Fund Democracy

February 3, 2014

FILED ELECTRONICALLY

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F St., N.E.
Washington, DC 20549-1090

Re: File No. S7-09-13

Dear Ms. Murphy,

I am writing on behalf of Fund Democracy[1] to comment on the SEC's proposed rules under the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 ("Crowdfund Act" or "Act"). The Act generally requires that the Commission adopt rules to permit unregistered offerings to retail investors under new Section 4(a)(6) of the Securities Act.

In summary, the Crowdfund Act creates an offering exemption that holds out great promise and presents great risk. In particular, the Act permits investors to purchase unregistered securities regardless of their income or net worth. Although there are limits on the amount of their purchases, investors may nonetheless experience financially devastating losses as a result of their crowdfunding investments. For example, investors may invest $2,000 in a crowdfunding offering even if they have no income and, after the investment, zero net worth. The high rate of small business failures ensures that the crowdfunding market will be characterized by many investments becoming worthless within a few years of an offering – regardless of investor protection measures. The SEC's rule proposals in some cases may increase the likelihood that investment limits for investors will be exceeded, which will exacerbate the effect of crowdfunding losses. These proposals may degrade the market integrity of crowdfunding and ultimately increase capital raising casts for legitimate small businesses. I strongly encourage the Commission to consider the importance of erring on the side of caution in what is likely to be only the first iteration of its crowdfunding rules.

This letter focuses on particular concerns regarding the SEC's proposal. In summary, I strongly encourage the Commission to adopt the following recommendations:

- Refrain from adopting rules that are inconsistent with specific mandates under the Act;

[1] Fund Democracy is a nonprofit investor advocacy that I founded in 2000. Fund Democracy frequently comments on regulatory proposals and has testified before Congress on more than 20 occasions. *See, e.g.*, *The SEC's Crowdfunding Proposal: Will it Work for Small Businesses?* Hearing before the Subcommittee on Investigations, Oversight and Regulations, Committee on Small Business, United States House of Representatives (Jan. 16, 2014) (testimony of Mercer Bullard). I would like to thank University of Mississippi law student Justin Bouchard for his assistance in preparing this comment letter.

- Prohibit advertising of offerings under non-crowdfunding exemptions from 60 days prior to the beginning of a crowdfunding offering until the end of that offering;
- Apply the $1 million fund-raising cap to all securities, as provided in the Act;
- Apply the 5 percent investment limit to investors with less than $100,000 in *either* annual income or net worth;
- Require actual verification of investor eligibility beyond mere self-certification;
- Require actual review of investor education material rather than accept a check-the-box approach;
- Apply the *individual* investor limits to *individuals*, not spouses;
- Prohibit the use of stale financial statements;
- Impose the PCAOB and only the PCAOB auditing standard;
- Leave the $500,000 trigger for audited financials in place until the Commission has developed an empirical basis for raising *or lowering* the trigger;
- Require a hyperlink in electronic communications that purport to deliver information;
- Prohibit first-come, first-served pro rata allocations in oversubscribed offerings;
- Require the filing of tax returns by issuers when the filing deadline; and
- Consider ways to allow offline crowdfunding activities in limited circumstances.

I. SEC Authority

As the Commission is aware, the Crowdfund Act sets forth a remarkably detailed regulatory regime for crowdfunding. The Act establishes very specific investment minimums, investor qualifications and disclosure requirements that afford the Commission very little discretion in fashioning rules under the Act. In this respect, the Act contrasts sharply with other rule-based exemptions where the rule's strictures were created not by statute, but by Commission. For example, the statutory basis for the private offering exemption under Rule 506 reflects nothing more than the phrase: "transactions not involving a public offering." The Commission wrote on a clean slate.

The Crowdfund Act, however, is not a clean slate. The Act establishes numerous specific requirements that permit little or no regulatory discretion. Yet in many respects the Commission has claimed the authority to change the Act where no such authority exists. In some cases, the Commission asserts the authority to dilute investor protections, in other cases to impose additional burdens on small businesses. In each case its approach would contravene specific directions from Congress. For example, the Commission is considering requiring CEO-certified financials for issuers with more than $100,000 in crowdfunding offerings,[2] whereas Congress specifically directed that this requirement

[2] *See* Crowdfunding, Securities Act Rel. No. 9470 at 83 (Oct. 23, 2013) ("Proposing Release").

apply only to issuers that have raised $100,000 or less.[3] The Commission is considering lowering the $2,000 minimum for investors with very low income and net worth,[4] but it does not have the authority to amend the $2,000 minimum chosen by Congress. The Commission is considering eliminating investment limits for accredited and institutional investors,[5] notwithstanding the very specific dollar amounts set forth in the Act. The Commission proposes to allow a couple to combine their income and/or net worth to meet investment minimum, notwithstanding that Congress specifically applied that minimum to a single investor. It has decided to apply the $1 million cap on issuer offerings only to crowdfunding securities, notwithstanding that the Act states that the cap applies to all securities of the issuer.

The SEC's second-guessing Congressional mandates may reflect good social policy, but the Commission has no authority to supplant Congress's judgment with its own. The overreaching reflects the findings of recent court decisions regarding the exercise of the SEC's authority. The most analogous is *FPA v. SEC*,[6] in which the court vacated an SEC rule that attempted to repeal the requirement that broker-dealers receive no special compensation The effect of the rule would have been to substantially narrow the group of broker-dealers who were subject to the Advisers Act and the fiduciary duty thereunder. Now the Commission proposes to *expand* the group of broker-dealers who are subject to the Advisers Act's fiduciary duty. The SEC's seesawing policies are partly a result of its disregard for a statutory mandate. The Commission risks the same long-term policy incoherence by arbitrarily deviating from the Crowdfund Act's terms.

The provisions of the Crowdfund Act reflect a reasoned compromise among members of Congress. Members voted for or against the Act based on its specific terms; they might have voted differently on the amendments to the Act being considered by the Commission. The SEC's repeated flouting of the express terms of the Act poses a particular threat to investors and capital markets because of the agency's apparent tendency, as discussed further below, to resolve any doubts as to Congress's intent against the interests of investors and efficient markets and in favor of those who would benefit most from weakening the Act's market integrity rules.[7]

II. Integration

As the Commission is aware, the problem of "integration" arises because concurrent offerings under different exemptions can allow an issuer to circumvent prohibitions of one exemption by engaging in the prohibited activities under another exemption.[8] For example, one exemption might permit public advertising and allow sales

[3] Securities Act § 4A(b)(1)(D)(i)(II).

[4] Proposing Release at 29.

[5] *Id.* at 28 – 29.

[6] 482 F.3d 481 (2007).

[7] *See infra* Part II (permitting indirect public advertising of crowdfunding offerings); Part VII (permitting the use of stale financial statements); Part XI (permitting reliance on exemption by issuers currently violating the Act).

[8] *See* Proposing Release at note 27 ("The integration doctrine seeks to prevent an issuer from improperly avoiding registration by artificially dividing a single offering into multiple offerings

only to accredited investors, while another prohibits public advertising but allows sales to any investor. Without integration rules, public advertising in the first offering could be used, in effect, to engage in indirect, illegal advertising of the second. In other words, by publicly advertising under the first exemption, the issuer would be able to reach potential nonaccredited investors where the issuer was prohibited from using public advertising to reach them. Unfortunately, the foregoing problem is exactly what the Commission would permit with respect to crowdfunding offerings.

Crowdfunding offerings are subject to strict limits on advertising. The Act provides that issuers may "not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker."[9] Even within the context of communications on the website for an offering, that is, "communication channels provided by the intermediary on the intermediary's platform,"[10] issuers may not compensate any person for promoting an offering unless the receipt of the compensation is disclosed "upon each instance of such promotional communication."[11]

These restrictions are necessary because, unlike private offerings in which only sales to accredited investors are permitted,[12] crowdfunded securities may be sold to anyone. Congress believed that, if a desperate investor with no income and $2,000 in savings was to be permitted to invest their last penny in crowdfunded securities, then issuers should not be allowed to lure them by running ads in public media. Public advertisements using exaggerated pitches may be allowable in the marketplace at large, but America's century-long dominance of the world's securities markets is substantially attributable to prohibitions against this kind of misleading sales practices. Nothing is more likely to expose the madness of crowds than permitting public advertising to infiltrate the crowdfunding space.

The kind of public advertising that has begun to emerge in the wake of rules permitting public advertising of private offerings illustrates what unrestrained crowdfunding advertising might look like. For example, a slide deck for a private offering by a fund that invests in Bitcoins includes a chart ("Bitcoin Upside") that shows the value of bitcoins rising to equal the value of 5 percent of the world's gold supply ($340 billion).[13] It appears that neither the SEC nor FINRA viewed such misleading ads to be problematic, but Fidelity apparently considered them to raise sufficient concerns to cause it to reverse its position permitting its clients to invest in the Bitcoin Investment

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such that Securities Act exemptions would apply to multiple offerings that would not be available for the combined offering.").

[9] Securities Act § 4A(b)(2). The phrase "*terms of the offering* means the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period." Proposed Rule 204.

[10] Proposed Rule 204(c).

[11] Securities Act § 4A(b)(3).

