COLORADO LAW
UNIVERSITY OF COLORADO BOULDER

Andrew A. Schwartz
Professor of Law
Wolf Law Building | 401 UCB
Boulder, Colorado 80309-0401
[redacted] | [redacted] fax
[redacted]

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United States Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: Comment on File Number S7-08-19

Dear Securities and Exchange Commission:

In response to your Concept Release on Harmonization of Securities Offering Exemptions (File No. S7-08-19), I offer the following comments on Part II.F regarding Regulation Crowdfunding (Questions 79-92).

By way of introduction, I am a Professor of Law at the University of Colorado Law School in Boulder, Colorado, and I have spent the better part of the past decade researching, publishing and speaking on equity crowdfunding.[1] My focus has been on domestic crowdfunding pursuant to the JOBS Act and Regulation Crowdfunding, but I have also studied the legal framework for equity crowdfunding in numerous foreign jurisdictions, including Korea, Australia, Canada, the United Kingdom, and New Zealand, the last as a Fulbright Scholar. This international experience has given me a broad perspective on how to engineer an effective regulatory scheme for equity crowdfunding, and I have shared my research and ideas in numerous articles, including the following, which I hereby incorporate by reference:

- *The Gatekeepers of Crowdfunding*, 75 WASHINGTON AND LEE LAW REVIEW 885 (2018)
- *Equity Crowdfunding in New Zealand*, 2018 NEW ZEALAND LAW REVIEW 243
- *Inclusive Crowdfunding*, 2016 UTAH LAW REVIEW 661
- *The Digital Shareholder*, 100 MINNESOTA LAW REVIEW 609 (2015)
- *Teenage Crowdfunding*, 83 UNIVERSITY OF CINCINNATI LAW REVIEW 515 (2014)
- *Rural Crowdfunding*, 13 U.C. DAVIS BUSINESS LAW JOURNAL 283 (2013)
- *Crowdfunding Securities*, 88 NOTRE DAME LAW REVIEW 1457 (2013)

Equity crowdfunding offers an exciting opportunity for retail investors to participate in private offerings that are currently offered only to accredited investors, and for entrepreneurs of all stripes to obtain the capital they need. But because issuers can only raise a small amount via crowdfunding, the system can only work if the legal framework is simple and the regulatory burden light. Our current system for equity crowdfunding is complex and overregulated, however, with the result that very few issuers or investors are participating in the market. We can do better. As explained below, and based on the example set by New Zealand, I recommend that we reform equity crowdfunding to minimize compliance costs by encouraging private ordering methods (specifically 'gatekeeping' and 'syndication') of investor protection.

[1] Also known as securities crowdfunding or investment crowdfunding.

Question #79

No. The requirements of Regulation Crowdfunding clearly address investor protection considerations, as evinced by the total lack of fraud—or even bankruptcy—among issuers,[2] but they do not appropriately address capital formation. By imposing significant disclosure and regulatory hurdles, Regulation Crowdfunding imposes high costs on issuers relative to the low level of funding startups can and do obtain, dissuading issuers from relying on the exemption.

There is a better way. My Fulbright research shows that the simpler, more lightly regulated form of equity crowdfunding practiced in New Zealand better achieves the dual goals of capital formation and investor protection.[3] New Zealand's equity crowdfunding law was expressly modeled on the JOBS Act, and went into effect in 2014, two years ahead of our own. But New Zealand did not slavishly copy the JOBS Act. Rather, they enacted a simpler and more liberal legal regime for equity crowdfunding than in the United States. Among the major differences between Regulation Crowdfunding and its counterpart in New Zealand:

- New Zealand has no mandatory disclosure and no equivalent to 'Form C';
- New Zealand has no individual investment limits;
- New Zealand has no restrictions on advertising.

Could such a lightly regulated system succeed? Would people really invest their hard-earned money in strangers' speculative start-up companies, over the Internet, without the usual set of government regulations and mandatory disclosures? As I explained in *The Gatekeepers of Crowdfunding*[4] and *Equity Crowdfunding in New Zealand*,[5] the answer is Yes. The minimal regulation imposed in New Zealand keeps costs very low and encourages capital formation, and the structure of the market relies on private ordering to protect investors.

In economic terms, New Zealand's equity crowdfunding market is orders of magnitude more successful than its American counterpart: Scaled for the size of its economy, and focusing on the first year in each jurisdiction, New Zealand had *thirteen times* as many crowdfunding campaigns, which collectively raised about *thirty times* as much capital, than the United States. Furthermore, zero instances of fraud have been reported since equity crowdfunding began in New Zealand in 2014. (We have a similarly clean record, but at a much higher cost.)

