

## **SUSTAINABLE ECONOMIES LAW CENTER**

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Elizabeth M. Murphy  
Office of the Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549

July 1, 2010

RE: Petition for Rulemaking: Exempt securities offerings up to \$100,000 with \$100 maximum per investor from registration.<sup>1</sup>

Dear Ms. Murphy:

The Sustainable Economies Law Center (SELC) is a non-profit organization working to facilitate the growth of sustainable, localized, and just economies through legal research, professional training, resource development, and education.<sup>2</sup> One of our primary development areas is community-supported entrepreneurship – providing resources to communities to grow through local involvement and investment. Our experience with the investment hurdles facing small business and commitment to promoting local growth provide the basis for this rulemaking petition.

The current registration requirements under Section 5 of the Securities Act of 1933, as well as existing exemptions from registration, impose considerable hurdles on small businesses. In an increasingly interconnected world, much potentially valuable intellectual property originates with low-budget creative ventures. Popular technologies and products are developed in garages, and major motion pictures are adapted from comic books and short indie films. Thanks to decreasing technology costs, many such efforts require little expenditure beyond the living expenses needed for people to devote time to them. Similarly, local businesses and other collaborative ventures can launch or expand to better serve their communities through relatively small expenditures: a build-

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<sup>2</sup> For more information about SELC, please visit <http://www.sustainableeconomieslawcenter.org>.

out for a popular café, land use rights for a community garden, a small stage and PA system for an independent bookstore.

These small enterprises are often stifled because of an inability to raise funds. Even though there may be no shortage of interested investors, and no shortage of capacity for these small enterprises to reward their investors, securities regulations create a prohibitive hurdle. Registration is costly, and there is currently no exemption that allows these projects to raise capital from the types of investors that would be most inclined to invest in them – community, customers, neighbors, and friends who are mostly unaccredited – without spending tens of thousands of dollars in legal fees. (See attached detailed comments on why existing exemptions are not sufficient for small businesses.)

Because of these concerns, we propose a new exemption for securities offerings up to \$100,000 with a limit of \$100 per investor. These small investments can be a powerful source of grassroots and local funding for developing small businesses. The small amount at stake and maximum aggregate cap ensure the protection of investors while furthering the public interest in this type of investment.

We hereby petition the U.S. Securities and Exchange Commission to issue, pursuant to Rule 192(a) of the Rules of Practice, a new rule, exempting securities offerings up to \$100 from Section 5 registration and from the extensive requirements imposed on exempt private and small offerings.

We welcome and encourage further discussion with Commission rulemakers on this issue. Please contact Jenny Kassan, Co-Director of SELC, at [jkassan@sbcglobal.net](mailto:jkassan@sbcglobal.net) or (510) 529-1860 with any comments or questions.

Thank you.

Sincerely,



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## **BASIS FOR REQUESTED ACTION**

### **A. This exemption is necessary to further small business growth.**

Small businesses cannot absorb the costs associated with the current regulatory structure. Registering a securities offering can be “an absolute bar to the very smallest offerings and a substantial impediment to slightly larger offerings.”<sup>3</sup> Registration costs and even costs to conduct an offering under an existing exemption involve legal fees, accounting fees, printing costs, filing fees, and substantial time for company employees preparing the offering.<sup>4</sup> Because many of these costs are fixed, they consume a larger portion of the funds raised for small offerings.<sup>5</sup> Though the actual time span varies, there is also a significant delay between the filing of a registration statement and the date it becomes effective. New and small businesses are often unable to withstand the financial pressure of this forced delay.

The public has already demonstrated an interest in making the types of small investments we propose the Commission exempt. Through websites like Kickstarter, Spot.U.s, IndieGoGo, and RocketHub (“crowdfunding sites”),<sup>6</sup> people currently raise funds for such projects by describing them online and accruing small donations from large numbers of people. This process is called “crowdsourced fundraising” or “crowdfunding.” As part of their online solicitations, people seeking donations typically promise rewards to their donors upon successful funding and completion of the projects, such as t-shirts, meals, or recognition. These rewards are usually structured into a hierarchy that encourages generosity, in much the same way that public television stations send tote bags, DVDs, books, and event invitations to varying levels of contributors.

Currently, crowdfunding is not subject to securities regulation because no return on investment is offered, but the moment a crowdfunding campaign offers any kind of financial return, it becomes illegal under securities regulations. Nevertheless, crowdfunding campaigns are already raising thousands of dollars for projects as diverse as films, software development, investigative journalism, urban gardens, and more. The success of these crowdfunding sites demonstrates the desire of the public to support projects that they believe in, and enabling the additional possible motivation of financial return would only reinforce this economically healthy impulse. The availability of donations is beneficial, but financial investment in a project or enterprise can bring

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<sup>3</sup> Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 24 (2001).