[12] Although the "private" offering exemption was intended to limit public communications, the JOBS Act required that the Commission permit public advertising in "private" offerings.

[13] *See* Investor Presentation, Bitcoin Investment Trust (Jan. 2014) *available at* http://www.bitcointrust.co/.

Trust in their self-directed IRAs.[14] It is because of this kind of advertising that Congress strictly limited crowdfunding advertising.

Nonetheless, the Commission would allow issuers to engage in prohibited public advertising during crowdfunding offerings. Issuers need only conduct their public advertising campaign under cover of a concurrent “private” offering. Crowdfunding issuers would be able to say anything, subject only to general antifraud rules, about the issuer’s prospects in precisely the public context that Congress specifically declared off-limits for crowdfunding. Integration rules are designed to prevent precisely this method of circumventing the requirements of offering exemptions. Integration rules also provide clarity to issuers and intermediaries that have legitimate reasons for raising funds under different exemptions but are concerned that permitted activities under one exemption might be viewed as violating another exemption under which they are not permitted. Clear rules save money while enhancing market integrity.

Integration problems are addressed in a variety of ways under the securities laws. For example, when issuers raise funds through public and private offerings, and the private offering does not opt to engage in public advertising,[15] the public registration statement could be viewed as a form of public advertising. Conversely, private communications made pursuant to the private offering could be viewed as offers that violate investor communication rules governing the public offering. The Commission has adopted a safe harbor that generally provides that a private offering that ceases at least 30 days before a registration statement is filed in a public offering will not be considered part of (be integrated with) the public offering. A public offering that is withdrawn at least 30 days before a private offering commences will not be considered part of the private offering.

The integration safe harbor is nonexclusive; concurrent offerings will not necessarily be integrated. For example, the Commission has taken the position that a non-advertised private offering could be undertaken concurrently with a public offering if the issuer could demonstrate that the investors in the private offering were reached by means other than the registration statement.[16] It is worth noting here that concerns regarding a registration statement serving as a form of illegal public advertising are not nearly as great as when public advertising occurs in connection with a private offering. The content of registration statements and other permissible public communications in public offerings are severely constrained, and these communications often would be impracticable for a billboard or advertisement in a newspaper, magazine or similar public media. The advertising concern is also mitigated by the fact that only accredited (and presumably more sophisticated) investors can invest in a private offering. These investors may be less likely to be misled by publicly available information. Indeed, this is precisely the argument for the JOBS Act’s recent elimination of the blanket prohibition on public advertising of private offerings -- that accredited investors supposedly can fend for themselves.

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[14] *See also* Gail Liberman, Palm Beach Discussion Group Invests in Single Bitcoin (Jan. 12, 2014).

[15] As noted in footnote 12, *supra*, the JOBS Act permitted public advertising in private offerings if securities are sold only to accredited investors. Issuers can still conduct private offerings and opt not to engage in public advertising subject to slightly different rules. *See* Securities Act § 4(a)(2).

[16] *See* Revisions of Limited Offering Exemptions in Regulation D, Part II.C (Aug. 3, 2007).

In contrast, the problem of public advertising in private offerings being used to communicate with potential crowdfunding investors is *heightened*. Anyone can invest in a crowdfunding offering, regardless of their income or net worth. The potential for investor losses is greater with start-ups than for any other category of businesses. Low- or no-income and low net-worth investors are those who are least able to bear losses. These factors argue for *greater* integration restrictions that ensure that crowdfunding rules are not circumvented through the use of concurrent offerings under other exemptions. In addition, the ability of a business to raise capital through a private offering generally is not the kind business for which the crowdfunding exemption was created; crowdfunding was intended to enable small businesses to access capital where not practicable under other exemptions, *i.e.*, to close the perceived "funding gap."[17]

Where the Commission should be *most* concerned about fraudulent securities offerings, it has chosen the *least* protective approach. Despite the greater fraud risk in concurrent private and crowdfunding offerings than in concurrent private and public offerings, and the greater investor harm that fraud in the crowdfunding market may cause, the Commission has proposed to impose a *less* restrictive standard for the former. In fact, it is not just a less restrictive standard; the Commission has proposed that no integration restrictions apply whatsoever. The only limitation that the Commission proposes to apply is that any:

> concurrent exempt offering for which general solicitation is permitted could not include an advertisement of the terms of an offering made in reliance on Section 4(a)(6) that would not be permitted under Section 4(a)(6) and the proposed rules.[18]

This "restriction" would provide no meaningful impediment to publicly advertising a crowdfunding offering under cover of a private offering.

With respect to restrictions on crowdfunding advertising, the Commission states that:

> [l]imiting the advertising of the terms of the offering to the information permitted in the notice is intended to direct investors to the intermediary's platform and to make investment decisions with access to the disclosures necessary for them to make informed investment decisions.[19]

Permitting public advertising in concurrent offerings directly contradicts this position. Public advertising of other offerings will encourage investors to make crowdfunding investment decisions based on information that is *not* on the intermediary's platform. This public information will be more accessible than information on the intermediary's platform and may be more likely to be relied on that information on the intermediary's platform. Crowdfunding issuers will have an incentive to engage in concurrent private offerings precisely to enable them to reach a wider audience. This is exactly what

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[17] Proposing Release at 17 (crowdfunding is intended to promote "the goal of alleviating the funding gap faced by startups and small businesses"). In fact, recent data published by the Commission itself shows that the claim that crowdfunding is needed because small amounts of capital cannot be efficiently raised under private offering rules is patently false. *See infra* note 21. The JOBS Act's elimination of the ban on public advertising in private offerings will make private offerings even more amenable to small issuances.

[18] Proposing Release at 19.

[19] *Id.* at 109.

Congress intended to *prevent* by restricting crowdfunding advertising to the intermediary's platform. Yet this is precisely what the Commission would *permit* by imposing no integration restrictions on such public advertising.

The Commission interprets the following provision in the Act (the "Integration Proviso") to prevent it from imposing integration restrictions:

> Nothing in this section or section 4(6) shall be construed as preventing an issuer from raising capital through methods not described under section 4(6).[20]

Rather than suggesting that integration concerns be entirely ignored by the Commission, the Integration Proviso actually assumes that some degree of integration is likely, if not inevitable. The Proviso warns the Commission not to impose integration tests that would "prevent" offerings under exemptions because Congress was well aware that the Commission was likely to impose integration restrictions in order to ensure compliance with, for example, the restriction of crowdfunding advertising to the intermediary's platform.

Yet rather than taking the Proviso as a warning not to apply integration restrictions too broadly, the Commission has distorted its meaning into a command that no integration restrictions be applied at all. Despite the dangerous loophole that permitting general solicitations in concurrent private offerings would create, the Commission has proposed to repeal, in effect, the crowdfunding restriction on advertising.

The Integration Proviso should be read according to what it says: integration rules should not *prevent* other offerings. Congress could have but did not use the word "delay" or "impede," or the phrase "interfere with." Congress was well aware that existing integration rules may "delay," "impede" and "interfere with" securities offerings, but it chose to warn the Commission only against integration rules' "preventing" other offerings.

Congress used the term "prevent" in the plain-meaning sense of keeping something from happening. Existing integration rules do not prevent offerings, nor would any reasonable application of these rules to crowdfunding offerings prevent other offerings. Requiring that no public advertising of an offering by an issuer occur, for example, within 60 days before the initiation of a crowdfunding offering by that issuer could not be said to "prevent" the other offering. It would only require that it complete the private offering before a subsequent crowdfunding offering. Such an integration rule would, however, "prevent" issuers from indirectly publicly advertising their crowdfunding offerings. In view of the regulatory risks that crowdfunding entails, such a bright line rule would be preferable to a fact-based determination. It would be impracticable to adopt the SEC's position on concurrent public and private offerings because one could not demonstrate that no crowdfunding investor was solicited through public advertising.

[20] Securities Act § 4A(g).

III. $1 Million Cap on Funds Raised

Congress intended that crowdfunding offerings remedy perceived difficulties encountered by issuers when raising small amounts of capital.[21] The crowdfunding exemption was not intended to cover large offerings, much less issuers that routinely raised substantial amounts by other means. Congress accordingly limited the aggregate amount of securities raised by a crowdfunding issuer in any 12-month period to $1 million. It also required that the Commission adjust this limit at least once every five years to reflect inflation.[22] Thus, an issuer that was able to raise $1 million through a private offering, for example, would not be able to avail itself of the crowdfunding exemption during the 12 months following the private offering, but it would be able to raise up to $1 million every year.

Congress was explicit in providing that the $1 million cap was not limited to non-crowdfunding offerings. The relevant provision Act exempts:

> (6) transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that—
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> (A) the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12- month period preceding the date of such transaction, is not more than $1,000,000; . . ..[23]

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[21] Recently published data undermines this assumption. From 2009 – 2012, there were 43,683 offerings under Rule 504, 505 and 506, and more than half – 22,126 – were for less than $1 million. *See* Ivanov and Bauguess, Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009 – 2012 at 8 (July 2013) *available at* http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf. These data do not even include all alternative offering exemptions, much less additional offerings that will be made as a result of the removal of the ban on public advertising in private offerings. Thus, offerings of less than $1 million are not just feasible under other offering exemption. They are *routine*.

