COLORADO LAW
UNIVERSITY OF COLORADO BOULDER

Andrew A. Schwartz
Associate Professor of Law
Wolf Law Building | 401 UCB
Boulder, Colorado 80309-0401

January 27, 2014

Elizabeth M. Murphy
Secretary
United States Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: File Number S7-09-13: Proposed Rule on "Crowdfunding"

Dear Secretary Murphy:

Please accept this letter in response to the Securities and Exchange Commission's Request for Comments on its Proposed Rule, "Regulation Crowdfunding," released on November 5, 2013. I am an Associate Professor of Law at the University of Colorado. Last year, I published several scholarly articles on securities crowdfunding, including:

- *Crowdfunding Securities*, 88 NOTRE DAME LAW REVIEW 1457 (2013).
- *Rural Crowdfunding*, 13 U.C. DAVIS BUSINESS LAW JOURNAL 283 (2013).
- *Keep it Light, Chairman White: SEC Rulemaking Under the CROWDFUND Act*, 66 VANDERBILT LAW REVIEW EN BANC 43 (2013).

In a previous submission to the Commission, dated June 13, 2013, I urged you to resist the temptation to promulgate additional disclosure requirements for crowdfunded securities beyond those already present in the statute, for the whole crowdfunding project depends on a very simple and inexpensive process for offering securities. My advice was to rely primarily on the existing statutory scheme, especially the annual investment cap of 5% or 10% of one's annual income or net worth.

Overall, I think the Proposed Rule largely heeds my advice and avoids adding additional disclosure or other obligations beyond those provided by the statute. Even so, there are a few places where the Proposed Rule could be modestly adjusted to best achieve the statutory goal of a low-cost securities marketplace that operates with integrity.

The remainder of this letter will respond in order to a few of the numbered Requests for Comment presented in the Proposed Rule.

Request for Comment No. 6:

The annual investment limitations in Section 4(a)(6)(B) are of critical importance to the entire statutory scheme. Federal securities law has traditionally attempted to protect investors through disclosure, but the CROWDFUND Act takes a different tack. The Act eschews extensive disclosure because it is too costly for offerings under $1 million. Rather, the statute protects investors by sharply limiting the amount they can invest each year in crowdfunded securities. *See Keep it Light*, 66 VANDERBILT LAW REVIEW EN BANC at 50-51.

I agree with the Commission that the statutory language in Section 4(a)(6)(B) is ambiguous and can be read either as a "greater of" or a "lesser of" limitation. The Proposed Rule calls for a "greater of" rule, which is the more liberal reading, in that it would allow more investors to make more investments.

Overall, however, I disagree with the Proposed Rule, however, and recommend that the Commission adopt a "lesser of" rule. While I am generally in favor of allowing all investors, regardless of their personal wealth, the chance to invest in crowdfunded securities, the annual investment cap is key to protecting investors and, ultimately, the marketplace itself.

There are good reasons to expect that at least some crowdfunded securities will lose some or all of their value after purchase. If the investors lose only a small portion of their wealth, they may be willing to try again. But if they lose a large amount, they will not only avoid crowdfunded securities in the future, but they (or their representatives) may lobby Congress to close down securities crowdfunding entirely.

Consider the example of a retired person with an annual income of $60,000 and a net worth (excluding her residence) of $300,000.[1] Under the "greater of" rule proposed by the Commission, this retiree would be allowed to invest up to $30,000 each year in crowdfunded securities. Under a "lesser of" rule, by contrast, she would only be permitted to invest $3,000 per year. If such a person were to lose her entire crowdfunding investment, a $3,000 loss would be upsetting, but a loss of $30,000—ten times that amount—would be devastating and potentially life-altering.

Or take the opposite example of a young worker at a high-paying job, such as a corporate law firm, with an annual income of $200,000 and a net worth of zero (perhaps due to student loans). Under the proposed "greater of" rule, she would be authorized to invest up to $20,000 per year in crowdfunded securities, while under a "lesser of" rule, she would only be allowed to invest $2,000. Again, to such a person, a loss of $2,000 would be a learning experience, but a loss of $20,000—again, ten times that amount—could take a serious toll on her long-term financial well-being.

I think that these two examples show that the thrust of Congress's intent in the CROWDFUND Act would be best served by a "lesser of" rule for calculating the annual investment limitation in Section 4(a)(6)(B). This annual cap is designed to protect investors from crushing losses, but the "greater of" rule would not protect the people in my examples to the extent envisioned by the statute. Investments of $2,000 or $3,000 are appropriate for crowdfunding, which by its nature calls for small investments by many people.

