SECURITIES AND EXCHANGE COMMISSION

Comments on Proposal to Implement Crowdfunding
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Comments Submitted By: Mr. Adam Cole
Villanova University School of Law
[redacted]

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Comments Submitted To: Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

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I. Introduction

I appreciate the opportunity to submit these comments in response to the Securities and Exchange Commission's (the "Commission") request for public comment regarding the proposed Regulation Crowdfunding implementing Title III of the Jumpstart our Business Startups Act of 2012 (the "JOBS Act").[1] Although I am currently a third-year law student at Villanova University School of Law, I submit these comments solely on my behalf. Thus, the following comments reflect only my personal views. I am interested in securities regulation generally because of several classes I have taken in law school and very much appreciate the opportunity to comment on the proposed Regulation Crowdfunding. I also believe small businesses need an easier path to access needed capital in the early stages of their development and believe a properly implemented crowdfunding regime could provide it.

I commend the Commission on its initial efforts to implement Title III of the JOBS Act. Implementing a regulatory scheme for the relatively new area of crowdfunding is a difficult task and I feel the Commission's first efforts are a great attempt to balance the need to help small businesses raise capital with investor protection. Although as a whole I feel the Commission struck an appropriate balance between facilitating capital formation and protecting investors, I would like to take this opportunity to comment on one specific area which I feel the Commission overly burdens issuers with costly regulatory hurdles.

The Commission's proposed Rule 201(f) mandating issuer-specific risk factor disclosures should be eliminated because it burdens issuers and other cost effective investor protections are available. Section II provides a brief background of the Commission's proposed Rule 201(f) that

[1] Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in various sections of 15 U.S.C.)

requires disclosure of issuer-specific risk factors. Section III contains the substantive comments on the proposed rule and argues why it should not be required. Section IV briefly concludes the comment.

II. Background on Proposed Rule 201(f) for Issuer-Specific Risk Factors

In order to use the crowdfunding exemption under Section 4(a)(6) of the Securities Act of 1933 and the proposed Regulation Crowdfunding, issuers must make several disclosures to potential investors.[2] The JOBS Act itself mandated certain specific disclosures for issuers,[3] but also gave the Commission the authority to promulgate additional disclosures "for the protection of investors and in the public interest."[4] The Commission used its discretion under this provision to propose that issuers make disclosures about both the general risks of investing in a Section 4(a)(6) security and the specific risks of investing in a specific issuer. The issuer-specific risk factor disclosure requires that issuers provide "a discussion of the material factors that make an investment in the issuer speculative or risky."[5] The Regulation Crowdfunding risk factor disclosure is similar to that in Item 503 of Regulation S-K, which requires "a discussion of the most significant factors that make the offering speculative or risky."[6]

The Commission seeks comment on the proposed risk factor disclosures in question 41 as follows:

> Should we require the issuer to include certain specified legends about the risks of investing in a crowdfunding transaction and disclosure of the material factors that make an investment in the issuer speculative or risky, as proposed? Why or why not? Should we provide examples in our rules of the types of material risk factors an issuer should consider disclosing? Why or why not? If so, what should those examples be?[7]

Section III below discusses several reasons why the Commission should not require issuers to disclose material risk factors.

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[2] *See* proposed Rule 201(a)-(t) of Regulation Crowdfunding.

[3] *See* Securities Act Section 4A(b)(1)(A)-(H).

[4] *Id.* at Section 4A(b)(1)(I)

[5] *See* proposed Rule 201(f) of Regulation Crowdfunding.

[6] *See* Item 503(c) of Regulation S-K [17 C.F.R. § 229.503(c)].

[7] *See Crowdfunding*, Release No. 33-9470 (Oct. 23, 2013), 78 Fed. Reg. 66443 (proposed Nov. 5, 2013).