The Commission cites this data in the Proposing Release, but it provides no analysis as to what types of startups and small businesses are having success with Reg D and what types are not. Why are some businesses able to find accredited investors and others are not? The fact that the accredited investor standard is based on wealth, one might speculate that some start-ups and small businesses are excluded from the kinds of networks in which they would have personal contact with accredited investors or with those who provide financial services to these investors. One might speculate further that crowdfunding's greatest potential may be its ability to remove arbitrary socio-economic constraints from capital allocation decisions.

Finally, the Commission acknowledges that Reg D offerings now may be publicly advertised, but it does not discuss what effect this might have on the ability of start-ups and small businesses to raise capital under that exemption. Again, it seems that considering the effect of this change would be necessary for the Commission to engage in informed rulemaking.

[22] Securities Act § 4A(g)(1).

[23] Securities Act § 4(a)(6).

Paragraph (6) applies to "the offer or sale of securities by an issuer," and subparagraph (A) limits "aggregate amount sold to all investors by the issuer" to "not more than $1,000,000." By its terms, "the offer and sale of securities" would mean all securities, including crowdfunding securities, a point further reinforced by the reference to "all" investors (not just crowdfunding investors). The term "securities" in Section 4(a)(6) is not limited to crowdfunding securities.

Subparagraph (A) expresses Congress's intent that crowdfunding securities be included in the aggregate $1 million cap[24] and accordingly added the clarification that is italicized and bolded below:

> (A) the aggregate amount sold to all investors by the issuer, ***including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction,*** is not more than $1,000,000 . . .[25]

In the event that it was not clear that the "aggregate amount sold" included crowdfunding securities, Congress stated expressly that these securities were included. There was no need to explain that the "aggregate amount sold" included *other* securities. Indeed, the use of the term "included" necessarily means that Congress also believed that other securities were included in the "aggregate amount sold." It is an obvious rule of statutory construction, easily understood by any lay person, that the term "including" means "illustrative of," and not, for example, "including *only*" or "limited to."[26]

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[24] *See* Willheim v. Murchison, 342 F.2d 33, 41 (2d Cir. 1965) ("Definitions in securities and other legislation often use the word 'include' out of abundant caution, and this serves a clear purpose when one or more of the things stated as included would not be so in the ordinary meaning of the term defined . . ..").

[25] Securities Act § 4(a)(6)(A).

[26] *See, e.g.,* Fed. Land Bank of St. Paul v. Bismarck Lumber Co., 314 U.S. 95, 99-100, 62 S. Ct. 1, 4, 86 L. Ed. 65 (1941) ("We recently had occasion under other circumstances to point out that the term 'including' is not one of all-embracing definition, but connotes simply an illustrative application of the general principle. (citing Phelps Dodge Corp. v. National Labor Relations Board, 313 U.S. 177, 189, 61 S.Ct. 845, 850, 85 L.Ed. 1271, 133 A.L.R. 1217; Helvering v. Morgan's, Inc., 293 U.S. 121, 125, 55 S.Ct. 60, 61, 79 L.Ed. 232); Stansell v. Revolutionary Armed Forces of Colombia, 704 F.3d 910, 915 (11th Cir. 2013)("When a statutory definition declares what a term "means" rather than "includes," any meaning not stated is excluded. Colautti v. Franklin, 439 U.S. 379, 392–93 & n. 10, 99 S.Ct. 675, 684 & n. 10, 58 L.Ed.2d 596 (1979). This is because the term "means" denotes an exhaustive definition, while "includes" is merely illustrative. United States v. Probel, 214 F.3d 1285, 1288–89 (11th Cir.2000)."); Citizens for Responsible Gov't State Political Action Comm. v. Davidson, 236 F.3d 1174, 1190-91 (10th Cir. 2000) ("Colorado is among "the overwhelming majority of jurisdictions" that read the word "includes" as "a term of extension or enlargement when used in a statutory definition." *Colorado Common Cause v. Meyer,* 758 P.2d 153, 163–64 (Colo.1988) (en banc)."); Dong v. Smithsonian Inst., 125 F.3d 877, 880 (D.C. Cir. 1997) ("We recognize, of course, that the word "includes" normally does not introduce an exhaustive list but merely sets out examples of some "general principle." *Federal Land Bank of St. Paul v. Bismarck Lumber Co.,* 314 U.S. 95, 100, 62 S.Ct. 1, 4, 86 L.Ed. 65 (1941)."); Federal Election Com'n v. Massachusetts Citizens for Life, Inc., 769 F.2d 13, 17 (1st Cir. 1985) ("'A term whose statutory definition declares what it 'includes' is more susceptible to extension of meaning by construction than where the definition declares what a term 'means.' It has been said 'the word "includes" is usually a term of enlargement, and not of limitation." . . . It, therefore, conveys the conclusion that there are other items includable, though not specifically enumerated . . . (*quoting* N. Singer, 2A Sutherland Statutes and Statutory Construction 133 (4th ed. 1984) (*quoting* Argosy Ltd. v. Hennigan, 404 F.2d 14, 20 (5th Cir.1968))); United States v. Mass. Bay Transportation Authority, 614 F.2d 27, 28 (1st Cir.1980) ("Includes is not a finite word of limitation.");

Notwithstanding the unambiguous meaning of Section 4(a)(6)(A), the Commission interprets the term "including" to mean "limited to." If the only securities that Congress intended the $1 million to apply to were crowdfunding securities, then it would have said:

> the aggregate amount ***sold in reliance on the exemption provided under this paragraph*** during the 12-month period preceding the date of such transaction, is not more than $1,000,000,

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Bautista v. Star Cruises, 286 F. Supp. 2d 1352, 1360 (S.D. Fla. 2003) aff'd, 396 F.3d 1289 (11th Cir. 2005) ("Plaintiffs' interpretation of the Convention Act overlooks the significance of the word "including" in § 202. "A term whose statutory definition declares what it 'includes' is more susceptible to extension of meaning by construction than where the definition declares what the terms 'means.' " Singer, *supra,* § 47:07. In fact, "the word 'includes' is usually a term of enlargement, and not of limitation ... It, therefore, conveys the conclusion that there are other items includable, though not specifically enumerated by the statutes." *See Argosy Limited v. Hennigan,* 404 F.2d 14, 20 (5th Cir.1968) (internal citations omitted). Based on these principles of statutory construction, the term "including" instructs that the transactions, contracts and agreements described in § 2 of the FAA are covered by the Convention Act, as well as other arbitration agreements that arise out of commercial legal relationships."); Argosy Ltd. v. Hennigan, 404 F.2d 14, 20 (5th Cir. 1968) ("In both of these statutes, we think the word 'including' is not to be restricted to the 'rate and amount of duties chargeable,' but read in relation to the phrase, 'all decisions entering into same.' 'The word 'includes' is usually a term of enlargement, and not of limitation.' United States v. Gertz, 9 Cir. 1957, 249 F.2d 662, 666. It therefore conveys the conclusion that there are other items includable, though not specifically enumerated by the statutes."); United States v. Gertz, 249 F.2d 662, 666 (9th Cir. 1957) ("The word 'includes' is usually a term of enlargement, and not of limitation. As stated in Federal Land Bank of St. Paul v. Bismarck Lumber Co., 314 U.S. 95, 100, 62 S.Ct. 1, 4, 86 L.Ed. 65, "including' is not one of all-embracing definition, but connotes simply an illustrative application of the general principle."); Braun v. Wal-Mart Stores, Inc., 2011 PA Super 121, 24 A.3d 875, 963-64 (Pa. Super. Ct. 2011); ("With respect to the term "include," "[t]he term 'include' is to be dealt with as a word of 'enlargement and not limitation.' " *Pa. Human Relations Comm'n v. Alto–Reste Park Cemetery Ass'n,* 453 Pa. 124, 130–31, 306 A.2d 881, 885 (1973) (alterations omitted); *accord Samantar v. Yousuf,* —— U.S. ——, —— n. 10, 130 S.Ct. 2278, 2287 n. 10, 176 L.Ed.2d 1047, 1062 n. 10 (2010)."); Vassiliu v. Daimler Chrysler Corp., 178 N.J. 286, 295, 839 A.2d 863, 868-69 (2004) ("Rather, "the word 'includes' is usually a term of enlargement, and not of limitation.... It, therefore, conveys the conclusion that there are other items includable, though not specifically enumerated [.]" 2A Norman Singer, Sutherland Statutory Construction § 47:07 at 231 (6th ed. 2000) (internal quotation marks and footnote omitted); accord Fraser v. Robin Dee Day Camp, 44 N.J. 480, 485, 210 A.2d 208, 210–11 (1965)."); Brown v. Scott Paper Worldwide Co., 143 Wash. 2d 349, 359, 20 P.3d 921, 926 (2001) ("RCW 49.60.040(3) contains the word "includes," which is a term of enlargement."); Ornelas v. Randolph, 4 Cal. 4th 1095, 1101, 847 P.2d 560, 563 (1993) ("The statutory definition of 'recreational purpose' begins with the word 'includes,' ordinarily a term of enlargement rather than limitation." (citing People v. Western Air Lines, Inc. (1954) 42 Cal.2d 621, 639, 268 P.2d 723; 2A Sutherland, Statutory Construction (4th ed. 1973) § 47.07, pp. 81–82.)); Matter of Estate of Corwin, 1987-NMCA-100, 106 N.M. 316, 317, 742 P.2d 528, 529 ("This appeal requires us to apply principles of statutory construction. We find the correct approach in 2A N. Singer, Sutherland Statutory Construction Section 47.07 (Sands 4th ed. 1984): 'A term whose statutory definition declares what it "includes" is more susceptible to extension of meaning by construction than where the definition declares what a term "means." It has been said "the word 'includes' is usually a term of enlargement, and not of limitation. . . . It, therefore, conveys the conclusion that there are other items includable, though not specifically enumerated. . . . "' (Footnote omitted.) This rule has found support in other jurisdictions. Federal Land Bank of St. Paul v. Bismarck Lumber Co., 314 U.S. 95, 62 S.Ct. 1, 86 L.Ed. 65 (1941); Smyers v. Workers' Comp. Appeals Bd., 157 Cal.App.3d 36, 203 Cal.Rptr. 521 (1984); Schwab v. Ariyoshi, 58 Hawaii 25, 564 P.2d 135 (1977); Janssen v. Janssen, 331 N.W.2d 752 (Minn.1983).").