<sup>4</sup> *Id.*

<sup>5</sup> The Advisory Committee on Capital Formation acknowledges, “[f]or smaller companies and newer entrants to the capital markets, the fees paid to the Commission, state regulators, accountants, lawyers, underwriters, and financial printers amount to a larger percentage of offering proceeds than for more seasoned issuers. Report of the Advisory Committee on Capital Formation and Regulatory Processes, Fed. Sec. L. Rep. (CCH) Special Report No. 1725, at 44 (July 24, 1996), available at <http://www.sec.gov/news/studies/capform.htm>.

<sup>6</sup> See generally <http://kickstarter.com>, <http://spot.us>, <http://indiegogo.com>, and <http://rockethub.com>.

greater psychological investment, and this greater interest can inspire participation that better leverages people's collective talents. By allowing supporters to benefit financially from their support, crowdfunding sites have the potential to become even richer sources of innovation and capital formation. This type of grassroots investment is a behavior that should be rewarded and supported rather than discouraged.

In addition to the protection of investors, the Commission must consider whether a new rule will “will promote efficiency, competition, and capital formation.”<sup>7</sup> An evaluation of efficiency requires comparing the costs of registration to its benefits. The Securities Act of 1933 suggests “the benefits of registration should correlate with the size of the offering.”<sup>8</sup> Thus, the less capital risked by investors, the less benefit extensive regulation provides. Because a standard Commission registration often costs more in legal fees than funding the project itself<sup>9</sup>, registration or even current exemptions are inefficient for offerings where each investor can only lose a maximum of \$100. An exemption for a de minimis offering promotes the goal of the Commission to promote capital formation with very minimal investor risk. As the high levels of activity on web-based crowdfunding platforms demonstrate, the public would favor the adoption of this exemption and micro-business would benefit immeasurably.

## **B. Current Registration Exemptions are Insufficient.**

Although there are legal ways for small businesses to offer and sell securities without registering with the Commission, none allow these businesses to raise small amounts of capital from many people in an affordable way.

### **1. Intrastate offering exemption**

Section 3(a)(11) allows local businesses to avoid registering with the Commission, however all offers and sales of securities are limited to residents of the state in which the business is incorporated. The Commission acknowledges the difficulty of qualifying for this exemption in the “Q&A” section of its website.<sup>10</sup> The intrastate limitation is severely restrictive as the exemption is lost if securities are offered or sold to even one out-of-state person. Further, even if a business is only operating in one state, state securities laws impose legal and regulation costs similar to the federal registration process.

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<sup>7</sup> 15 U.S.C. § 77b (Section 2(b) of the Securities Act).

<sup>8</sup> *Id.* at 29.

<sup>9</sup> Tim Kappel, *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?*, 29 *LOY. L.A. ENT. L. REV.* 375, 384 (2009).

<sup>10</sup> “It will be difficult for your company to rely on the intrastate exemption unless you know the purchasers and the sale is directly negotiated with them. If your company holds some of its assets outside the state, or derives a substantial portion of its revenues outside the state where it proposes to offer its securities, it will probably have a difficult time qualifying for the exemption.” Q&A: Small Business and the SEC, U.S. Securities and Exchange Commission, <http://www.sec.gov/info/smallbus/qasbsec.htm#eod6> (Last visited June 10, 2010).

## 2. Regulation D

Regulation D establishes three different exemptions under the Securities Act. Rule 504 permits an offer or sale of up to \$1 million in a twelve-month period. However, the offering must comply with the law in each state where the securities are sold. Thus, the multitude of state law requirements often offset any costs saved by the federal registration exemption.<sup>11</sup>

Rule 505 provides an exemption for offers and sales of securities totaling up to \$5 million in any twelve-month period. This avenue is still costly, for disclosure documents that must be given to unaccredited investors “generally are the same as those used in registered offerings.”<sup>12</sup> And both Rules 505 and 506 cap the number of unaccredited investors to just 35 per offering. Rule 506 further requires that the unaccredited investors be “sophisticated”—“they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.”<sup>13</sup> Often members of a community want to invest in friends and family—people they trust. The willingness to invest does not come solely from a desire for profit, but to support a specific project while also participating with others in its success. Requiring business or financial expertise for investments of \$100 from people inexperienced in financial and business matters is not only impractical, but also unnecessary.

