Consumer Federation of America

February 2, 2014

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

Re: File Number S7-09-13
Crowdfunding

Dear Secretary Murphy:

I am writing on behalf of the Consumer Federation of America (CFA)[1] to express our views with regard to the proposed new Regulation Crowdfunding. The regulations implement Title III of the JOBS Act, which creates the framework for a new online marketplace where start-up companies can raise small amounts of capital without the regulatory costs that accompany a full public offering or the limitations imposed on private offerings. While there are some aspects of the rule proposal that we support, taken in its entirety it fails to deliver the investor protections that such a risky experiment demands or that Congress intended when it included a robust set of regulatory requirements in the crowdfunding title of the JOBS Act.

The rule proposal will require substantial revisions in order to be even minimally protective of investor interests. Most importantly:

- Investment limits must be revised to reduce the risk of devastating investor losses.
- More robust procedures for enforcement of investment limits must be developed, with a particular focus on preventing unintentional errors in calculating the limits.
- Meaningful procedures must be put in place to ensure that intermediaries play a significant role in preventing fraud and ensuring compliance by issuers.
- The approach to integration of offerings must be revised to prevent issuers from evading regulatory restrictions by conducting side-by-side offerings under different exemptions.
- The definition of electronic delivery must be revised to ensure the disclosures themselves, and not just notices of the availability of disclosures, are delivered to investors.

[1] CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1967 to represent the consumer interest through research, advocacy and education.

While there are many other aspects of the proposed rules that are in need of revision, these are the areas where the proposed regulations are both weakest and most important to investor protection. Failure to address these fatal flaws in the proposal will not only put investors at extreme risk, it will undermine the already tenuous ability of crowdfunding to serve as a viable means of capital formation for small start-up companies.

I. Background

Traditionally, issuers seeking to raise capital from investors have been required to meet certain basic standard designed to ensure that they provide complete and accurate information on which to base an investment decision. Those regulatory requirements impose cost on companies that many – particularly early stage start-up companies – are not able to afford. In the past, companies that could not meet those standards were largely (though not entirely) restricted to raising money from wealthy, sophisticated and institutional investors who were viewed, rightly or wrongly, as being able to fend for themselves without the protections afforded in the public markets.

There were good reasons for these restrictions. Experience tells us that a significant percentage, perhaps even a majority, of these early stage start-up companies will fail, causing their investors to lose their entire investment. In addition, there are a lot of other ways for investors to lose money in such start-up investments, even if the company itself survives and even prospers. For example, the securities of such companies are likely to be highly illiquid, making it difficult for investors to divest their holdings if they need to or forcing them to sell at a considerable loss. Setting an appropriate initial price on the securities of young companies can be extremely difficult. Even sophisticated investors may end up over-paying. And investors who do not know how to protect their interests may find the value of their shares diluted through insider-only financing rounds, financing rounds at reduced prices or other means. Thus, our regulations have sought to ensure that investors in such offerings possess the financial resources to bear potential losses and the financial sophistication to understand the risks.

Crowdfunding turns that concept on its head. In order to provide a new source of funding for start-up companies at the earliest stage of raising capital, it opens investments in these high-risk companies to anyone through a new online marketplace. Its proponents suggest that the "wisdom of the crowd" will substitute for traditional securities law requirements to protect investors. According to this view, the crowd will quickly identify potential frauds, help determine whether shares are fairly valued, alert potential investors to potential risks, such as the risk that the shares being offered are subject to dilution, and help to identify those companies with the best prospects for delivering strong investment returns over the long-term. While we have no doubt that there will be instances in which the crowd serves this function, we are equally confident that there will be times when the crowd fails to detect the risks and other times when the "madness of crowds" prevails, driving share prices to irrational heights not supported by the business fundamentals. There is a rich history of examples to suggest that the potential for crowd dynamics to work in ways that are harmful to investors is a risk the Commission should seriously consider in developing the regulatory framework for crowdfunding. But it is a risk that the Commission has almost entirely ignored.

In drafting the crowdfunding title of the JOBS Act, Congress did not rest its faith entirely on the "wisdom of the crowd." Instead, it included a number of provisions designed to improve issuer compliance, alert investors to the potential risks of crowdfunding, and limit their potential losses. Inherent in this approach is the possibility that providing protections to investors that are commensurate with the risks of crowdfunding would impose costs that undermine the financial viability of crowdfunding for issuers and intermediaries. Put another way, there has always been a risk that Congress's proposed approach to crowdfunding would prove to be unworkable.

In developing its proposed regulatory framework for crowdfunding, the Commission appears to have concluded: 1) that the regulatory requirements imposed by Congress are too onerous and costly to enable crowdfunding to survive and 2) that it is the Commission's job to "correct" this problem. In several key areas – most notably the requirements for enforcement of investment limits and intermediary responsibility for issuer compliance – it has proposed a regulatory approach that, for all intents and purposes, writes these congressionally mandated investor protections out of existence. Consistently, in developing its regulatory approach, the agency has chosen to prioritize minimizing regulatory costs over protecting investors.

This represents an unconscionable failure of the Commission to fulfill its central investor protection mandate. Ironically, this laissez-faire approach also threatens the long-term viability of crowdfunding. If the predominant story out of crowdfunding over the next three to five years is that it has been an unmitigated disaster for investors, legitimate issuers will be forced to look for other alternatives to raise money, intermediaries will see their businesses destroyed, and the Commission's reputation as an effective regulator will be further tarnished.