III. Discussion of Proposed Rule 201(f) for Issuer-Specific Material Risk Factors

The Commission should not require issuer-specific risk factor disclosures because the cost burden on issuers outweighs the benefit from risk factor disclosures. In addition, less costly investor protections are available in the proposed rules. Proposed rules in Regulation Crowdfunding already require intermediaries[8] to educate investors on the substantial risks of investing in Section 4(a)(6) securities before investing. The proposed rules also require issuers to legend generic risk factors on Form C. Further, the Commission itself recognizes the "wisdom of the crowd" provides some protection to investors.

A. The Compliance Costs of Issuer-Specific Risk Disclosures Outweigh the Benefit to Investors

The Commission should not mandate issuer-specific risk disclosures because any benefit to investors is outweighed by the substantial burden placed on issuers. Instead, the burden of educating investors about risk should be placed upon intermediaries because they will be in a better position than issuers to absorb compliance costs. Many issuers will be startup companies who have scarce resources that are better spent on productive business items rather than compliance costs.

Issuer-specific risk disclosures will be expensive because these disclosures are lengthy and are usually drafted by outside professionals such as lawyers or accountants. The Commission estimates the drafting of the entire Form C will take 60 hours, with only 15 of those hours performed by outside professionals.[9] Even without considering the other disclosure items, the risk factor disclosures will likely be lengthy and take several hours to draft and review. The Regulation S-K risk factor disclosure requirement is similarly worded to proposed Rule 201(f) of Regulation Crowdfunding, but the Regulation S-K item also includes a requirement that the "discussion must be concise."[10] Even with this instruction, risk factors disclosed under this requirement for securities offerings are anything but concise. For instance, in the recently filed Twitter S-1, the risk factors filled 33 out of 175 total pages, or approximately 19% of the document. Although Twitter is a more sophisticated company than any company that will use the Section 4(a)(6) exemption and thus has more risk factors, the ratio of pages for risk factors to total pages in Form C could be similar. If risk factors comprise a substantial total of Form C as they do for similar documents, this requirement will be very costly and burdensome to issuers.

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[8] The JOBS Act requires issuers to use an intermediary to conduct a Section 4(a)(6) transaction, either a registered broker or a newly created entity called a funding portal. *See* Securities Act Section 4A(a)(1). This comment will use the term intermediary as the substantive comments apply equally to both registered brokers and funding portals.

[9] 78 Fed. Reg. 66540.

[10] *See* Item 503(c) of Regulation S-K [17 C.F.R. § 229.503(c)].

The Commission recognized the costly nature of mandatory risk factor disclosures and exempted smaller reporting companies from this requirement on Forms 10-Q and 10-K.[11] Smaller reporting companies are issuers that, among other requirements, have a public float of less than $75 million.[12] Smaller reporting companies are eligible for scaled disclosure and reporting requirements in some Securities Act and Exchange Act filings. Part of the purpose of these scaled requirements was to provide relief and simplification to smaller companies because there was a "special concern for small businesses."[13] In enacting scaled disclosure requirements, the Commission expected companies would be able to "reduce costs associated with the preparation of disclosure."[14]

To be sure, issuer-specific risk disclosures do provide important information to investors, but any protection to investors is outweighed by the substantial compliance cost. The Commission provided only a one sentence justification for the rule without discussing the rule's substantial costs to issuers.[15] In its justification for rules allowing scaled disclosure requirements in Securities Act and Exchange Act filings for smaller reporting companies, the Commission recognized that "more information is not necessarily better if the cost to provide the information is greater than the benefit. [Smaller Reporting Companies] would be providing scaled disclosure to fit the characteristics of their company while balancing the burdens of providing information with their benefits."[16]

The Commission should follow its prior reasoning for providing relief to smaller reporting companies and also provide relief to Section 4(a)(6) issuers. The cost burden on issuers to provide mandatory risk factor disclosures outweighs the benefit to investors in the crowdfunding regulatory scheme, just as it did for smaller reporting companies in other filings. Further, there are additional protections available to investors in Regulation Crowdfunding that mitigate some of the risk that comes with eliminating mandatory issuer-specific risk disclosures.

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[11] *See* Item 1A on Forms 10-Q and 10-K.

[12] *See* Item 10(f)(1) of Regulation S-K [17 C.F.R. § 229.10(f)(1)].