## 3. Regulation A

This exemption appears promising to small businesses as it was created “to exempt from registration small securities offerings.”<sup>14</sup> There are no limits on the number of investors and no restrictions on investor qualifications, as with Regulation D. However, as the Commission acknowledges, “Regulation A offerings share many characteristics with registered offerings.”<sup>15</sup> In practice, many companies cannot use the simplified SCOR Form U-7 because they are trying to raise more than \$1 million. Further, because companies still need to provide audited financials if they prepare audited financials for other reasons, most will be required to submit audited financials as most states require them. The cost to conduct a Regulation A offering is almost as great as a full registration and therefore prohibitive for most small business.

## 4. Private offering exemption

Section 4(2) of the Securities Act exempts “transactions by an issuer not involving any public offering” from registration with the Commission. The investors

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<sup>11</sup> Tim Kappel, *supra* note 9, at 384.

<sup>12</sup> Q&A: Small Business and the SEC, U.S. Securities and Exchange Commission, <http://www.sec.gov/info/smallbus/qasbsec.htm#eod6> (Last visited June 10, 2010).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

must be “sophisticated”, and are subject to the same standards as under Rule 506 of Regulation D. This provision is not sufficient, partly because of its uncertainty—“The precise limits of this private offering exemption are uncertain. As the number of purchasers increases and their relationship to the company and its management becomes more remote, it is more difficult to show that the transaction qualifies for the exemption.”<sup>16</sup> Further, capping the number of unaccredited investors at 35 is inconsistent with the Supreme Court’s finding that the exemption applies regardless of the number of offers.<sup>17</sup> The Commission has further explained that, “the number of persons to whom the offering is extended is relevant only to the question whether they have the requisite association with and knowledge of the issuer which make the exemption available.”<sup>18</sup> This Section could serve as an appropriate avenue for an exemption for de minimis offerings, but would require additional clarification.

### **C. Purpose of the Amendment is consistent with the proposed Reform Act**

Creating approximately two out of three new jobs in the country, small businesses are the heart of the American economy.<sup>19</sup> A recent study showed that businesses with fewer than five employees have created all of the net new jobs between 1989 and 2005.<sup>20</sup> Thus, helping small businesses to launch and expand will help lead economic recovery. Although the government established several tax cuts and supported nearly \$29 billion in new lending, President Obama recently noted that, “too many entrepreneurs can’t access the capital to start, operate, or grow their business.”<sup>21</sup>

Further, more loans only mean more debt. Reform that helps small businesses raise equity, not just debt, will allow businesses to better grow because they will not suffer the high cost of servicing debt, the risk of insolvency, or restrictions that result from carrying liabilities on their balance sheet. The current regulatory requirements make access to capital even more difficult for small businesses that are trying to raise less than \$100,000, and they do nothing to help stimulate the part of the economy that has always led the U.S. out of recession – very small business. With no de minimis dollar

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<sup>16</sup> *Id.*

<sup>17</sup> See *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) (“the statute would seem to apply to a ‘public offering’ whether to a few or many.”)

<sup>18</sup> Final Rule: Nonpublic Offering Exemption, Release No. 33-4552, U.S. Securities and Exchange Commission, available at <http://www.sec.gov/rules/final/33-4552.htm>.

<sup>19</sup> Remarks by the President on Small Business Jobs Initiative, Office of the Press Secretary, The White House, available at <http://www.whitehouse.gov/the-press-office/remarks-president-small-business-jobs-initiatives> (Last Visited June 15, 2010).

<sup>20</sup> Terry Bibbens & Philip Borden, *Very Small Business Creates Very Large Change*, 7 UWEST MIN. & SM. BUS. REV., Jan. 20, 2009, at 2, available at <http://www.google.com/url?sa=t&source=web&cd=1&ved=0CBiQFjAA&url=http%3A%2F%2Fwww.essergy.net%2FVERY%2520SMALL%2520BUSINESS%2520-%2520FINAL-1-20-09w.cover%2520.pdf&rct=j&q=small+businesses+create+very+large+change&ei=HhUhTNaEGpbqnQfx5uly&usg=AFQjCNGAba-29FYLZaUBqp8jv6CWuChXwg>.

<sup>21</sup> Barack Obama, U.S. Pres., Obama’s Speech to Small Business Owners (Mar. 16, 2009), available at <http://politics.mynyc.com/2009/03/full-text-obamas-speech-to-small-business-owners/>.

cutoff in the regulatory framework below which extensive compliance costs stop, potential investors are deterred right now from investing small amounts that they would like to be able to put into their local economies.