The remainder of this comment letter discusses how the proposed rules should be revised in a way that is faithful to the underlying statute and minimizes the risk to investors. It focuses first on those areas with the greatest potential impact on investor protection, then on other aspects of the rule that we believe are in need of revision. The conclusion looks at some possible explanations for the Commission's fundamentally flawed approach to regulation and how those problems can and should be corrected.

II. Key Investor Protection Provisions Are Too Weak to Be Effective

The economic analysis that accompanies the rule proposal makes clear that the Commission understands the considerable risks that crowdfunding poses to investors. As the Proposing Release states, "There is broad evidence that many of these potential issuers are likely to fail after receiving funding." Perhaps the most sobering example cited in the Commission's economic analysis is a recent study that found that, of more than 2,000 companies that received at least $1 million in venture funding from 2004 through 2010, almost three-quarters subsequently failed. According to another study, among the more than 16,000 venture-capital backed companies that received their first institutional funding between 1980 and 1999, approximately one-third failed after the first funding round. These high failure rates are evident in companies that had a business plan attractive enough to attract venture capital backing and the benefit of venture capital involvement. If crowdfunding attracts companies that can't get funding through other sources, the failure rates could be even higher.[2]

A high failure rate among crowdfunded companies is one of the chief risks, but it is far from the only risk to investors associated with crowdfunding. As the Proposing Release notes, early stage companies are notoriously difficult to value, and the limited disclosures provided by issuers may not be sufficient to enable investors to determine an appropriate price for the shares. As the Proposing Release further states, "it is unlikely that purchasers in crowdfunding transactions would be able to follow the typical path to liquidity that investors in other exempt offerings follow." We agree with the Commission's prediction that most companies that raise capital through crowdfunding, because of their small size, "are unlikely to progress directly to an initial public offering on a national securities exchange."

Furthermore, as the Commission notes, there are considerable liquidity risks associated with crowdfunded securities. It is "currently unclear how securities offered and sold in reliance on Section 4(a)(6) would be transferred in the secondary market after the one-year restricted period ends, and investors who purchased securities in reliance on Section 4(a)(6) and who seek to divest their securities would be unlikely to find a liquid market." Even if shares migrate to the over-the-counter market or trade on platforms that trade shares of private companies, the secondary trading costs are likely to be substantial, spreads are likely to be wide, and price volatility is likely to be high. The unsophisticated investors who will be permitted to participate in crowdfunding could "face additional challenges in addressing the impact of illiquidity, either in finding a suitable trading venue or negotiating with the issuer for an alternative retirement provision."

Even those investors who are fortunate enough to invest in a company that grows and prospers may not see that success reflected in their investment returns. Again, the Commission makes clear that it is cognizant of this risk. As the Proposing Release states, "This could occur if issuers issue securities with certain features (*e.g.*, callable securities or securities with differential control rights) or have insider-only financing rounds or financial rounds at reduced prices (the so-called "down rounds") that could have the effect of diluting an investor's interest or otherwise diminishing the value of the securities offered and sold in reliance on Section 4(a)(6). Investors purchasing securities issued in reliance on Section 4(a)(6) might not have the experience or the market power to negotiate various anti-dilution provisions, right of first refusal, tag-along rights, superior liquidation preferences and rights upon a change in control that have been developed by institutional and angel investors as protections against fundamental changes in a business."

In drafting the crowdfunding title of the JOBS Act, Congress acknowledged the risks inherent in crowdfunding and sought to limit those risks. Among the most important investor protection provisions in the statute set limits on the amounts that investors can invest through

[2] If on the other hand crowdfunding attracts companies that do have other available funding options – whether from banks, venture capitalists, or through other types of securities offerings – the failure rates for crowdfunded companies may not be as high as they otherwise would be, but its contribution to enhanced capital formation will be reduced. The stated justification for crowdfunding, that it is needed to fill a funding gap for very small companies, would be belied by such an outcome.

crowdfunding, give intermediaries important gatekeeper functions, including with regard to enforcing investment limits and ensuring issuer compliance, and ensure that investors receive adequate warnings about the potential risks and other key features of crowdfunding. In addition, the Commission could adopt additional regulatory protections consistent with, though not mandated by, the JOBS Act. It could, for example, require that certain protections against dilution be adopted as a condition of relying on the exemption. It could take stronger steps to limit the ability of issuers to engage in deceptive practices. And it could prohibit certain practices, such as dynamic pricing, that increase the risk that the madness rather than the wisdom of the crowd will prevail. It proposes to do none of these things. Even in areas where the statute has mandated investor protections, the Commission has proposed a completely inadequate regulatory approach.

A. The Commission's proposed approach to setting investment limits maximizes the potential for devastating investor losses from crowdfunding.

Foremost among the statute's mandated investor protections are the required limits on the amount that investors can invest through crowdfunding in a single 12-month period. Unfortunately, the statutory language imposing the investment restrictions is ambiguous. Specifically, the statute imposes one standard for calculating investment limits for individuals whose "annual income or net worth" is below $100,000 and another standard for individuals whose "annual income or net worth" is equal to or greater than $100,000. The Commission is left to interpret which standard should apply when an individual's income is below $100,000 and their net worth is above $100,000, or vice versa. Should it apply the stricter five-percent limits in any case where either income or net worth is below the threshold, or should it apply the looser ten-percent limits in any case in which either income or net worth is above the threshold? And, even if both income and net worth fall into the same category, how is the Commission to determine whether the percentage limit should be calculated using income or net worth? Any of these approaches can be defended as consistent with the statutory language, but they have very different effects on investor protection.