[1] This is a realistic example, as Fidelity Investments recently reported that its average 401(k) balance is $255,000 for "pre-retirees (age 55 or older) who had an employment history of 10 years or more with their current employer." *See* http://www.fidelity.com/inside-fidelity/employer-services/fidelity-reports-record-gains-for-401-k-savers.

In conclusion, I recommend that the Commission change Section 227.100(1) to a "lesser of" rule. The annual cap is the key investor-protection component of the statutory scheme and should be rigidly enforced.

Request for Comment Nos. 24-25:

The disclosure obligations mandated by the CROWDFUND Act are ample and should generally not be embellished. Section 4A(b)(1)(B) requires the disclosure of the names of the issuer's directors, officers, and 20% shareholders, but the Proposed Rule in Section 227.201(b) adds a number of additional disclosures that impose extraneous expense on issuers, which is contrary to the spirit of the statute. Section 227.201(b) should be edited to require only the disclosures called for by statute.

Beyond what the statute provides, the Commission proposes to require disclosure of all the positions held by directors and officers, as well as their "business experience" and employment history during the past three years. The Commission suggests that this should not be considered onerous because registered and Regulation A offerings require disclosure of a five-year period.

But the whole point of the CROWDFUND Act was to create a new and different kind of securities regime that is not premised on extensive disclosure, as are those other types of offerings. Also, the business experience of officers and directors are often easily available on social networks like LinkedIn or Facebook.

In short, the Commission should only require the disclosures specifically called for by the CROWDFUND Act. It should excise the former-positions disclosure and the business experience disclosure requirements found in proposed Section 227.201(b).

Request for Comment No. 38:

The Proposed Rule imposes eight additional disclosure requirements on issuers, over and above those mandated by the statute. As stated above, I believe that the disclosure obligations mandated by the CROWDFUND Act are ample and should generally not be embellished. Each specific additional requirement will be addressed in this and the following responses:

Intermediary identification: See Request for Comment No. 39.

Intermediary compensation: See Request for Comment No. 40.

Legends: See Request for Comment No. 41.

Number of Employees: This is a close call. The proposal in Section 227.201(e) seems easy and inexpensive for an issuer to disclose, as well as important to an investor, in which case it should be included. In most instances, simply counting up the employees and providing a numeral should be easy. But it may actually be somewhat difficult for some businesses to give an accurate count of employees if they engage many contract workers or have some workers on “flex-time,” “half-time,” or some other arrangement. In such cases, it may be unreasonably costly to be forced to disclose the current number of employees, in relation to the benefit gained. Moreover, to the extent this requirement bears a relation to the statutory goal of “creating jobs,” it surely could have been included in the statute by a Congress focused on that goal—but it was not. Given the need to keep costs (especially disclosure costs) as low as possible, the Commission should probably excise proposed Section 227.201(e).

Material Risk Factors: See Request for Comment No. 41.

Indebtedness: I agree with the Commission that the material terms of any indebtedness of the issuer should be included as a required disclosure. This information is exceptionally important for investors, and it is easy and low-cost for issuers to disclose.

Prior Exempt Offerings: See Request for Comment No. 45.

Related-Party Transactions: See Request for Comment No. 42-44.

Request for Comment No. 39:

Identifying the intermediary through which an offering is being conducted is easy and inexpensive for an issuer to disclose, as well as important to an investor. This is fine as is.

Request for Comment No. 40:

Proposed Section 227.201(o) should be excised from the final rule. Disclosing the amount of compensation paid to an intermediary would not always be very easy or inexpensive for an issuer, and it also may expose private business information or trade secrets. It may be important to an investor, but the cost is simply too high, and it is not required by the statute. To keep the cost of crowdfunding securities low, the rules simply must not add on useful, but costly, disclosure obligations like this one.

Request for Comment No. 41:

The Legends are very low-cost and may be included as an additional requirement. It may make sense to include them as boilerplate on Form C.

By contrast, the requirement in Section 227.201(f) that an issuer provide a “discussion of the material factors that make an investment in the issuer speculative or risky” should definitely be excised from the rules. This is not required by the statute, creates a potentially limitless and unworkable standard, and would impose a significant burden and risk of liability on crowdfunding issuers, all for minimal gain.