How has New Zealand achieved such impressive results? First, it keeps costs very low for issuers by exempting them from mandatory disclosure and other obligations, like annual reports. Second, it established a legal framework where private ordering—gatekeepers and syndication—can effectively protect investors.

On the first point, the cost of conducting a crowdfunding offering in New Zealand is much lower than the United States, because New Zealand completely exempted crowdfunding companies from the usual disclosure and registration obligations, placing the primary regulatory

[2] SEC Staff, *Report to the Commission on Regulation Crowdfunding* (June 18, 2019) [hereinafter, Staff Report] at 42, 44-45.

[3] New Zealand provides a useful comparison to the United States because both countries have similar histories and legal structures, including with regard to securities regulation. Furthermore, fraud and misconduct are unfortunately common occurrences in both countries. *See* Andrew A. Schwartz, *The Gatekeepers of Crowdfunding*, 75 WASH. & LEE L REV. 885, 915-19 (2018).

[4] *Id.*

[5] Andrew A. Schwartz, *Equity Crowdfunding in New Zealand*, 2018 N.Z. L. REV. 243.

onus on the Internet platforms that act as online stock exchanges. Our domestic legislation, by contrast, retained traditional concepts of mandatory disclosure and standard forms.

On the second, the two key methods of private ordering that act to protect investors are 'syndication' and 'gatekeeping.' In syndication, the crowd invests alongside a large and sophisticated 'lead' investor, who has herself done careful due diligence. Syndication is a direct consequence of New Zealand's liberal crowdfunding law which allows investors to make very large single investments, sometimes as high as $500,000, which would be illegal in the United States due to the individual investment limits.

As for gatekeeping, New Zealand's system relies on the online platforms to not just allow any company on to their site but rather to only permit legitimate and promising companies to participate, on the theory that they have a strong interest in establishing and maintaining a reputation as a reliable place for people to invest. In practice, New Zealand platforms take their gatekeeper role seriously and are highly selective in deciding which companies to allow to list on their site. They understand that they must protect their reputation and accordingly exclude companies that are unlikely to succeed, or that have any chance of being fraudulent. This acts to protect the investing public.

These findings, as well as our own experience in the United States under Regulation Crowdfunding, should give us confidence that we can liberalize our crowdfunding laws to encourage more capital formation without diluting investor protection. At the very least, you should reform the rules to:

- Increase the annual offering limit to $5 million;
- Eliminate individual investment limits for accredited investors;
- Simplify the individual investment limit to $5,000 per investment;
- Permit any and all advertising and general solicitation;
- Simplify or eliminate Form C and the disclosures for which it calls.

<u>Question #80</u>

No. I recommend making significant changes outlined in my response to Question #79 and below.

<u>Question #81</u>

No fraud has been reported among crowdfunding issuers in the history of the market.[6] This is an impressive result, considering that crowdfunding investors would likely make their complaints known online (*e.g.*, via Twitter or Facebook), if they had any.[7]

<u>Question #82</u>

Yes, you should increase the offering limit, and $5 million would be a fine choice. A primary purpose of the JOBS Act was to encourage the growth of startup companies, and reports from the field indicate that there exists a particular need for a vehicle to raise $1-$5 million

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[6] *See also* Staff Report at 42, 44 (noting the "absence of documented instances of misconduct").
[7] *See* Andrew A. Schwartz, *The Digital Shareholder*, 100 MINN. L. REV. 609, 675 (2015).

dollars.[8] Furthermore, the squeaky clean record of crowdfunding issuers to date should give you confidence to let the market have a bit more freedom. Finally, while it is true that most crowdfunding issuers are in fact raising only $100,000-$200,000 under the current rules,[9] this is a red herring. It has no logical bearing on whether there is an untapped market of companies that would use crowdfunding if they could raise, say, $5 million.

<u>Question #83</u>

No comment.

<u>Question #84</u>

I would merely point out that New Zealand permits foreign issuers to make public offerings via its equity crowdfunding system but, as a matter of practice, the participating issuers are all, or nearly all, domestic companies.

<u>Question #85</u>

No comment.