In deciding which approach to adopt, it is useful to think about the types of individuals who might be affected. They might include, for example, a young person, perhaps a doctor or an engineer, with a high-paying job but who has yet to amass any significant financial assets. At the other end of the spectrum, they might include an older person living on Social Security benefits but with a small nest egg they rely on to keep them in their own home and living above the poverty line. The question the Commission faces is, in essence, whether it should adopt the approach that maximizes the amount that well-heeled young engineer can invest through crowdfunding or one that minimizes the risk that the retiree would be impoverished as the result of failed crowdfunding investments.

One would think that a Commission that cites investor protection as its central mandate, that likes to tout itself as the investor advocate, and that clearly is acutely aware of the enormous risks to investors from crowdfunding would interpret the statute in a way that maximizes investor protection. Instead it has chosen to interpret each of these questions in the least investor-protective way possible. Based on the Commission's proposed "greater of" approach, the looser investment restrictions would apply if either income or net worth were equal to or greater than

$100,000 *and* the calculation would be based on the higher of the two amounts. The Commission also proposes to allow income and net worth to be calculated jointly with income and net worth of the spouse when determining investment limit, which it justifies based on the treatment of income and net worth under the accredited investor definition. In adopting this approach, the Commission fails to account for the fact that the accredited investor definition sets a higher income limit when combining income of spouses for purposes of determining accredited investor status, something the Commission fails to do here.

We do not question that the statute allows for this "greater of" interpretation of the investment limits. However, the normal approach when faced with ambiguous statutory language would be to interpret that language in a way that is consistent with the underlying goal of the provision. As the Commission itself acknowledges, the purpose of the investment limitations is to reduce risks to investors inherent in a market that allows individuals with few financial resources and less financial sophistication to invest in the highly speculative securities of early stage start-up companies. It is in this spirit that the Commission could and should have interpreted the investment limitations.

The economic analysis makes a feeble effort to justify the Commission's proposed "greater of" approach on investor protection grounds. In it, the Commission expresses the concern that the aggregate cap on investments "could limit the ability of investors to diversify within the securities-based crowdfunding market." Reiterating its prediction that crowdfunded companies are likely to experience high failure rates, the Proposing Release expresses the concern that the statutory thresholds for overall securities-based crowdfunding investments "might limit an investor's ability to choose a sufficiently large number of investments to offset this risk and to recover the due diligence costs of sufficiently investigating individual investments." In its frankly shoddy analysis of this point, the Commission entirely ignores the risk that maximizing the investment amounts will increase the portion of an investor's overall portfolio that will be devoted to crowdfunded securities. One of the ironies of this approach is that the Commission is seeking to maximize the money that may be devoted to investments that, for many of the investors likely to participate in crowdfunding, would not be deemed to be "suitable" for the investor if recommended by a broker-dealer.

In order to be true to the investor protection intent of this provision of the statute, and to minimize the risk that crowdfunding will result in devastating harm to investors, we urge the Commission to adopt a "lesser of" approach to setting the investment limits. In other words, in any case in which either income or net worth falls below the $100,000 threshold, the investment limit should be limited to five percent of the lesser of the two amounts. The difference in the investor protection effect of the two approaches is potentially quite dramatic.

- Under the Commission's proposed interpretation, for example, a retiree living on $25,000 a year in Social Security income and with a $100,000 nest egg could invest $10,000 through crowdfunding, with a high risk that they would lose some or all of that money and no reasonable expectation that they could recover those losses.

- Under the alternative, more investor-protective "lesser of" approach, that same individual could invest just $2,000 through crowdfunding (the statutory minimum that any investor would be permitted to make). That still represents a risk that any conscientious investment professional would likely recommend against, but the effect of any losses, while painful, would be substantially less devastating.

There are two middle ground approaches the Commission could alternatively adopt. The first would be to make the calculation using five percent if either income or net worth falls below $100,000, but to base the calculation on the greater of income or net worth. Under this approach, our retiree in the above example could risk up to $5,000 on crowdfunding investments, far more than seems appropriate but still just half of what the Commission proposes to allow. The other middle ground alternative would be to make the calculation using 10 percent if either income or net worth is $100,000 or above, but to base the calculation on the lower of the two amounts. In that case, our retiree would be limited to investing $2,500 in crowdfunding. While we prefer the "lesser of" approach, either of these two approaches would be preferable to the Commission's proposal maximizing the amount of the investment limits.

We frankly do not see how the Commission can, in good conscience, ignore the huge potential for investor harm under its proposed approach. It is symptomatic of the Commission's distorted approach to rulemaking, however, that while the Proposing Release asks whether adopting the more investor protective "lesser of" approach would unnecessarily impede capital formation, it does not ask whether its proposed "greater of" approach exposes investors to inappropriate risks.

B. The proposed approach to enforcing investment limits provides no assurance that even these weak investment limits will be adhered to.

Problems with the proposed investment limits do not end with the Commission's proposal to maximize investment amounts. The Commission also proposes an approach to enforcing the limits that is completely inadequate to prevent either evasion of the limits or to prevent innocent errors in calculating the limits. Since the error investors are most likely to make, including the value of the home in the calculation of net worth, will greatly inflate the amount that an investor can put at risk, the inevitable result of this approach is that it will dramatically magnify potential investor losses. Fixing this key component of the regulations, should therefore be a top priority of the Commission as it finalizes these rules.

The statute conditions an issuer's ability to rely on the exemption on their compliance with the individual investor limits. In implementing this requirement, the Commission proposes to allow issuers to rely on intermediaries in order "to determine that the aggregate amount of securities purchased by an investor will not cause the investor to exceed the investor limits," unless the issuer has actual knowledge that the "investor had exceeded, or would exceed, the investor limits as a result of purchasing securities in the issuer's offering." We agree that intermediaries are generally likely to be better positioned than issuers to ensure compliance with the investment limits. After all, the calculations of investment limits are potentially confusing, with a high probability for errors. Intermediaries will be in a position to gather the information necessary to make the calculation from investors when they open an account. Because much of that information is likely to consist of sensitive personal financial data, responsibility for collecting and analyzing that data is best handled by an entity that is subject to robust regulatory requirements to protect the privacy and security of that data.