and not what it actually said:

> the aggregate amount sold to all investors by the issuer, ***including any amount sold in reliance on the exemption provided under this paragraph during the 12- month period preceding the date of such transaction,*** is not more than $1,000,000.[27]

Yet the Commission interprets "including" to mean "only." I am not aware of *any* support for the SEC's interpretation of the term "including" in this context. Courts have consistently interpreted "include" and "including" to precede a nonexclusive example of the set of things that "include" or "including" follows. The sentence, "All cars must be registered, including blue cars," cannot mean that only blue cars must be registered. The sentence, "All felons must report to their parole officer, including felons who have served sentences of less than one year," cannot mean that murderers are not required to report to their parole officers.

Moreover, Congress knows how to limit a provision to crowdfunding securities. In fact, Congress proved as much *in this very same* Act. Section 4A(a)(8) requires crowdfunding intermediaries to comply with SEC rules designed:

> to ensure that no investor in a 12-month period has purchased ***securities offered pursuant to section 4(6)*** that, in the aggregate, from all issuers, exceed the investment limits set forth in section 4(6)(B) . . ..

This provision prohibits the sale of crowdfunding securities – and only crowdfunding securities -- to an investor if the sale would result in the investor's total purchases in the preceding 12 months exceeding the investor investment limits (5% of net income, *etc.*). Thus, an investor whose income and net worth are less that $40,000 purchased his investment limit of $2,000, a different issuer could not sell the investor another dollar in *crowdfunding* securities until 12 months had passed.

This limit in Section 4(a)(6)(8) is significant here because it shows that Congress knew how to draft a 12-month dollar limit that applies only to aggregate sales of crowdfunding securities. It use the words: "has purchased securities offered pursuant to section 4(6) that, in the aggregate, ..." It did not say: "has purchased securities, ***including those*** offered pursuant to section 4(6) that, in the aggregate, ..." Congress used different terms to impose separate 12-month dollar limits on sales of only crowdfunding securities for a reason. It specifically identified crowdfunding securities and *only* crowdfunding securities where the limit applied *only* to crowdfunding securities. In contrast, it used "including" in the $1 million issuer cap to clarify that crowdfunding securities were "included" in the aggregate amount but were *not* the only securities to which the provision applied. The only rational reading of the $1 million issuer cap is that it applies to all securities sold by the issuer.

The *FPA v. SEC* case again is relevant. In that case, the court declined to allow the Commission to write the "special compensation" prong out of the broker-dealer exclusion in the

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[27] *See* Coastal Barge Corp. v. Coastal Zone Indus. Control Bd., 492 A.2d 1242, 1246-47 (Del. 1985) ("We are mindful of the fact that the General Assembly used the words 'bulk product transfer facility means' rather than 'bulk product transfer facility includes' and that a term whose statutory definition declares what it 'includes' is more susceptible to extension of meaning by construction than where the definition declares what a term 'means.'" (citing 2A. Sutherland, Statutes and Statutory Construction § 47.07 (4th ed. 1984)).

Advisers Act. The court's analysis applies equally to the SEC's outlandish interpretation of "including" in the Crowdfund Act:

> As "[t]he plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters,'" the terms of the IAA establish the precise conditions under which broker-dealers are exempt from the IAA. "To read out of a statutory provision a clause setting forth a specific condition or trigger to the provision's applicability is ... an entirely unacceptable method of construing statutes."[28]

The Commission defies the rule that it "assume that in drafting ... legislation, Congress said what it meant"[29] by simply writing the term "including" out of the statute.

The Commission's interpretation of the $1 million cap provision also violates the spirit and intent of the Act. The Commission's interpretation would allow, for example, an issuer to raise $10 million, or $100 million in a private or public offering and follow up with a $1 million crowdfunding offering. Conversely, a business could raise $1 million and immediately follow that with a $10 million or $100 million private offering.

It could not have been further from Congress's intent to help startups and small businesses by creating an exemption for billion-dollar businesses. The Commission contends that:

> requiring aggregation of amounts raised in any exempt transaction – would be inconsistent with the goal of alleviating the funding gap faced by startups and small businesses because it would place a cap on the amount of capital startups and small business could raise.[30]

How, exactly, is there a "funding gap" for a business that raises tens or even hundreds of millions in a mere 12 months through non-crowdfunding offerings? Such a business definitionally does *not* have a "funding gap." Nor is it a startup or the kind of small business for which Congress created the crowdfunding exemption. The SEC's contention is also an exaggeration. The cap would apply only during the 12-month period; issuers would be free to engage in offerings outside of the 12-month window. The plain reading of the statute discussed above is not, as the Commission contends, "inconsistent" with the statute because no reasonable person would argue that the crowdfunding exemption was created to enable large businesses to raise capital.

Moreover, the Commission also stated that the:

> offering exemption in Section 4(a)(6) was designed to help alleviate the funding gap and the accompanying regulatory concerns faced by startups and small businesses, many of which ***may not be familiar with the federal securities laws***.[31]

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[28] 482 F.3d at 488 (citations omitted).

[29] *United States v. LaBonte*, 520 U.S. 751, 757 (1997).

[30] Proposing Release at 17.

[31] *Id.* at 269.

The startup or small business that is "not familiar with the federal securities laws" is not the business that would be able to raise substantial capital through a private offering and other methods.

The Commission stated further:

> As discussed above, the crowdfunding provisions of the JOBS Act, which we would implement through this proposed regulation, were designed to help alleviate the funding gap and accompanying regulatory concerns faced by small businesses by making ***relatively low dollar offerings*** of securities less costly and by providing crowdfunding platforms a means by which to facilitate the offer and sale of securities without registering as brokers, with a framework for regulatory oversight to protect investors.[32]

and:

> We understand that Title III was designed to help alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses in connection with raising capital in ***relatively low dollar amounts***.[33]

and:

> [T]he crowdfunding exemption] is intended to alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses in connection with raising capital in ***relatively low dollar amounts*** . . ..[34]

It is unclear why the Commission believes that interpreting a statute to allow businesses to raise *more* than $1 million in a 12-month period reflects its view that crowdfunding was "designed" or "intended" for small businesses "making relatively low dollar offerings of securities" or offerings in "relatively low dollar amounts."

It is not reasonable to read the Act as intended to help businesses that raise tens, hundreds or even thousands of millions of dollars by allowing them to raise an extra $1 million through crowdfunding. In contrast, it is entirely logical to read the statute to mean that Congress decided that $1 million was more than a "low dollar amount." Under the SEC's interpretation, tens or hundreds of millions of dollars would qualify as a "low dollar amount."

The Commission attempts to support its interpretation by referencing the Integration Proviso, which, as discussed in Part II, *supra*, is clearly intended to address the problem of using one offering to circumvent the rules of another concurrent offering. First, the $1 million limit is not ambiguous; it allows for only one reasonable reading. Second, the Integration Proviso refers to "preventing" offerings, whereas the $1 million

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[32] *Id.* at 465.

[33] *Id.* at 11.

[34] *Id.* at 305.

cap would only limit the amount raised and even then for no longer than 12 months. It would “prevent” nothing. The Commission states:

> An issuer that already sold $1 million in reliance on the exemption provided under Section 4(a)(6), for example, would be prevented from raising capital through other exempt methods and, conversely, an issuer that sold $1 million through other exempt methods would be prevented from raising capital under Section 4(a)(6).[35]

This is plainly incorrect. An issuer would never be subject to the limit for longer than 12 months. An offering would never be prevented; at worst, it could only be delayed.

The $1 million cap provision states that the “aggregate” amount of “securities” “sold to all investors” shall not exceed the $1 million limit in any 12-month period. These terms are unambiguous. The SEC’s interpretation makes a mockery of Congress’s plain English use of the phrase in the provision: “including any amount sold in reliance on the exemption provided under this paragraph.” The only rational interpretation is that the term “including” means that the category of offerings to which the $1 million cap applies “includes” crowdfunding offerings. There is no reasonable basis for interpreting the term “including” crowdfunding offerings to mean “only” crowdfunding offerings, just as it would be unreasonable to twist the meaning of a statute to enable large businesses that conduct multi-million-dollar offerings the ability to rely on the crowdfunding exemption. Finally, the Commission’s interpretation contradicts its repeated characterization of the entities for which crowdfunding was intended as “small businesses” raising “small dollar amounts” in order to remedy existing “funding gaps.”