[13] *See Smaller Reporting Company Regulatory Relief and Simplification*, Release No. 33-8819 (Jul. 5, 2007), 72 Fed. Reg. 39671 (proposed July 19, 2007).

[14] 72 Fed. Reg. 39686.

[15] The Commission "believe[s] that this risk factor information should help investors to better understand the risks of investing in a specific issuer's offering." 78 Fed. Reg. 66442.

[16] 72 Fed. Reg. 39686.

B. Proposed Rules in Regulation Crowdfunding Provide Additional Investor Protections that Help Mitigate any Additional Risks From Eliminating Issuer-Specific Risk Factor Disclosures

The cost of mandating issuer-specific risk factor disclosures outweighs any benefit partly because Regulation Crowdfunding already contains other rules that protect investors. First, Congress required intermediaries to educate investors on the generic risks of investing in Section 4(a)(6) offerings.[17] The Commission did an excellent job expanding on Congress's directive by requiring intermediaries to deliver educational materials at various times that inform investors of a number of important items, including "the risks associated with investing in securities offered and sold in reliance on Section 4(a)(6)."[18] Second, the Commission proposed a rule to require issuers to legend certain risk disclosures on Form C. Third, the individual investor cap limits the amount an investor could lose in a year.

1. Intermediary Educational Materials Warn Investors About the Risks of Investing in Section 4(a)(6) Securities

The Commission's proposed rules for intermediary educational materials adequately warn investors because the Commission requires intermediaries to provide a substantial amount of information to investors at several key intervals prior to investing. First, investors would need to receive extensive educational material warning of potential risks in Section 4(a)(6) offerings in general before opening an account. The investor must represent to the intermediary that the investor has reviewed the educational material at account opening.[19] Next, before any investment commitment the intermediary would need to obtain these same representations from an investor that the investor has reviewed the latest educational material.[20] Finally, investors would need to complete a questionnaire demonstrating the investor's understanding of risks and other key provisions.[21]

The extensive investor education rules adequately warn investors about the substantial risks of investing in Section 4(a)(6) securities. Although the rules do not provide a specific form

[17] *See* Securities Act Section 4A(a)(3) (requiring intermediaries to "provide such disclosures, including disclosures related to risks and other investor education materials, as the Commission shall, by rule, determine appropriate")

[18] *See* proposed Rule 302(b) of Regulation Crowdfunding. Other notable risks address in the educational material include information on the risks of investing in the specific type of security and the restrictions on resale of Section 4(a)(6) securities. *See id.*

[19] *See* proposed Rule 303(b)(2) of Regulation Crowdfunding.

[20] *See* proposed Rule 302(b)(2) of Regulation Crowdfunding.

[21] *See* proposed Rule 303(b)(2)(ii)(A)-(C) of Regulation Crowdfunding. The investor must also demonstrate an understanding about the investor's ability to cancel a commitment and the difficulties of re-sale of Section 4(a)(6) securities. *See id.*

for the investor educational materials, intermediaries will be free to develop materials that they believe will be most effective at informing investors. This freedom can allow intermediaries to experiment and compete with one another to produce high quality materials that strike the proper balance between effectively informing investors without overwhelming them.

Providing investors with educational material early in the process could potentially be more helpful than issuer-specific disclosures in Form C. The early review of risk factors allows investors to consider the risk before even committing funds in any specific issuance. Educating investors early can deter unwary investors, especially because many investors will be unaccredited with little prior investing experience. These unaccredited investors may not read the issuer-specific disclosures in Form C and are not required to do so, but investors are required to read the intermediary educational materials and represent that they have done so. Although skeptics may argue investors are likely to falsely represent having read the materials, the representation requirement will likely result in more investors reading the materials than if no such requirement existed.