If the Commission were to adopt a strong standard to ensure that intermediaries handle this responsibility effectively, allowing reliance on intermediaries could be expected to streamline the process, minimize the cost of compliance, reduce the number of errors, and reduce the incidence of evasion. Unfortunately, the Commission has done no such thing. While the Commission proposes to require that intermediaries have a reasonable basis for believing that the investor satisfies the investment limits before making an investment through their platform, it doesn’t require intermediaries to collect the information that would form the basis of a reasonable belief in this regard. Instead, it proposes to allow intermediaries to rely on investor representations to satisfy their reasonable belief obligations. Specifically, it requires only that investors provide information on their income, net worth, and the amount of other crowdfunding securities they have purchased in the previous year. The intermediary can rely on investors’ representations with regard to those three numbers, unless the intermediary has reason to question the accuracy of those representations.

There are a number of reasons why relying on investor self-certification in unacceptable, starting with the fact that Congress specifically rejected this approach when it adopted the JOBS Act. While the original House bill would have allowed for investor self-certification, that provision was replaced in the final bill with the requirement that intermediaries enforce the limits. The Commission’s proposal would undo that change and as such is inconsistent with clear congressional intent. Furthermore, the Commission has no basis for believing its proposed approach will be effective. Even if investors didn’t have an incentive to inflate those income and net worth figures in order to maximize their crowdfunding investments, there is a high likelihood that many if not most of those investors who intend to comply with the limits will get the numbers wrong. The most likely mistake is also among the most serious in terms of its potential impact: investors are likely to include the value of their home when calculating their net worth. This could dramatically increase the amount they are able to invest, both by increasing the dollar amount on which their investment limit is based and, in many cases, by moving them into the above-$100,000 category that bases the investment cap on a higher percentage. Finally, this approach is unacceptable because there are alternative approaches available that would be more effective and that should not impose unreasonable costs.

As a starting point for a more effective regulatory approach, the Commission should require intermediaries to collect the underlying data on which a calculation of income and net worth would be based. At a minimum, the rules should require intermediaries to include the categories of income and assets used in determining the thresholds and the value assigned to each. Taking advantage of the functionality of the Internet, intermediaries could and should be required to collect the data in a way that minimizes the potential for errors. For example, the data entry form used by investors could include prompts informing them of the need to deduct outstanding liabilities with respect to assets or to exclude the value of the principle residence. While it would not be perfect, such an approach would be expected to dramatically reduce the number of honest errors. Furthermore, unless intermediaries are required to collect the underlying data on which these calculations are based, intermediaries will have no basis to question the reliability of the investors’ representations and a strong incentive not to look for information that might cause them to question the reliability of those representations. It is difficult to see how the Commission can justify this "hear no evil, see no evil" approach to enforcement of investment limits.

While strengthening requirements for enforcement of investment limits on a single platform should be quite easy, determining what activity investors may have engaged in on other platforms presents a more significant challenge. But it is precisely the kind of challenge that technology is very good at solving. It should be possible, for example, for either a company or regulators (perhaps the SEC, FINRA and NASAA in cooperation) to develop a central database where all intermediaries are required to report their trades. Creation of such a database would involve costs, particularly on the front end, but intermediaries would have an incentive to fund its creation if they were subject to meaningful compliance obligations with regard to enforcement of investment limits. By proposing to allow intermediaries to satisfy their responsibilities by relying on investor representations, the Commission has removed any incentive for intermediaries to invest in a more robust compliance system.

In justifying its proposed approach, the Commission argues that it cannot force intermediaries to use a centralized database that does not yet exist. However, the Commission could and should require intermediaries to avail themselves of readily available information to satisfy their verification obligations. In that way, if a centralized database were developed, intermediaries would be required to use it unless they could show that they had adopted other comparable means for enforcing investment limits. In addition, the Commission could and should do more to create an incentive for development of such a system. One possible approach would be to impose a time limit, of three to five years for example, after which intermediaries would no longer be permitted to satisfy their obligations in this area by relying on investor representations with regard to their investments through other platforms. This would give either private entrepreneurs or regulators sufficient time to develop a technological solution to the problem of investment limit enforcement across multiple platforms and would create an incentive for intermediaries to support those efforts. We urge the Commission to consider either this or some alternative approach that would give meaning to the statute's requirement that intermediaries serve as gatekeepers with responsibility for ensuring that investment limits are not breached.

The Commission's self-certification approach to income and net worth verification might be more acceptable if the amounts of money at risk were small – on the order of $250 to $500 – and if intermediaries were required to collect the information necessary to ensure that investors aren't setting up multiple accounts to evade the limits. But when an investor can risk up to a tenth of their net worth and up to $100,000 in crowdfunding, more rigorous requirements are necessary – particularly when the mistakes investors are most likely to make, including the value of the house in the net worth calculation and not subtracting the amount of debt, have the potential to dramatically increase the investment amounts. Some have suggested that the Commission consider a tiered approach to compliance in this area, scaling verification and perhaps other regulatory requirements for issuers and intermediaries based on the size of the investments permitted. Under such an approach, funding portals that wish to serve small local businesses and other non-traditional offerings could do so without facing a significant compliance burden. While we are not entirely convinced that the costs of verification are necessarily prohibitive, such an approach would be far superior to the laissez-faire approach adopted by the Commission in the proposing release.