IV. Limited on Investments by Investors

Virtually every member of Congress who has spoken about the Act has affirmed the importance of investor protection, and the Act’s most important investor protection provision is its limit on the amount that investors may invest. This provision is critical because typically one-third to half of small businesses fail within the first few years of their founding.[36] Crowdfunding businesses may have a high concentration of businesses that were rejected by angel investors, which suggests that their failure rate may be even higher, a view with which the Commission agrees.[37] Thus, a substantial percentage of investments made in small businesses will be worthless within a few years. Investors in these firms will lose their entire investment.

Small business failures are not typically the result of fraud. They are *business* failures that most often result from incompetence and/or inexperience. This means that,

[35] *Id.* at 17.

[36] The data varies greatly as to small business failure rates, but most show about a 40 to 50 percent failure rate after three years. *See, e.g.*, Scott Shane, Small Business Failure Rates by Industry: The Real Numbers, www.smallbiztrends.com (Sep. 24, 2012). The Commission cites various studies that show similarly high failure rates. *See* Proposing Release at 335 (“There is broad evidence that many of these potential issuers are likely to fail after receiving funding.”).

[37] *See* Proposing Release at 335 (“Because we expect that issuers that would engage in offerings made in reliance on Section 4(a)(6) would potentially be in an earlier stage of business development than the businesses included in the above studies, we believe that issuers that engage in securities-based crowdfunding may have higher failure rates than those in the studies cited above.”).

no matter what disclosures are provided, sophistication tests are applied, or intermediary rules are adopted, about half of crowdfunding investments in crowdfunded startups may be a total loss. This would not necessarily reflect negatively on crowdfunding, although one hopes that crowdfunding would result in improved survival rates. The only way to protect investors from a high rate of losses is to limit the amount that they are permitted to invest.

The Act imposes two forms of investment limits on crowdfunding investors as follows:

- The aggregate dollar amount of investments in any 12-month period in securities of a single crowdfunding issuer (including crowdfunding securities); and

- The aggregate dollar amount of investments in all crowdfunding securities in any 12-month period.

In each case the dollar limit is the same: from $2,000 to $100,000, depending on the investors' wealth and net worth. Thus, the limits protect investors against two primary investment risks: (1) issuer risk (the risk that a single crowdfunding issuer will fail), and (2) crowdfunding risk (the risk of investing in crowdfunding offerings by multiple issuers). In addition, the limits are generally based on a percentage of net worth/income, which more closely aligns the dollar amount at risk with the ability of the investor to bear the loss. This is a significant improvement over the application of investment limits in other scenarios. In contrast, the SEC's Rule 506 allows an investor with $1 million in net worth to bet all of it on a single offering, while an investor with only $999,999 can invest nothing. While the particular dollar limits that Congress chose are questionable (they allow someone with no income and $2,000 in assets to invest their last penny in a crowdfunding offering), and over a number of 12-month periods a crowdfunding investor could experience devastating losses, Congress should be applauded for designing a structure that arguably provides greater protection against financially devastating losses than that provided by the structure for private offerings.

The Commission recognizes the investor protection purpose of the limits on crowdfunding investments by investors, stating:

> Congress provided important investor protections for crowdfunding transactions under Section 4(a)(6), including individual investment limits.[38]

However, where there is any ambiguity in the operation of these investor protection limits, the Commission seems to have opted to interpret them to permit *larger* investments by *less wealthy* investors. Under the status quo, issuers may sell securities to investors who are below certain net worth and income floors only pursuant to a public offering or under a limited number of exemptions. Where the law departs from the status quo with respect to the protection of investors, as is the case with crowdfunding, it is incumbent upon the Commission that any reduction in investor protection occur only where the law is clear. Where there is doubt, the regulator should err on the side of the status quo unless Congress has expressed a clear intent to the contrary. However, the Commission seems to view every provision of the Act as intended to increase access to capital for small businesses without any regard for the Act's investor protection goals (or

[38] *Id.* at 12.

any regard for the likelihood that weakening investor protection is likely to undermine the crowdfunding market and hurt small businesses).

This tendency is particularly evident in the SEC's position on the investment limits in Section 4(a)(6)(B), in which there is a flat contradiction in the application of the investment limits. Subparagraph (B)(i)'s limit applies "if ***either*** the annual income or the net worth of the investor is less than $100,000." Subparagraph (B)(ii)'s limit applies "if ***either*** the annual income or the net worth of the investor is equal to or more than $100,000." The provisions are clear as long as an investor's income and net worth are *both* below $100,000, or *both* equal to or above $100,000. However, if one is below $100,000 and the other is equal to or above $100,000, both standards apply. Such a patent drafting error is, ironically, a reflection of the dark side of crowd psychology. Dozens of experts, perhaps hundreds, failed to detect this error during the drafting phase because we believed that the Emperor certainly could not be walking the streets with no clothes on. Nonetheless, the contradiction exists, and the Commission cannot adopt rules without resolving it.

Normally, one would resolve such a contradiction in way that furthers the goal of the particular provision. The Commission acknowledges that this is an investor protection provision, yet it has interpreted it to provide *less* investor protection rather than *more*. The Commission's justification for its position is that "this clarification would give effect to the provision and would be consistent with Congressional intent in providing investment limitations."[39] However, taking the opposite position would *also* be consistent with this intent. Virtually *any* interpretation would impose investment limitations, which renders the SEC's explanation completely meaningless. The question is: What did Congress want the limit to be when an investor has less than $100,000 in income but at least a $100,000 net worth, or vice versa?

Consider the investor with a small income or no income who has managed to save $100,000. This person may be a retiree living exclusively or primarily on Social Security who is particularly vulnerable to investment scams and has no means of recovering from losses. Thus, the Commission's interpretation would allow such a retiree with an annual income of $10,000 and $100,000 in assets to invest $10,000 in a crowdfunding offering, whereas an investor-protection interpretation would limit her investment to $5,000, as shown in the table below.

[39] *Id.* at 24.

Investor Characteristics	SEC Interpretation	Investor Protection Interpretation
$10,000 Annual Income + $100,000 Net Worth	$10,000	$5,000
$10,000 Annual Income + $500,000 Net Worth	$50,000	$25,000

Granted, Congress clearly decided that it is appropriate for a retiree living on Social Security with only $100,000 saved to make, at a minimum, a $5,000 investment (or a $2,000 investment with *no* income and a $2,000 net worth), which certainly makes a one-time increase of $5,000 under the SEC's interpretation seem less egregious.

What is difficult to understand, however, is why the Commission would choose to exacerbate an already bad situation by resolving a conflict in an investor protection provision that is in perfect equipoise in a way that further *reduces* investor protection.[40] This is difficult to understand, in part, because the Commission provides no discussion of the potential harm to investors from its position. The more that vulnerable crowdfunding investors experience financial distress as a result of crowdfunding, the less likely it is that the crowdfunding market will succeed. The SEC's position is not doing small businesses any favors at the same time it is increasing the financial risks for investors.

V. Investor Qualifications and Knowledge

The Commission has proposed that intermediaries be permitted to rely on the representations of investors regarding their eligibility to invest. The Commission must be mindful of imposing unnecessary burdens on crowdfunding, but in this respect it is imperative that stronger procedures be required when confirming investors' eligibility.

Investors will have an incentive to inflate their net worth, income or both in order to establish their eligibility and increase the amount they are permitted to invest. For example, an investor with a $90,000 net worth may represent that she has a $1 million net worth in order to be allowed to invest her entire net worth (up to 10% of $1 million), rather than the $5,000 allowed under the Act. The total reliance on self-certification ignores the fact that these are not just limits on issuers; the limits also effectively constrain investors' ability to invest in certain offerings.

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[40] In a belated letter to Congress, former SEC Chairman Shapiro expressions her concerns regarding the inadequacy of investor protections under crowdfunding. If this did not include minimizing the investment amounts made by the most vulnerable Americans, it is hard to imagine to what she was referring.

Self-certification does not take investor qualification requirements seriously. It imposes absolutely no controls on investors' ability to circumvent the limits, and it imposes no obligation on the part of issuers or intermediaries to ensure that the limits are not being circumvented. This approach creates a mutual incentive to require as little information as possible so as to provide the greatest freedom to both sides. If it were appropriate to leave the determination of an investor's qualifications entirely in the hands of the investor, then one might as well not impose any investor protection measures at all. Self-certification ignores the basic premise that this kind of investor protection provision operates to limit an investor's choices. *Investment limits are paternalistic*; they deny investors the discretion to make certain choices. Self-certification converts the limits to an investor early warning system that Congress simply *hoped* investors would heed. Self-certification allows the investor the discretion to make an investment that Congress decided not to allow him to make.

Self-certification also will result in mistakes. For example, investors are likely to routinely consider the value of their home in calculating their net worth and may even neglect to reduce that amount by any outstanding mortgage. Intermediaries should be required to obtain specific confirmation regarding the investors' calculation of their net worth, such as an account statement that shows the value of an investor's securities account or pay stubs that show their income. These documents can be sent electronically without an unreasonable burden on the investor. At a minimum, investors should be asked specifically about whether they have included the value of their home in their calculation.