Moreover, no commenter asked for this addition and the Proposed Rule addresses this proposal in a single conclusory paragraph. The Commission should more carefully consider this aspect of the Proposed Rule.

The CROWDFUND Act already mandates that issuers provide “a description of the business of the issuer” (Section 4A(b)(1)(C)) as well as “a description of the financial condition of the issuer,” including “financial statements” (Section 4A(b)(1)(D)). The proposed addition in Section 227.201(f) would add little material information beyond that already found in those other statutorily required disclosures.

Even worse, there are a huge number of “material factors that make an investment in the issuer speculative or risky” that have nothing to do with the issuer itself, including: national economic trends; potential legislative or regulatory changes; threats that war, terrorism or natural disasters could disrupt the supply chain; the fact that many startups and small businesses routinely fail; where interest rates might move in the near, medium and long term; et cetera, et cetera, et cetera. Thus if the Commission forces issuers to disclose a complete list of “material factors,” this alone could render crowdfunding too expensive to be used, especially considering that issuers would be worried about their potential legal liability for misleading omissions.

For all these reasons, it is important that the Commission delete the proposed requirement, found in Section 227.201(f), that issuers disclose “the material factors that make an investment in the issuer speculative or risky.”

<u>Request for Comment No. 42-44:</u>

Proposed Section 227.201(r) should be excised from the final Rule. The CROWDFUND Act does not require issuers to make these disclosures, and this portion of the Proposed Rule is complex and costly to comply with. The information proposed to be disclosed here is potentially useful to an investor, but the anticipated compliance costs of the rule do not justify its inclusion. The CROWDFUND Act mandates a lot of disclosure by issuers, and issuers are free to offer additional disclosure as they see fit. But this proposed additional disclosure item calls for a careful analysis by legal counsel of any related-party transactions, which may drive up the cost of crowdfunding too high. To keep the cost of crowdfunding low, which is a primary aim of the legislation, the Commission must not add on potentially helpful, but costly, disclosure obligations like this one.

<u>Request for Comment No. 45:</u>

Proposed Section 227.201(q) should be deleted from the final Rule. The CROWDFUND Act does not call for disclosure of prior exempt offerings and to add this disclosure obligation on issuers would raise the cost of crowdfunding higher than it needs to be. To keep the cost of crowdfunding low, the Commission must not add on potentially helpful, but inevitably costly, disclosure obligations like this one.

<u>Request for Comment No. 46:</u>

The disclosure obligations mandated by the CROWDFUND Act are ample and should not be further embellished, because doing so would raise the cost of crowdfunding too high for it to function well.

Request for Comment No. 243:

The "safe harbor" for insignificant deviations from Regulation Crowdfunding is a welcome and thoughtful addition to the statute. It should help to give issuers comfort and confidence that they can rely on this new and untested exemption from the registration requirements. Well done.

Request for Comment No. 244:

I recommend against defining the term "insignificant." Rather, market participants, regulators and courts can and should look to how that term has been construed in precedents decided under Rule 508 of Regulation D, on which the proposed Section 227.502 is modeled.

Alternatively, the Commission should consider revising Section 227.502(a)(1) to say that the failure to comply was "immaterial" with respect to the offering as a whole. Thanks to the many important precedents on point, including from the United States Supreme Court, the concept of materiality has become very well-defined and understood, and is much more familiar than the proposed "significance" test which, although not novel, is far more obscure.

Also, it seems that a safe harbor for "immaterial" deviations would provide more protection for issuers than the proposed safe harbor for "immaterial" deviations. The upshot is that issuers would have even more comfort and confidence in their ability to rely on the exemption, which should benefit the entire crowdfunding project.

Finally, the broader safe harbor I recommend would not lead to significant investor harm for two reasons. First, the definition of "material" turns on whether a reasonable investor would consider it important. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Hence, any deviation that falls within the broader safe harbor would necessarily be unimportant to a reasonable investor and thus not a matter of concern. Second, the Commission retains the authority to bring an enforcement action even in cases where the issuer falls within the safe harbor.

In sum, I recommend that the Commission change "insignificant" to "immaterial" in Section 227.502(a)(1), but otherwise leave the Section as proposed.

Request for Comment No. 244:

I recommend against placing any specific deviations outside the bounds of the safe harbor. This is a new marketplace and we need time to see what deviations occur and how parties and the courts handle them.

Respectfully Submitted,

Andrew A. Schwartz