C. The Commission's proposed approach essentially eliminates the requirement that intermediaries act as gatekeepers to promote compliance and protect investors.

Whether crowdfunding works to the benefit of issuers and investors will depend in large part on whether crowdfunding intermediaries take the steps necessary to prevent fraud, ensure compliance, and promote informed decision-making by investors. The small start-ups expected to turn to crowdfunding to raise capital will often have neither in-house expertise on securities laws nor outside legal counsel guiding them through compliance issues. Just as inexperienced issuers are unlikely to fully understand their compliance obligations, the small investors who are expected to participate in crowdfunding will often lack the ability to protect their own interests based solely on the types of disclosures companies are required to provide. This gives enhanced importance to the regulatory requirements for intermediaries. It is therefore particularly troubling that the Commission has proposed rules for intermediaries that are far to weak to achieve the intended regulatory goal. This section addresses the obligations of intermediaries in three areas of particular importance to investor protection: ensuring issuer compliance with securities laws and regulations, conducting background checks on individuals associated with issuers, and ensuring issuers maintain complete and accurate records of share transfers.

1. The proposed rules on intermediary responsibility for ensuring issuer compliance gut what was intended to be one of the statute's central investor protections.

Among the central investor protections of the JOBS Act is its provision making intermediaries responsible for ensuring issuer compliance with securities laws and regulations. The proposed rule seeks to achieve this goal in part by requiring intermediaries to have "a reasonable basis for believing that an issuer seeking to offer and sell securities in reliance on Section 4(a)(6), through the intermediary's platform, complies with the requirements in Securities Act Section 4A(b) and the related requirements in Regulation Crowdfunding" and to deny access where the intermediary believes there is a risk of fraud. It then renders this otherwise promising requirement meaningless first by permitting intermediaries to reasonably rely on representations of the issuer to satisfy its obligations, "absent knowledge or other information or indications that the representations are not true," and second by failing to establish any standards of inquiry intermediaries would have to follow in order to reasonably conclude that the issuer is in compliance.

Intermediaries are well positioned to detect and deter non-compliance, but the proposed rule gives them no incentive to do so. On the contrary, the Commission's proposed approach actually creates an incentive for intermediaries not to do too much digging into the issuer, since the intermediary would be in the clear under the proposed approach as long as it could show that it didn't actually know there was a problem. The lack of any sort of "know your issuer" requirement for intermediaries, combined with the provision allowing reliance on issuer representations, all but ensures that at least some funding portals will simply require issuers to check a box indicating they are in compliance with the relevant laws and regulations when they post the offering on the portal.

The Commission has no reasonable basis for concluding that this approach is likely to be effective in reducing the risk of fraud. Issuers who are intentionally engaged in fraud will certify compliance without hesitation. But even legitimate issuers may falsely certify their compliance out of simple ignorance and inexperience. There is no justification for such a lax approach to such a serious issue, particularly when intermediaries could easily put appropriate compliance mechanisms in place if the rules created the incentive for them to do so. Intermediaries would be free to decide whether to provide those compliance services themselves or to engage an independent third party to conduct compliance reviews. But the proposed rule provides no incentive for them to do either. Investors won't be the only ones harmed by such a lax approach to compliance. As the Commission itself notes elsewhere in the release, permissive rules that increase risks for individual investors will indirectly undermine the capital formation process for the startups and small businesses that turn to crowdfunding to raise capital.[3]

In order to fix this fatally flawed aspect of the rule proposal, the Commission must eliminate the provision that allows intermediaries to satisfy their obligations by relying on the representations of issuers. As a second step, the Commission should adopt a "know your issuer rule," modeled on the "know your customer" rule for brokers, that requires intermediaries to make certain basic investigations to determine whether issuers are in compliance with the applicable laws and regulations. The reviews we are proposing would be different than the background checks required by the statute, focusing instead on an examination of offering documents and other materials to ensure the issuer is in compliance with the crowdfunding regulations with regard to the specific offering in question. Finally, once the offering is underway, intermediaries should have an affirmative obligation to monitor issuer communications to identify communications that violate prohibitions against false and misleading statements as well as those that violate the requirement to conduct all crowdfunding activities through the portal.

As discussed above with regard to verification of investment limits, the standards for these "know your issuer" reviews could be scaled to match the size of the offering and other risk markers (*e.g.*, the types of securities being offered, the size of individual investments being accepted in the offering, the background of the individuals associated with the offering, participation of individuals associated with the issuer in the offering, etc.)[4] The compliance reviews could be conducted in-house or by outside specialists, which ever the intermediary deems to be more efficient and cost-effective. In order to promote transparency and take advantage of the "wisdom of the crowd" in evaluating such issues, the results of the compliance reviews should be required to be posted on the website. Such transparency would create an incentive for intermediaries to be rigorous in their reviews and for issuers to adopt a high standard of compliance.

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[3] See, for example, Proposing Release page 13: "Rules that are too permissive, however, may increase the risks for individual investors, thereby undermining the facilitation of capital raising for startups and small businesses."

[4] For example, the Commission's weak bad actor rule will allow participation by individuals with a history of securities law violations. The involvement of such individuals in an offering should trigger a heightened obligation on the part of the intermediary to review offerings for compliance violations.