The Commission also should clarify that intermediaries are responsible for compliance with investor qualification requirements. The reason that Congress decided to require that crowdfunding occur only through intermediaries[41] is that it is intermediaries, and probably *only* intermediaries, that offer any reasonable hope that investor qualification requirements will be enforced. The kind of small businesses that are likely to engage in crowdfunding will not have the expertise, experience or incentives to ensure compliance with *any* of the crowdfunding rules. In contrast, intermediaries are the kind of repeat-player, regulated entities that are most likely to ensure crowdfunding compliance.[42] As noted above, a large percentage of crowdfunding securities will be a total loss within a few years of their sale.

The Crowdfund Act specifically contemplates that the Commission adopt rules that require that intermediaries enforce the Act's investor qualifications. For example, the Act specifically requires that intermediaries "make such efforts as the Commission deems appropriate" to ensure that "no investor" exceeds the annual $2,000 to $100,000 investment limit. Under the this provision, the Commission has required only that intermediaries have no reason to believe that the limits have been exceeded or an investor is otherwise ineligible. This test not only requires no "efforts" of intermediaries; it also rewards willful ignorance. If self-certification is adequate, then an intermediary may consider it a litigation risk if it asks for more information and thereby creates a record on which knowledge of ineligibility could be argued.

[41] An earlier draft of the Act would not have required intermediary involvement. *See generally* Hearing before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, Committee on Oversight and Government Reform, United States House of Representatives (Sep. 15, 2011) (testimony of Mercer Bullard).

[42] *Id.* at 12.

VI. Investors' Review of Investor-Education Material

The Act requires that intermediaries "ensure that each investor reviews investor-education materials," which the Commission appears to believe may be satisfied by having the investor check a box. This standard does not satisfy Act's direct requirement that intermediaries ensure that investors "review" information. The active verbs "ensure" and "review" require active compliance.

As the Commission is aware, there is no more common misrepresentation by Internet users than their checking a box stating that they have read something. Anyone who uses a computer routinely checks boxes stating that they have read licensing terms and other disclosures when they know that they have not. Investors will undoubtedly do the same with respect to investor-education materials. The check-the-box approach is especially odd because an intermediary could easily determine whether the relevant document had been opened or the investor has actually scrolled past the first few lines. This information would demonstrate that the box-checking investor had *not* reviewed the information, but the intermediary would be allowed to ignore this information (although one could argue that it had imputed if not actual knowledge that the material was not reviewed). The Act does not permit such a lackadaisical approach to the "review" requirement.

Indeed, just a few lines below the "ensure that each investor *reviews*" standard there is a "ensure that the investor *positively affirms*" standard. The term "positively affirms" means that the investor has made an active representation – silence or a non-response would be inadequate – that, in this case, the investor understands the risk of loss and can bear the loss. Thus, Congress knew how to establish an investor affirmation standard. It is unreasonable to interpret a requirement to ensure that an investor "review" an act as a requirement that the investor merely "positively affirm" it. The SEC's proposed check-the-box requirement is not consistent with Congress's choice of words.

It is impracticable, of course, to require intermediaries look over the shoulder of investors to confirm that they have read investor-education materials. However, it would be practicable to require investors to take a quiz that demonstrated that they had reviewed the materials, a method that the Commission has suggested could be satisfactory. This quiz could be combined with the quiz that intermediaries are otherwise required to administer to confirm each investor's understanding of liquidity risk and the risk of investing in small businesses. Alternatively, the Commission could require that the investor scroll through a series of web pages that show only one or two short sentences in a large font setting forth the most important investor-education facts, with a button confirming that they have read them and a link to more information related to that web page.

Finally, the Commission should clarify that broker-dealers continue to be subject to FINRA rules with respect to crowdfunding offerings. These rules require that the *broker-dealer* "positively affirm" that crowdfunding investments are suitable for their clients. Broker-dealers also must gather information to support that finding to a degree that exceeds the requirements of the Act. It is very likely that, if funding portals are created, FINRA will extend identical rules to those intermediaries as well. The Commission would be remiss not to review, in its adopting release, existing broker-dealer rules in order to dispel any notion that the Act's intermediary requirements in any way supplant these rules, and to place in this broader context the additional requirements that the Act imposes.

VII. Meaning of "Investor" and "Investor and their Spouse"

The $2,000-to-$100,000 investment limit under the Act applies to the "aggregate amount sold to ***any investor***."[43] The same provision refers in subparagraph (B)(i) to "the annual income or the net worth of ***the investor***." Subparagraph (B)(ii) also refers to "the annual income or the net worth of ***the investor***." In each case, the term "investor" is singular. None of the foregoing provisions refers to "investors." None of the foregoing provisions states or even implies that the term "investor" should be interpreted to mean and "investor" *and their spouse*.

Nonetheless, the Commission chose to interpret the singular "investor" to include the investor's spouse.[44] The SEC's only justification for interpreting a singular noun as a plural noun (and to identify the other investor as a spouse) is that it:

> believe[s] that this approach is consistent with the rules for determining accredited investor status because the accredited investor definition contemplates both individual and joint income and net worth with a spouse as methods of calculating annual income and net worth.[45]

This explanation might make sense but for the fact that it is *not* the accredited investor definition that is being applied. It is the investment limit for investments in crowdfunding offerings, where Congress specifically chose to use the singular term "investor." The Commission has simply decided that Congress *should have* applied the same standard to a couple and accordingly amended the statute.

Nor is the SEC's position consistent with the accredited investor definition. The accredited investor definition requires at least $200,000 in income for an individual investor, but the joint income requirement is higher, at $300,000. Even assuming that it has the authority to replace Congress's crowdfunding standard for a single investor with a standard for singles and couples, which it does not have, the Commission has violated its own position that the minimum for a couple should be *50 percent higher.*

This is also despite the fact that Congress knew very well how to apply the accredited investor definition when it believed that this standard was appropriate. Congress did precisely that when the standard that it provided that crowdfunding net worth and income should be "calculated in accordance with" the calculation of net worth and income for an accredited investor. Thus, Congress specifically chose the accredited investor calculation methodology (*e.g.*, the exclusion the value of a home in calculating net worth) but not accredited investor treatment of a couple's income or net worth. Yet the Commission seems to believe that this was a mere Congressional oversight that it is the SEC's prerogative to fix.

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[43] Securities Act § 4(a)(6)(B).

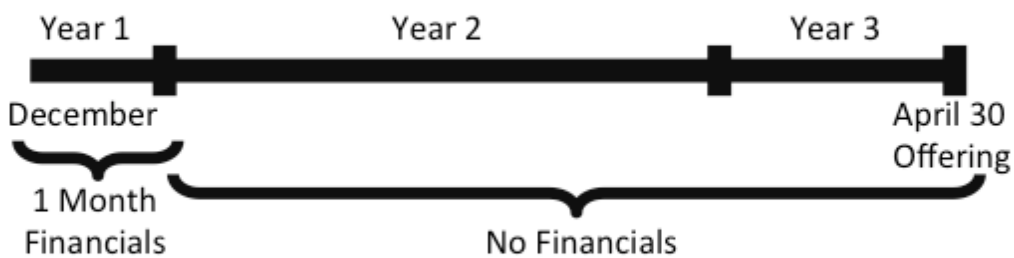
[44] On a related matter, the Commission asks whether the 5 and 10 percent limits should apply to the higher or lower of the investor's income or net worth. The Commission is correct that subparagraphs (B)(i) and (ii) do not expressly state to which the limit should apply. In view of the placement of the phrase "the greater of" immediately preceding the dollar amount and percent limits, that phrase should be interpreted also to apply to "the annual income or the net worth" that immediately follows. This approach avoids the anomalous result, for example, where an investor with annual income of $40,000 and a net worth of $1,000,000 could not invest more than $2,000 (or $4,000 under the SEC's proposal). It also mitigates the limiting effect of applying the 5 percent limit when either an investor's income or net worth are below $100,000.

[45] Proposing Release at 25.

VII. Stale Financial Statements

The Act requires that crowdfunding issuers provide financial statements to investors. This information will be critical in helping the crowd evaluate issuers, but it will not be helpful if the information is stale. Stale information is of particular concern here because many issuers will have a very short operating history. For example, if an issuer with a calendar fiscal year begins operations in December and makes an offering the following June, then the financial statement from its most recent fiscal year would cover only one month, *i.e.*, one-seventh of the lifespan of the business.

The Act does not indicate how current the financial statements must be. The Commission has proposed that financial statements need only be as recent as the end of the issuer's most recent fiscal year. During the first 120 days of an issuer's fiscal year, the financial statements need only be as recent as the end of *preceding* fiscal year. In the latter scenario, the issuer with a calendar fiscal year that began operations in December in Year 1 could submit financials covering only that month for a crowdfunding offering beginning as late as April of Year 3. The financials would be 16-months stale and cover only one month in the issuer's 17-month lifespan, as illustrated below.