## **D. Requested Action**

### **1. Description of the Proposed Amendment**

We request the Securities and Exchange Commission adopt a rule exempting individual purchases of securities totaling \$100 or less from registration requirements and from all other requirements other than those described below. It is our belief that exemption of these small investments is necessary to promote sustainable, local enterprise and that the Commission can grant the exemption while preserving its aims of protecting investors while furthering the public interest.

We propose the following limitations on the proposed exemption. The limitations serve to protect investors—who we anticipate will often be members of the population inexperienced in complicated financial transactions—while still allowing this type of small-scale investment with minimal cost.

- 1) No purchaser may invest more than \$100.
- 2) The aggregate offering is limited to \$100,000 maximum.
- 3) Offerors must be individuals. Offerors may not be entities, and must be United States Citizens or legal residents.
- 4) No offeror may have more than one offering open at any time.
- 5) All offering materials and communications must contain a disclaimer clearly stating the possibility of total loss of the investment, and the necessity of careful evaluation of each offeror's trustworthiness by the individual purchaser.

### **2. Detailed Comments on investment limitations**

- 1) *\$100 maximum investment.* The limitation of a \$100 maximum investment by each purchaser ensures investor protection by preventing individuals from incurring significant financial risk. Even a total loss of \$100 is unlikely to be financially crippling for anyone considering investment.

At the same time, the cap on investment furthers the public interest by giving small business owners an alternative method to raise capital. This type of grassroots capital raising allows the offeror to make a meaningful community connection, which is likely to promote growth and widespread customer support. It encourages business owners to connect with other individuals in the area where their business operates, while simultaneously encouraging community members to financially support new ventures in which they have a small financial stake.

- 2) *The aggregate offering is limited to \$100,000 maximum.* The aggregate maximum of \$100,000 furthers the public interest by preventing large devastating aggregate losses in a single community.

- 3) *Offerors must be individuals. Offerors may not be entities, and must be United States Citizens or legal residents.* This limitation protects investors by minimizing the opportunity for fraud. If every offeror has an identity that may be verified, individuals attempting to manipulate the structure can be easily detected. No one utilizing this small-scale investment mechanism should be permitted to hide behind a corporate shell. This protects investors by ensuring accountability and minimizing the risk for fraud.
- 4) *Offeror is limited to one offering at a time.* This limitation works with the previous requirement to minimize the risk of fraud. Requiring that each offeror be limited to one open offering at a time prevents offerors from defeating the \$100,000 maximum offering of \$100,000 by conducting several offerings at the same time.
- 5) *All offering materials and communications contain a disclaimer clearly stating the possibility of total investment loss, and the necessity of careful evaluation of each offeror's trustworthiness by the individual purchaser.* This limitation ensures that the investor understands the risk of losing the entire \$100 investment. Other required disclosures could include:
  - a. Investments and returns on investments are not FDIC-insured and are not guaranteed. Investments are risk-bearing and speculative—you should therefore only make an investment you can afford to lose. Investments may lose value and there is a risk of total loss of your investment.
  - b. The Securities and Exchange Commission does not regulate, recommend, or endorse the purchase of these securities.
  - c. Do not invest any money unless you have determined for yourself that the offeror is trustworthy and can be relied upon to use the investment funds in a prudent manner.

### **Private Offering Exemption vs. Small Offering Exemption**

We have examined the Securities Act to determine the appropriate section under which this proposed rule could be made. Both Section 3(b) and Section 4(2) are possibilities. We welcome discussion with the Commission on the best placement for this new exemption.

Section 3(b) is an appropriate avenue for this measure in that it grants the Commission the power to:

*Add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering...*



Investments of this character—capped at \$100—should not rise to the level of interest or administrative procedure that Section 5 of the Securities Act of 1933 requires. By placing appropriate limitations on the requirements to offer and purchase these small investments, the Commission minimizes the already small risk to investors while promoting the growth of community enterprise, small business, and the development of local economies.

Alternatively, Section 4(2) is also an acceptable provision for this exemption. Section 4(2) exempts private offerings from the Section 5 filing requirements. If the rule were made under Section 4(2), no general solicitation would be permitted and offerors would be required to limit their search for investors to persons with whom they have a pre-existing relationship. This limitation might be appropriate given the fact that this sort of investment is most likely to be based on existing relationships and trust.<sup>22</sup> Another benefit of creating this rule under Section 4(2) is that it would exempt these de minimis offerings from state-level regulatory requirements under the National Securities Markets Investment Act.

We respectfully request the Commission promptly create a new rule exempting de minimis investments. We are confident the social and economic response to the proposed rules will be significant and beneficial.

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<sup>22</sup> This rule may also necessitate clarification on the question of whether solicitation via "friend" connections in an online social network is consistent with private offering.