2. The proposed requirements for background checks need to be based on clear, enforceable standards.

The proposed rules would require an intermediary to deny access to its platform, if the intermediary has a reasonable basis for believing that an issuer, or any of its officers, directors (or any person occupying a similar status or performing a similar function) or 20 Percent Beneficial Owners, is subject to a disqualification under the proposed rules or if the intermediary believes that the issuer or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection. To fulfill the first part of that requirement, the rules would require an intermediary to conduct a background and securities enforcement regulatory history check on each issuer whose securities are to be offered by the intermediary, as well as on each of its officers, directors (or any person occupying a similar status or performing a similar function) and 20 Percent Beneficial Owners.

Although several commenters have urged the Commission to clarify intermediary obligations with regard to such background checks, the Commission fails to set even the most general of standards for these checks. Instead, it relies on intermediaries to use their "experience and judgment … to design systems and processes to help reduce the risk of fraud in securities-based crowdfunding." Given that many crowdfunding platforms are likely to be new entrants to the securities markets, they are unlikely to have extensive experience on which to base such judgments. And past experience should have taught us that concerns about reputational risks are a slender reed to rely on when companies are battling for market share.[5] We do not find any reasonable basis for the Commission's conclusion that its anything-goes approach to background checks is likely to be effective.

In one of the stronger requirements under the proposed rules, intermediaries would also be required "to deny access to an issuer if it has information that is not necessarily the basis for a disqualification under proposed rules, but that the intermediary nevertheless believes presents the potential for fraud or otherwise raises concerns regarding investor protection." And it would not be required to prove that it has a reasonable basis for its concern. We strongly agree that it is important for intermediaries to have discretion in taking steps to reduce the risk of fraud. Among other things, we hope that intermediaries will use this authority to deny offerings by issuers who would be deemed "bad actors" but for the fact that their violations occurred before the bad actor rules were adopted. However, we are concerned with how this requirement could interact with the Commission's loose approach to required background checks. While some crowdfunding platforms will likely embrace their obligations in this area, others may adopt a lax approach to background checks precisely in order to avoid developing knowledge that might otherwise require them to deny listing to a potentially problematic offering.

One provision of the proposed rule that doesn't eliminate, but does help to ameliorate this concern is the requirement that intermediaries promptly remove an offering if the intermediary becomes aware of troubling information after it has granted the issuer access to its platform. Because having to remove an offering is likely to be embarrassing to the intermediary and could impose significant costs, this requirement creates an incentive for platforms to be more rigorous

[5] Credit rating agencies offer the most recent example belying the notion that reputational risk will be sufficient to ensure that rigorous standards will be adopted.

in their initial access decisions. It must not be weakened in the final rule. Even with this requirement in place, we nonetheless believe that strengthened standards for background checks are necessary to deliver the full intended benefits of this otherwise beneficial proposed rule.

Ironically, in a market that is designed to benefit from the "wisdom" of the crowd, the Commission proposes to deny requests from commenters that intermediaries be required to post the results of the background checks on their platforms. The Commission correctly concludes that simply requiring the background checks meets the statutory requirement, but it does not offer any reasons why it could not provide the added transparency. Given the Commission's lack of clear guidelines for background checks, investors would greatly benefit from being able to easily distinguish between intermediaries who are conducting robust background checks and those that are adopting a more cursory approach. This would have the added benefit of creating an incentive for intermediaries to fulfill this responsibility in a way that can withstand investor scrutiny. Moreover, requiring intermediaries to post the background checks imposes at most a minor additional cost, a cost that is far exceeded by the potential benefits to both investors and legitimate issuers. We therefore urge the Commission to reconsider its position on this issue and to adopt an approach that maximizes the ability of the crowd to fairly assess this key factor regarding both issuers they may want to invest in and portals through which they may want to invest.

3. The proposed approach to ensuring that issuers maintain accurate records of the holders of their securities is entirely inadequate.

While the Commission acknowledges the importance of issuers' maintaining accurate records of accurate records of the holders of their securities, it imposes no standards to ensure that such records are in fact maintained. As the Commission notes, the "ability to keep track of the ownership of an issuer's securities is necessary to protect investors and critical for maintaining the integrity of securities transactions made in reliance on Section 4(a)(6), both with respect to the initial offering and any subsequent transfers of the securities." It further notes that "the failure to accurately record or maintain shareholder records of an issuer, or to prevent fraudulent transfers, can have significant negative impacts for both investors and issuers."

Given the importance of the issue, the Commission's proposal simply to require intermediaries to have a reasonable basis for believing that an issuer has established means to keep accurate records of the holders of the securities strikes us as entirely inadequate. It is rendered meaningless by the Commission's proposal to allow the intermediary to rely on issuer representations to satisfy its obligations. Ideally, the Commission would adopt an approach that imposes concrete requirements, such as the use of transfer agents or other comparable methods, to ensure that accurate records are kept. At the very least, the intermediary should have to do more to satisfy itself that accurate records are being kept than simply rely on inherently unreliable issuer representations. In a market that will be dominated by inexperienced issuers who do not fully understand their compliance obligations, an approach that relies on self-certification will inevitably prove to be inadequate.

D. The Commission's proposed approach to integration of offerings is unjustified and puts investors at risk by enabling issuers to evade regulatory restrictions.

The Commission adopts a ridiculously broad interpretation of the statute's rule of construction, which it then uses to justify several problematic regulatory approaches, including an approach to integration of offerings that puts investors at risk. The statute's rule of construction simply states that, "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)." Based on an overly broad reading of the statute's rule of construction, the Commission concludes that it can't take any steps that might limit offerings under other exemptions. Specifically, based on its unfounded interpretation that anything that would "limit" other offerings would by definition "prevent" them, the Commission concludes that crowdfunding offerings should not be integrated with other exempt offerings since to do so would impose limits on those other offerings. If adopted, this misguided approach would enable issuers to evade regulatory restrictions applicable both to crowdfunding and to other exemptions.