Investor questionnaires that test an investor's basic understandings of risk could also be more helpful than issuer-specific disclosures because the questionnaires are proactive in ensuring investors read and understand the risks. Again, investors would be free to ignore issuer-specific risks, but the proposed rule would require investors to complete the questionnaire and demonstrate a base level of risk awareness. Although the specific form of questionnaire is left to intermediaries, the investors must demonstrate knowledge that the investor should not invest unless they can afford to lose their entire investment.[22] Requiring an investor to demonstrate this level of knowledge and recognize the high level of risk before each and every investment is another layer of investor protection because investors must read the generic disclosures to answer the questionnaire.

The generic warnings in intermediary educational materials provide effective warnings to investors because the disclosures warn investors about the possibility of total loss. If an investor is aware about the risk of total loss, any issuer-specific risk factor is unlikely to induce an investor to modify the investor's behavior. At several points an investor is presented with disclosures that explain the high level of risk. The repeated disclosures and requirement to represent to having read them and take a questionnaire demonstrating knowledge of the risk greatly reduces or eliminates the possibility that an investor could invest in a Section 4(a)(6) security oblivious to the possibility of total loss of investment.

2. Legend Disclosures on Form C Provide Additional Protections

Legend disclosures issuers would need to provide on Form C provide additional investor protection that renders issuer-specific risk factors unnecessary. Item 2 of the instructions to Form C requires issuers to include a legend that includes, among other things, a statement that

[22] *See* proposed Rule 303(b)(2)(ii)(C) of Regulation Crowdfunding.

"[a] crowdfunding investment involves a risk. You should not invest any funds in this offering unless you can afford to lose your entire investment."[23]

As stated above in Part 1, generic risk disclosures can be an effective way to warn investors because they warn of the possibility of a total loss of an investment. These legend disclosures are also more cost effective than issuer-specific disclosures. Legend disclosures cost issuers no additional money because there is no time spent researching and drafting the disclosures.

The legend disclosure proposed in Item 2 of Form C is an effective disclosure because it is yet another warning of total loss. An investor who is aware of the likelihood of total loss and still willing to invest is unlikely to be persuaded by issuer-specific risk disclosures. Even the highest risks an issuer could disclosure would essentially state the exact same message as the generic disclosures: an investor could lose the entire investment if the specific risk comes to fruition.

3. Investors Only Risk Limited Funds Because of the Annual Investment Cap

Another protection of Regulation Crowdfunding that reduces the need for issuer-specific risk factor disclosures is the annual investment cap that limits the total an individual may invest in Section 4(a)(6) securities each year. For individual investors with both an annual income and net worth less than $100,000, the annual cap is the greater of $2,000 or 5% of annual income or net worth, whichever is higher.[24] For individuals with either an annual income or net worth greater than $100,000, the annual cap is 10% of annual income or net worth, whichever is higher, up to a maximum of $100,000.[25] Congress recognized the higher risk of Section 4(a)(6) securities and set these strict annual investment caps to protect investors.[26]

The annual investment cap is one of the most important provisions for protecting investors because it limits the total any individual investor could lose in a single year if an investor suffered a total loss to an affordable amount. In an article published before the proposed rules, Professor Andrew Schwartz argued that the Commission should keep issuer rules as light as possible partly because the annual investment cap is so important to limiting investor's exposure to fraud that other investor protection provision would do more harm than good.[27] Professor Schwartz also urged the Commission to refrain from expanding on Congress's list of

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[23] *See* proposed Form C, Item 2 of Regulation Crowdfunding.

[24] *See* Proposed Rule 100(a)(2)(i) of Regulation Crowdfunding.

[25] *See* Proposed Rule 100(a)(2)(ii) of Regulation Crowdfunding.

[26] *See* Securities Act Section 4(a)(6)(B).

[27] *See* Andrew A. Schwartz, *Keep It Light, Chairman White: SEC Rulemaking Under the CROWDFUND Act*, 66 VAND. L. REV. EN BANC 43, 45 (2013).

mandatory disclosures for issuers, which the Commission did when enacting Rule 201(f) for mandatory issuer-specific risk factor disclosures.[28] The Commission should rely on the investor protections of the annual investment cap and eliminate issuer-specific risk factor disclosures.