The SEC's proposal will substantially dilute the value of crowdfunding financial information. The proposal permits extremely stale information relative to the life of a firm to be the basis for an investment decision by nonaccredited investors. It is unclear how the "wisdom" of the crowd will be able to evaluate a firm based on financial information that may be effectively irrelevant to an issuer's financial condition at the time of the offering.

The Commission correctly notes that an issuer must disclose any material changes that have occurred since the date of the financials. For example, issuers must disclose material changes in reported revenue and net income. However, requiring such disclosure without also requiring that the information be provided in the format of a financial statement undermines the purpose of using financial statements in the first place. A financial statement is, in effect, a standardized way of organizing information that facilitates interpretation and comparison. A generalized disclosure about changes in revenues and net income does not satisfy this standard. It promotes the dissemination of financial information in obtuse, inconsistent formats. Enforcement of the requirement to correct material changes, which is highly subjective, would be far more difficult than enforcement of a requirement to provide current financial statements, which is relatively objective.

If changes in financial information were unlikely, stale financials might not be a significant problem, but early stage businesses are very likely to experience significant changes in their financial information over short periods. These changes will be critical information because they will be both more current and reflect the possible direction of the business. The SEC's approach is also problematic because it leaves substantial discretion to issuers to update financial information when the changes are positive, while not disclosing information when it is negative.

The Commission should require that crowdfunding issuers provide truly *current* financials. These need not necessarily meet the same degree of formality. For large offerings, the Commission could require that issuer provide their audited financial statements for the two most recently ended fiscal years plus non-audited (*e.g.*, CEO-certified) financial statements[46] through the end of the month that ends no more two months before the month in which the offering begins (*e.g.*, an offering any day in March would require financials up to January 31). It should not be burden for an issuer what is otherwise providing audited financial statements.

For smaller offerings that have less burdensome financial statement requirements under the Act, a modified standard for providing current information might be appropriate. However, permitting issuers to sell shares off of financial statements that may be 16-months stale, especially where that 16-month period may represent almost the entire lifespan of the business, will not facilitate the development of an efficient market. Issuers will exploit the opportunity to make offerings based on stale information and thereby dilute investor confidence in crowdfunding and disadvantage other issuers that are more forthcoming.

IX. Auditing Standard

The Act appropriately grants the Commission the authority to determine the standards and procedures for crowdfunding issuers' financial statements. The Commission has proposed to apply the AICPA's accounting standards, which are widely used and understood. This standard will ensure consistent disclosure across crowdfunding issuers.

However, the Commission has chosen not to provide uniformity with respect to the auditing standards that are applied. It would allow issuers to choose between standards promulgated by the AICPA, a private body, and the PCAOB, a public regulator. Allowing different auditing standards will eliminate the benefits of uniformity across all crowdfunding audits. This position would allow issuers to game the system and achieve an unfair competitive advantage by allowing them to choose the lower standard. The AICPA standard already is lower than the PCAOB standard in some respects, and as the PCAOB continues to review and develop auditing standards the differences between the two are likely grow. Congress created the PCAOB in part to address perceived deficiencies in AICPA standards. The Commission should not encourage a retreat with the respect to the work that the PCAOB is doing to improve the quality of audits.

X. $500,000 Trigger for Audited Financials

The Act requires that a crowdfunding issuer provide audited financial statement if the amount of the offering exceeds $500,000. However, it also authorizes the Commission to establish some other amount. This means that the Commission could raise or *lower* this amount, yet the Commission describes this authority as permitting only an increase in the amount.[47] The

[46] The Act's financial statement requirement could be read to require current financial statements or only the most recent financial statements. In light of this lack of clarity, the Commission should be viewed as having the authority to impose a reduced requirement for current financials or to require that current financials be provided that meet the Act's standard.

[47] Proposing Release at note 31 ("*Cf.* Securities Act Section 4A(b)(1)(D)(iii) (giving the Commission discretion to increase the aggregate target offering amount that requires audited financial statements).").

Commission should acknowledge that this authority also allows for a reduction in this amount and that it will, in fact, reduce the amount if subsequent events warrant such a reduction.

Such an increase *or reduction* may be appropriate in the future, but the Commission does not currently have any analytical or empirical basis to do so. Debt crowdfunding, such as offered by Prosper.com and LendingClub.com, has been operational for years. It may offer insight into the relevance of financial statement standards in the crowdfunding context. Gift-based crowdfunding sites have enough of an operating history that they also might shed light on this question. I am not aware of the SEC's having considered the role played by financial statements in either context. The only current basis for the audited financial trigger is the specific dollar amount of $500,000 provided by Congress. In view of the current lack of any basis for second-guessing the default standard, the Commission should neither raise nor lower the $500,000 trigger. However, it should promptly establish information collection and analysis procedures in order to ensure that it has the capacity to evaluate changes in the $500,000 trigger in the future.

XI. Disqualification of Crowdfunding Issuers That Are in Violation of the Act

Congress granted the Commission express authority to prohibit certain issuers from relying on the crowdfunding exemption. Under this authority, the Commission proposes to exclude issuers that have not provided to investors the annual reports that are required under the Act. I agree that issuers that have demonstrated an inability to comply with the *only* obligation that continues after a crowdfunding offering should not be allowed to engage in another crowdfunding offering until they have come into compliance. The delivery of the annual report is entirely within the control of the issuer. Its inability to make this disclosure shows that it should be relied upon to make appropriate disclosures or meet other legal obligations in the course of new offering.

However, the Commission has proposed to disqualify issuers only if they have not filed and delivered their ***two*** most recent reports. Under this standard, an issuer could make a crowdfunding offering even it had gone 23 months and 30 days without having filed a report. Indeed, it might *never* have filed a report. Pursuant to the crowfunding offering, the issuer would have to provide information that would constitute more, if not all of what would otherwise have been included in its annual report. It is unclear why an issuer that is able to provide adequate offering disclosure should be allowed to continue to withhold the same information from its existing shareholders.

There is no reason that an issuer that is currently delinquent on the filing or delivery of one report, much less two should be allowed to avail itself of the crowdfunding exemption. Permitting such issuers to participate in the same market as small businesses that do comply with the law will only degrade investor confidence in the crowdfunding market and create an unlevel playing field by imposing costs of some issuers that are not imposed on others.

On a related issue, the Commission asks whether issuers should be permitted to redact personal identifying information from their tax returns. The purpose of filing tax returns is to provide investors with useable information on which to base an investment decision. To the extent consistent with this purpose, the Commission should permit the redaction of personal information.

XII. Online-Only Offerings

The Commission proposes to limit crowdfunding activities – transactions, advertising, and communications – to a single intermediary platform.[48] This is based on the SEC's view that a primary benefit of crowdfunding is the exchange of information that occurs among members of the crowd and the "wisdom" created thereby.[49] It appears that the Commission believes that corralling such communications on a single site avoids the potential diffusion of crowdfunding communications across a number of venues. The Commission also correctly notes that limiting offerings to a single intermediary would also facilitate enforcement of the Act's investment limits.

However, the Act provides little support for the SEC's online-only position. The Act says nothing about the wisdom (or madness) of crowds or the value of concentrating communications regarding a crowdfunding offering on a single intermediary platform. The inclusion of the term "Online" in the Act's name does not suggest that offers in other contexts should be disallowed; only that online offerings clearly should be facilitated. The Commission cites comments by two members of Congress that crowdfunding will facilitate investing on the Internet, but neither comments implies, much less states that crowdfunding should not be allowed anywhere else.[50] The Commission cites to James Surowiecki's popular book <u>The Wisdom of Crowds</u> for the proposition that the Internet is a "'perfect technology capable of aggregating millions of disparate, independent ideas in the way markets and intelligent voting systems do, without the dangers of "too much communication" and compromise.'"[51] (It is noteworthy that the Commission mentions this book while nowhere mentioning one of the most widely cited books

[48] *See id.* at 31 ("Although the statute does not expressly require it, we also believe that in enacting Section 4(a)(6)(C), Congress contemplated that crowdfunding transactions made in reliance on Section 4(a)(6) and activities associated with these transactions would occur over the Internet or other similar electronic medium that is accessible to the public. We believe that an "online-only" requirement enables the public to access offering information and share information publicly in a way that will allow members of the crowd to decide whether or not to participate in the offering and fund the business or idea. We believe that other mechanisms would not offer this opportunity. The proposed rules would require that an intermediary, in a transaction involving the offer or sale of securities in reliance on Section 4(a)(6), effect such transactions exclusively through an intermediary's platform. We propose to define the term "platform" to mean an Internet website or other similar electronic medium through which a registered broker or a registered funding portal acts as an intermediary in a transaction involving the offer or sale of securities in reliance on Section 4(a)(6)." (footnotes omitted)).

[49] *See id.* at 33 ("Finally, we are not proposing to permit offerings to be conducted through means other than the Internet or similar electronic medium because we believe that allowing other non-electronic means would be inconsistent with the underlying principles of crowdfunding and the statute. Offerings made by other means would not be widely accessible by the public, which would defeat the benefit of the collective wisdom of the members of the crowd.").

[50] *See id.* at note 55 (quoting Senators Warner and Landrieu).