1. Failure to require integration of offerings will allow issuers to evade regulatory requirements.

One of the most likely results, if this approach were adopted, would be issuer evasion of the strict crowdfunding advertising restrictions by simultaneously conducting an offering under Regulation D in which it engaged in general solicitation. The proposed rule states that such an offering under Reg D "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," but that would not realistically prevent advertisements for the Reg D offering from being used to help raise the profile of and interest in the "separate" crowdfunding offering. The proposed approach to integration would thus render meaningless the crowdfunding advertising restrictions. Conversely, a Reg D offering that is not permitted to include general solicitation could be indirectly promoted through the buzz generated by the crowd in a simultaneous crowdfunding offering. While the Proposing Release specifies that purchasers in the Reg D offering could not be solicited through the crowdfunding offering, the Commission does not suggest what would suffice to "satisfy" issuers that the purchasers had not been solicited through the crowdfunding offering.

There is no justification for the Commission's overly broad interpretation of the rule of construction, and the potential for investor harm is clear. Realistically, it simply would not be possible to ensure that simultaneous offerings were not being used to circumvent important investor protection rules. Certainly, the Commission does not have sufficient resources to provide effective regulatory oversight. We therefore urge the Commission to adopt an appropriate approach to integration that is based on a reasonable interpretation of the rule of construction and that is enforceable in light of the Commission's limited resources. The most appropriate approach would be to impose a delay between offerings of one to two months, so that the ability to use one offering to condition the market for a separate offering would be reduced. Such an approach would have the added advantage of providing clear compliance guidelines for issuers.

2. Failure to require integration of offerings will undercut the Commission's otherwise pro-investor approach to requiring that crowdfunding offerings be conducted exclusively through an intermediary.

The Commission's failure to adopt a reasonable approach to integration of offerings also undermines the Commission's otherwise generally pro-investor implementation of the statute's requirement that crowdfunding transactions be conducted through an intermediary. Requiring ransactions to be conducted through a regulated broker-dealer or crowdfunding portal is among the more important investor protections in the crowdfunding title. Without this requirement, crowdfunding activity could be dispersed over the Internet in a way that simply would not allow for effective monitoring and oversight by regulators, dramatically increasing the risk of fraud. Effectively implemented, the requirement that transactions be conducted through regulated intermediaries also strengthens the mechanisms for ensuring compliance by issuers and for providing essential information and procedural protections to investors.

In general, we believe the Commission has done a good job of writing rules designed to ensure that all crowdfunding activities occur through the regulated intermediary. We strongly support, for example, the requirement that issuers use only one intermediary for a particular offering or simultaneous offerings. And we further agree that the requirement that investors consent to electronic delivery is appropriate in the context of an online marketplace. These requirements are essential to deliver the purported benefit of crowdfunding – that all members of the crowd will have access to comparable information and the ability to participate in general discussions regarding the offering and its merits. While we believe its potential benefits have been over-sold, it is only this sort of centralized, open exchange that the "wisdom of the crowd" can be expected to work. Moreover, crowdfunding can only succeed if compliance costs are kept to a minimum. Allowing offerings through multiple portals or multiple distribution means would exponentially increase the difficulty of providing effective regulatory oversight. As such, they would demand more detailed and rigorous compliance systems by issuers and intermediaries alike. And, in a system where offerings through multiple portals were permitted, issuers rather than intermediaries would have to carry more of the compliance burden.

These provisions of the rule are undercut by the Commission's failure to adopt an appropriate policy with regard to integration of offerings. All of the Commission's efforts to ensure that all crowdfunding activities occur through the intermediaries will be undermined if issuers can engage in a simultaneous offering under a different exemption. We therefore support the Commission's proposed approach to requiring transactions to be conducted through an intermediary but urge the Commission to safeguard that approach by strengthening its policy with regard to integration. As noted above, we believe the best approach is for the Commission to require a one- to two-month cooling off period between offerings made subject to different exemptions.

E. The Commission’s proposed approach to investor education and disclosure requirements fails to ensure that investors will receive and review the necessary information and over-relies on disclosure in areas where it is unlikely to be effective.

The statute includes several provisions designed to ensure that crowdfunding investors receive and review educational materials and disclosures. These requirements are designed to ensure both that investors are alerted to potential risks associated with crowdfunding and receive basic information necessary to assess individual crowdfunding offerings. As discussed above, the Proposing Release discusses a range of risks to investors – from the high failure rate of small start-up companies, to liquidity and valuation risks, to risks of expropriation – that could discourage investors from participating in crowdfunding. It is therefore in the interests of investors, issuers, and intermediaries alike that the Commission adopt strong and effective rules to address these risks. Unfortunately, the Commission’s proposed rules fail to ensure that investors receive essential information, including risk disclosures, let alone that they carefully review and understand that material. In addition, the Commission proposes to rely on disclosures to address certain risks despite its obvious understanding that disclosure is unlikely to be effective in preventing investor harm. We therefore urge the Commission to strengthen its provisions related to disclosure, including in particular its proposed definition of electronic delivery, and to adopt more meaningful protections to address risks that cannot be effectively addressed through disclosure alone.

1. The Commission’s proposed definition of electronic delivery would fail to ensure that investors receive essential information, including risk disclosures.

The Commission proposes that intermediaries would provide all information they are required to disclose to investors through means of electronic delivery. We agree that this is consistent with the nature of crowdfunding as an online marketplace. However, the Commission’s definition of what would satisfy electronic delivery is completely unacceptable. Specifically, when it is perfectly feasible to provide information either “through an electronic message that contains the information” or “through an electronic message that includes a specific link to the information as posted on the intermediary's platform,” there is absolutely no justification for allowing the delivery requirement to be satisfied through delivery of “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.”