C. The "Wisdom of the Crowd" Can Inform Investors about Issuer-specific Risks in a Cost Effective Manner

In addition to investor protections the proposed rules provide, the Commission should not mandate issuer-specific disclosures because the "crowd" or issuers can voluntarily educate fellow investors about specific risks. This potential communication is yet another factor that would mitigate any risks of not requiring issuer-specific risk factors. The Commission recognizes the benefit of the "wisdom of the crowd" several times throughout the proposing release. For example, the Commission explains the need for the investing public to have information about an issuer's business plan to share information with each other and collectively decide whether or not to invest.[29]

Recognizing this benefit of shared communication, the Commission proposed rules to require intermediaries to provide channels of communication on its platform.[30] These proposed rules allow potential investors to communicate with one another and with representatives of the issuer. The Commission believes these rules "should provide transparency and accountability, and thereby further the protection of investors."[31] The Commission also believes these communications would help investors "better assess the issuer and investment opportunity."[32]

Issuer-specific risk disclosures should not be mandated because it would be more cost effective to allow issuers to voluntarily disclose risks to the public on an intermediary's platform. If members of the crowd raised issues or had questions about an issuer, the collective thinking of the crowd could lead investors to shy away unless the issuer responded appropriately. Investors already have enough information to evaluate an issuer from the congressionally mandated list of disclosures. It would be in the best interest of the issuer respond to any investor questions about certain risks on these platforms. This regulatory structure would also allow the market to determine which types of risk factor disclosures it needed to make a decision. In addition to

[28] *See id.* at 53 (arguing disclosures mandated by JOBS Act enough also because "potential investors are unlikely to read the document in the first place").

[29] 78 Fed. Reg. 66437. The decision of whether or not to invest is based on "the wisdom of the crowd." *Id.*

[30] *See* proposed Rule 303(c) of Regulation Crowdfunding.

[31] 78 Fed. Reg. 66472.

[32] *Id.*

disclosure on the intermediary platform, nothing in the proposed rules would prevent an issuer from voluntarily disclosing risk factors on Form C.[33]

Market determined risk factor disclosures are also more beneficial because they avoid the overly complex and lengthy risk factor disclosures seen in most Securities Act and Exchange Act filings. These disclosures are not helpful to the average unaccredited investor who would be investing in Section 4(a)(6) offerings because of their length and complexity. Voluntary disclosures would allow issuers to address only the concerns raised by the crowd instead of a voluminous list of risk factors that would be costly and intimidating to investors.

Without a mandatory duty to disclose specific material risk factors, issuers might refrain from disclosing anything voluntarily through either the intermediary platform or Form C. Even if issuers did refrain from doing so, the generic risk factors from both the intermediary's educational materials and the issuer's legend disclosures on Form C would still be presented to investors and provide warnings even without issuer-specific risk factors. If the investing public as a whole decides it will refrain from investing unless issuers disclose certain risk factors, then issuers would respond to market demands and disclose more than the suggested rules would require.

III. Conclusion

Regulation Crowdfunding is an important first step towards providing small businesses access to much needed capital. I commend the Commission for carrying out its duties under the JOBS Act and proposing a framework for implementing equity crowdfunding. Hopefully with public comment, the Commission can improve its proposed rules to strike the proper balance between facilitating capital formation and the use of this exemption and protecting investors from fraud.

I believe mandated issuer-specific risk factor disclosures in proposed Rule 201(f) over burden issuers with compliance costs that outweigh the proposed rule's benefits to investors. In addition, other important and less costly investor protections in Regulation Crowdfunding are available. I would like to thank the Commission for reading this comment and respectfully ask the Commission to consider my suggestions to reduce the burdens on issuers to comply with Regulation Crowdfunding.

Respectfully Submitted,

Adam Cole

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[33] *See, e.g.,* instruction 10 to paragraph (t), proposed Rule 201(t) of Regulation Crowdfunding. The Commission explicitly recognizes the right of issuers to voluntarily provide financial statements that meet the requirements of a higher offering amount. Issuers are presumably free to disclose more information than is required, provided those disclosures are not false or misleading. *See* Securities Act Section 4A(c) (providing private right of action for investors).