<u>Question #86</u>

Mandatory disclosure should be minimized in order to keep costs down, and I would point out that a significant percentage of crowdfunding issuers have very little income or assets to report, making financial statements practically irrelevant for them.[10]

<u>Question #87</u>

The individual investment limits are an innovative means of protecting investors from losing significant sums on speculative issuers. Unfortunately, they have caused several significant problems and should be reformed.

First, the individual investment limits make syndication—one of the methods of investor protection in New Zealand—effectively impossible. As discussed above with respect to Question #79, syndication is where retail investors invest alongside a wealthy and sophisticated lead investor, who has herself done careful due diligence. For syndication to work, the lead investor must be permitted to make a large enough investment to make her effort worthwhile. But under current law, even someone with an annual income of $50 million and a net worth of $200 million could only invest $100,000 annually in all crowdfunded offerings, rendering syndication infeasible. If accredited investors were exempted from the individual investment

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[8] Seth C. Oranburg, *Bridgefunding: Crowdfunding and the Market for Entrepreneurial Finance*, 25 CORNELL J.L. & PUB. POL'Y 397, 413–14 (2015) (Between . . . $0.3 million and $11.3 million is a valley where funding is increasingly hard to find. The valley reaches a critical low point—a gap—between about $1 to $5 million, where startups fail because funds are in such short supply.").

[9] Staff Report at 4.

[10] *See* Staff Report at 5 (reporting that "the median issuer had total assets of approximately $30,000, cash holdings of $4,000, and no revenues").

limits, they could act as lead investors in a syndicate, to the benefit of all. I recommend making that change.

A separate problem with the individual investment limits is that they are calculated based on the investor's net worth and annual income. These two figures are highly private and sensitive information, and I suspect that many potential crowdfunding investors abandon the project once they are asked to enter those numbers on a web-based intermediary. They are rightfully concerned about hacking or leaks of their sensitive financial information. To solve this problem, I recommend eliminating the algorithm and imposing a flat dollar-based per-transaction limit, as is the law in Australia. In my view, $5,000 per investment would serve to protect investors from losing too much on a single investment while allowing for adequate capital formation. It would be a simple rule that would not depend on any other investments or on other platforms, and would also avoid asking investors for their personal financial information.

Finally, New Zealand has, in its liberal spirit, totally abandoned individual investment limits. There is wisdom in this stance. After all, it is a free market and people are allowed to spend as much as they want at the casino, or on a car, so why not permit them to spend freely on crowdfunded securities? At the same time, the Congress that enacted the JOBS Act was deeply concerned with investor protection and it would be reasonable to retain the individual investment limits as a substitute for the mandatory disclosure usually required of public offerings.

<u>Question #88</u>

You should follow the example of New Zealand and allow issuers to engage in general solicitation and advertising prior to and after filing a Form C, as well as allow more communication about the offering outside the funding portal's platform channels. It is possible that issuers who would otherwise use regulation crowdfunding shy away from it and decide to run either a donation- or reward-based crowdfunding campaign because the latter forms do not impose limitations on advertising. My research shows that several issuers switched intermediaries either during their first campaign or for their second campaign, indicating that the success of the offering may have a lot to do with the way the campaign is advertised by intermediaries. Because of the high number of campaigns listed on an intermediary's website at any given time, it seems that it would be difficult for issuers to differentiate themselves in the market without being able to engage in general solicitation prior to filing the Form C, and then being limited in the ways they can present information outside the platform. Further, it is unlikely that retail investors are really paying much attention to the mundane, fine print of a campaign, and thus this regulation may offer only a façade of protection for investors.

Because equity crowdfunding is premised on the idea that the 'crowd' should decide which business plans should be funded, it seems contradictory to unnecessarily limit the ways that issuers can present their ideas to the public. Finally, New Zealand's experience shows that free advertising does not inexorably lead to fraud or other misconduct.

<u>Question #89</u>

See response to Question #88.

Question #90

No comment.

Question #91

The central focus of regulatory enforcement by the SEC and FINRA should be the oversight of intermediaries, not issuers or offerings, as per the New Zealand model. The intermediaries should exercise direct oversight of the issuers, and the regulators should ensure that the intermediaries have proper practices and procedures in place for doing so. Beyond that, each platform should 'run its own shop' and bear the market and regulatory consequences if it allows fraudulent or overly speculative issuers to list on its site. This may include, for instance, limiting the types of securities that issuers may offer to plain equity or debt, or requiring issuers to clearly explain to potential investors the different types of securities offered in campaigns.

Question #92

No comment.

Thank you,

Andrew A. Schwartz