance costs from the limit, such as intermediary fees, auditing fees, or legal fees.

The proposed rules do not include any such deduction, but the Commission seeks comment as follows:

> Should we propose that the $1 million limit should be net of fees charged by the intermediary to host the offering on the intermediary's platform? Why or why not? If so, are there other fees that we should allow issuers to exclude when determining the amount to be raised and whether the issuer has reached the $1 million limit?[17]

I believe the Commission should allow issuers to calculate proceeds under the exemption as the net of total proceeds after deducting certain costs that are necessary to comply with the exemption. Such costs should include the following: (1) fees charged by the intermediary site for hosting the offering, (2) auditing fees incurred pursuant to the

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[15] The JOBS Act does require the Commission to update the limit every five years based on inflation, but this is not discretionary.

[16] See 78 Fed. Reg. 66432 ("We believe that the overall intent of providing the exemption under Section 4(a)(6) was to provide an additional mechanism for capital raising for startup and small businesses and not to affect the amount an issuer could raise outside of that exemption. Thus, we believe the capital raised in reliance on the exemption provided by Section 4(a)(6) should be counted toward the limitation. Capital raised through other means should not be counted.").

[17] 78 Fed. Reg, 66432 (Question 1).

exemption's requirement for disclosure of audited financials, and (3) legal fees incurred in drafting disclosures in compliance with the exemption.

Concededly, allowing issuers to deduct these fees could introduce some confusion regarding the $1 million limit. Intermediary fees are generally tied to the amount raised, and different sites will charge varying percentages as commissions for hosting crowdfunding offerings. Thus, allowing companies to deduct these fees could lead to inconsistency in the total maximum that the exemption permits issuers to raise. For example, if Intermediary A charged a commission rate of 6% of the proceeds of the offering, companies would be able to raise $1,063,800, and still come in under the $1 million limit after netting out an intermediary commission of 6%, or $63,828. If Intermediary B charged a commission rate of 10%, companies using that intermediary could raise $1,111,000 and still come in just under the $1 million limit. Thus, deducting these costs could potentially create confusion as to what the actual maximum allowable offering is under the exemption. It may also be difficult for issuers or the Commission to determine which legal and accounting services were directly required by the exemption, and which might have been incurred anyway. For example, a financial statement audit is required, but the company may have had an audit performed prior to making a Section 4(a)(6) offering.

However, I believe the Commission could include this beneficial deduction without creating confusion by capping the total amount of fixed costs that can be deducted. Imposing a cap would create a clear total maximum limit on proceeds. In other words, the exemption would allow issuers to deduct fixed costs associated with regulatory compliance up to a certain capped limit. My recommendation is to allow $150,000 in compliance costs over the $1 million limit, but this number could be revised based on the Commission's estimates of compliance costs.

To implement this deduction, I propose adding the following language to Section 227.100(a):[18]

> *Instruction to paragraph (a)(1).* In determining the amount that may be offered and sold in reliance on Section 4(a)(6) in light of the $1 million aggregate limitation, issuers may deduct up to $150,000 of the following costs from their total proceeds:
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> (1) Commission fees paid to the intermediary site hosting the offering;

[18] In addition to the $1 million limit, the Commission should consider allowing issuers to make similar deductions for the purpose of determining what level of financial statement is required. Rule 201 requires an expensive public audit if the offering is greater than $500,000. If an issuer could deduct intermediary hosting and legal drafting fees, then the total proceeds could be over $500,000 without triggering the requirement of a public audit.

(2) Third party legal fees associated with drafting of disclosures required by Section 4(a)(6); and
(3) Third party accounting and auditing fees associated with disclosures required by Section 4(a)(6).

One benefit of my proposed instruction is that it will help defray the otherwise heavy cost of compliance for large offerings. But my approach also benefits investors by incentivizing issuing companies to expend more resources on drafting high quality disclosures and choosing a high quality intermediary to host the offering. This in turn will lead to more information being provided to the crowd.

VII. Conclusion

To conclude, I want to applaud the Commission for overcoming leadership changes, a heavy regulatory workload, and a complex list of statutory mandates to publish proposed rules for Regulatory Crowdfunding. It is clear that the Commission took the first round of public comments to heart and incorporated many ideas from commenters. Overall, I really believe that the Commission struck a good balance between protecting investors and crafting an exemption that will work. And most of my comments today reflect that approval. My primary goal with the above comments is to help the Commission create an exemption that small businesses can actually use, and that encourages open communication between entrepreneurs and the crowd.