[51] *Id.* at note 56. The CDFIs described in a comment letter from City First and materials submitted to the Commission illustrate the type of entities whose crowdfunding activities may be unfairly inhibited by the online-only rule. *See* SEC Memorandum (July 30, 2013) *available at http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-250.pdf*; City First Enterprises Letter (July 2013) *available at* http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-245.pdf. City First recommends that the Commission use its broad authority to adopt investor protection measures to reduce investor protections under the Act. As discussed above, the Commission does not have the authority to repeal detailed investor protections established by Congress. Nor is the laudable mission or record of CDFIs a reason to do so.

on bubbles, Extraordinary Popular Delusions and the Madness of Crowds,[52] which may more accurately reflect the typical crowd behavior exhibited in financial markets.) But this does not mean the Internet must be the *exclusive* means communications. There is a difference between the reasons to funnel *all Internet communications to a single website* and the reasons to funnel *all communications to the Internet*.

In addition, it is not clear why it would necessarily be inconsistent with the facilitation of communications to permit transactions to be processed or communications to occur at physical locations. One of the benefits of crowdfunding may be that it facilitates community investing where investors who have geographic ties seek to invest in neighborhood businesses. Investors in a local store or restaurant, for example, should be allowed to engage with the issuer one-on-one at the bricks-and-mortar location where the funds raised will actually be spent. Investors should be able to interact in the office of the community bank that may be providing loans in connection with an equity offering by a community enterprise. Investors who prefer not to communicate in an electronic environment should not be kept in the dark. Investors who prefer to read material on paper rather than online -- to avoid printing burdens, for example -- should be able to obtain paper copies of filings at physical locations. Transactions could be required to be processed through the electronic portal or documents printed off the website, which would satisfy compliance concerns. The SEC's implied assumption that online and offline communications are substitutes is not intuitive, much less empirically based.

Physical access should not be denied to some investors pursuant to the somewhat idealized view that investors should be permitted to interact with a crowdfunding offering only on an electronic basis in virtual space. The SEC's online-only position seems to contradict crowdfunding's purpose of making both access to capital and access to investments not more inclusive, but less. Permitting physical locations to promote local businesses should be viewed as an important potential benefit of crowdfunding.

Nonetheless, the Commission is correct that crowdfunding is likely to be a predominantly online activity. There are significant compliance benefits to requiring online-only offerings. The requirement that investors agree to delivery exclusively by online means will provide some assurance that investors in online offerings are Internet users. It is this delivery requirement that may be the most difficult to accommodate if in-person activities are permitted. The Commission should consider further how crowdfunding activities could occur offline without compromising investor protection and market integrity.

XIII. Electronic Delivery

The Commission takes the position that the online delivery requirement could be satisfied by "an electronic message that provides notice of what the information is and that it is located on the intermediary's platform or on the issuer's website."[53] The electronic delivery requirement is both an agreement by the investor to receive information electronically and *by the portal to actually deliver the information*. This can be accomplished by including the information or an active hyperlink to the information in the message. The information should not be considered to have been delivered if the recipient must go to another website guided only by the site's home URL (actually, the proposed rule does not even require a URL[54]). The SEC's position is also

[52] Charles MacKay, Extraordinary Popular Delusions and the Madness of Crowds (1841).

[53] Proposing Release at 150.

[54] *See* Proposed Rule 302 ("Unless otherwise indicated in the relevant rule of Subpart C, in satisfying this requirement, an intermediary must provide the information through an electronic message that contains the information, through an electronic message that includes a specific link to the information as posted on

inconsistent with its position in other contexts in which an active hyperlink is necessary to fulfill a delivery requirement,[55] including amendments to Reg A proposed just two months ago.[56] Conversely, the Commission has taken the position that an *inactive* URL would *not* be treated as having incorporated the information at that URL.[57] Consistent with these positions, the Commission should require that electronic message include the information or an active hyperlink.

XIV. Oversubscribed Offerings

The Commission has proposed that issuers be required to disclose how they will allocate shares in oversubscribed offerings, but otherwise grants them the discretion to decide how the allocation will be done. One problem is that this is not quite what the proposed rule says. The proposed rules states that issuers must disclose whether they:

> will accept investments in excess of the target offering amount and, if so, the maximum amount that the issuer will accept and whether oversubscriptions will be allocated on a pro-rata, first come-first served, or other basis.[58]

Read literally, this provision would permit an issuer to disclosure that it will allocate oversubscriptions on a basis other than pro rata or first-come, first-served and provide no other guidance. The last part of the rule might be clearer as follows: "and how oversubscriptions will be allocated, whether on a pro-rata, first come-first served, or other basis."

This is a rather minor point relative to the more important question of whether first-come, first-served allocations should be permitted at all. The Williams Act and rules thereunder specifically prohibit tender offers for public companies from being made on a first-come, first-served basis. Rule 14d-8 requires that tender offers be made on a pro rata basis because first-come, first-served offers have the potential to harm investors by creating a stampede effect.[59]

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intermediary's platform, or through an electronic message that provides notice of what the information is and that it is located on the intermediary's platform or on the issuer's website.").

[55] *See* Note 1 to Paragraph (b)(2)(i) of Rule 433, Securities Act Rule 433; Securities Act Rel. No. 8591 at 88 (July 19, 2005) ("For purposes of Rule 134, including a URL address to the statutory prospectus that is not an active hyperlink in an electronic communication does not mean that the prospectus has been delivered.").

[56] Securities Act Rel. No. 9497 at note 202 (Dec. 18, 2013) ("In the case of an electronic-only offering, the notice must include an active hyperlink to the final offering circular or to the offering statement of which such final offering circular is part.").

[57] *See, e.g.*, Securities Act Rel. 7856 at Part B(1) & note 41 (Apr. 28, 2000) ("we would not consider the presence of the URL to make our web site, or an issuer's web site, as the case may be, part of a document if the party presenting the URL takes reasonable steps to ensure that the URL is inactive (for example, by removing "a>href" tagging) and includes a statement to denote that the URL is an inactive textual reference only.").

[58] Proposed Rule 201(h).

[59] *See San Francisco Real Estate Investors v. Real Estate Invest. Trust of Am.*, 692 F.2d 814, 817 (1st Cir. 1982) ("When Congress enacted the Williams Act in 1968, it recognized that an offeror who hoped to gain control of a target firm might well rely on a 'stampede' effect. The offeror would encourage shareholders to decide in its favor by offering a high price for only a portion of the outstanding shares and making that

The stampede effect is, of course, a reflection of a less appealing form of crowd dynamics. As Senator Merkley has stated, the Act's provisions "are designed to allow investors the chance to carefully consider offerings, permitting the 'wisdom of the crowd' to develop, rather than perhaps just the 'excitement of the crowd.'" The Senator was referring here to withdrawal rights, which are also important in mitigating the stampede effect (the Commission has proposed to required a right to withdrawal up to 48 hours before the deadline for an offering[60]). However, issuers will have an incentive to use a first-come, first-served approach to allocating oversubscribed offering in order to pressure investors to act quickly based on "excitement" rather than "wisdom." This could and should be mitigated by requiring pro rata allocations of oversubscription amounts.

XV. Extension of Time to File Taxes

The Act requires that issuers raising $100,000 or less in a 12-month period file a copy of their most recently "filed" tax return. The Commission interprets this requirement literally, which means that issuers that have obtained an extension to file their returns would not be subject to this requirement. The Commission asks whether issuers should be allowed circumvent this requirement simply by obtaining an extension of time to file.

In my view, The Commission should interpret the date that a tax return is "filed" as a date not later than the deadline for the filing. The Commission should adopt this interpretation in order to prevent issuers from improperly evading the tax return filing requirement. Alternatively, the Commission could impose this interpretation when the issuer has never filed a tax return in order to ensure that at least one tax return is available.

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In conclusion, I greatly appreciate this opportunity to comment on the SEC's proposed rules under the Crowdfund Act. Crowdfunding has great potential, but it also presents significant investor, issuer and intermediary risk. The Commission staff has done an extraordinary job creating a comprehensive regulatory scheme under severe time constraints. However, in some respects the SEC's proposal takes positions that seem based on the theory that investor protection and access to capital are inconsistent goals and then decided in favor of the latter over the former. However, access to capital will not be advanced by policies that undermine market integrity and benefit only those issuers or portals that choose not to follow good business practices. Only disreputable small businesses will take advantage of policies that make it easier to accept ineligible investors, disregard compliance, conceal financial information and engage in misleading advertising. The effect will be to increase relative costs incurred by reputable businesses while degrading the market integrity on which the future of crowdfunding depends. The term "crowdfunding" could easily and quickly become synonymous with "penny stocks." The Commission should ensure that at least the first iteration of crowdfunding rules minimizes the likelihood of crowdfunding being relegated to the dark alleys of capital markets.

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price available."). There are other anti-stampede provisions under the Williams Act, including a minimum offer period and withdrawal rights.

[60] Proposed Rule 304(a). The Act requires that issuers provide a "reasonable opportunity" to cancel their orders prior to sale, Securities Act § 4A(b)(1)(G), and 48 hours prior to the deadline meets this requirement.

I look forward to what may be the beginning of a new era in capital raising and thank you for your consideration of my comments.

Sincerely,

Mercer Bullard
President and Founder
Fund Democracy, Inc.

cc by Email and/or U.S. Mail:

Honorable Mary Jo White, Chairman
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