Sending investors to hunt for the information somewhere on the website significantly reduces the likelihood that they will read and carefully review the information. It makes a mockery of the requirement to “deliver” the information, and it sets a terrible precedent for defining the nature of electronic delivery in a way that makes disclosures less rather than more transparent. It is particularly disturbing that the Commission would propose this unjustifiably weak approach to electronic delivery given the significance of the information that issuers and intermediaries are required to provide through this means. Among the disclosures subject to this electronic delivery requirement are educational materials covering the risks associated with crowdfunding, disclosures of the risks specific to a particular offering, information on how to calculate investment limits, information about an issuer’s valuation practices, information on any limitations associated with the types of securities being offered, transaction confirmations, and more.

We recently delivered a report to key Commission officials discussing how the Internet could be used to improve the effectiveness of disclosures.[6] In it, we noted that the decisions the Commission makes today with regard to electronic delivery will determine whether investors receive the potential benefits of Internet disclosure or suffer the potential pitfalls. If the Commission adopts the proposed definition of electronic delivery contained in this release, it will have placed itself firmly on the side of those who would use the Internet to reduce transparency and undermine disclosure effectiveness.

2. The Commission fails to take advantage of the functionality of the Internet to better ensure that investors review and understand the required disclosures and educational materials.

In order to better ensure that investors understand the risks associated with crowdfunding, the statute makes intermediaries responsible for ensuring that: investors review educational materials, positively affirm that they understand that they could lose all their money and that they can afford to do so, and "answer questions demonstrating an understanding of the level of risk generally applicable to investments in startups, emerging businesses and small issuers, the risk of illiquidity and such other matters as the Commission determines appropriate."

The proposed rules include a potentially beneficial provision to require that educational materials be provided to the investor both at account opening and each time the investor makes an investment. Unfortunately, as discussed above, the requirement to "provide" the materials could be satisfied by sending the investor an electronic message that the materials are available on the intermediary's website without even providing a direct link. This completely inadequate delivery requirement doesn't even ensure that investors receive, let alone review, the required disclosures. Its inadequacies are exacerbated by the Commission's proposal to allow intermediaries to rely on investors' representation that they have reviewed the material.

The rules also require that the issuer obtain an affirmation from the investor, each time they invest, that they could lose all of their money and that they are able to bear that loss. While we appreciate the intent of this requirement, we are all familiar with the practice common with online disclosures of checking a box to indicate we have read and understood account conditions and other disclosures. There is every reason to believe that, unless the Commission strengthens the proposed rule, this requirement will result in the same sort of check-the-box response, thereby serving more to protect issuers and intermediaries from liability than to protect investors from losses they cannot afford.

Potentially more meaningful is the requirement that the intermediary ensure, each time before accepting an investment commitment, that each investor answers questions demonstrating the investor's understanding that there are restrictions on the investor's ability to cancel an investment commitment and obtain a return of his or her investment, that it may be difficult for the investor to resell the securities, and that the investor should not invest any funds in a

[6] Roper, Barbara, "Can the Internet Transform Disclosures for the Better?" January 2014, available here.

crowdfunding offering unless he or she can afford to lose the entire amount of his or her investment.

Revising the definition of electronic delivery is the first essential step in any effort to deliver the full potential of the statute's requirements that investors review and understand educational materials. In addition, the Commission should:

- Require intermediaries to monitor whether investors actually access the materials, either by opening the email or following the link. We understand this is easily achieved using the functionality of the Internet and is common practice among securities firms today. While this will not assure that investors carefully review the material, it increases the likelihood that they will.

- Require intermediaries to design the "questionnaire" to not only test investor knowledge of the covered topics but increase investor understanding. The questionnaire CFA and VantageScore adopted to test and enhance consumer understanding of credit scores is a model of one potentially effective approach. Investors, issuers and intermediaries alike could benefit if regulators (perhaps FINRA and NASAA working together) were to develop an appropriate model that intermediaries could adopt in place of developing their own materials or could use as a model if they prefer to develop their own content.

- Adopt similar requirements to develop an interactive questionnaire with regard to disclosures about other of the key risks associated with crowdfunding. One such risk is the risk that investors will fail to achieve the full upside potential of their investment because of practices that dilute the value of their shares. Another area where a similar approach may be warranted is with regard to the risk that the securities may not be accurately valued.

Finally, while we recognize the potential benefits of allowing innovation in how intermediaries approach their investor education obligations, there are also risks with this approach. We are frankly unconvinced that the Commission has proposed regulatory requirements that are sufficiently rigorous and clear to reliably deliver the benefits of innovation. It is just as likely, in our view, that these regulatory requirements will result in a mish-mash of practices that in all too many cases rely on check-the-box compliance based on poor quality educational materials. Even if it adopts the strengthening amendments suggested above, it will be incumbent on the Commission to carefully monitor practices in this area and to impose tighter restrictions if experience shows that intermediaries are not faithfully fulfilling their obligations to ensure that investors review and understand clear, unbiased education messages warning of the general and particular risks associated with crowdfunding.

3. The Commission has failed to take other steps that it could and should take to strengthen protections for investors.

In a number of areas, the proposed rules rely on disclosures to protect investors, even when the Commission's own analysis indicates that such disclosures are unlikely to be effective. Of particular concern is the Commission's willingness to rely on disclosure alone with regard to issues where there is a significant risk of investor confusion and abuse and little reason to believe that unsophisticated crowdfunding investors are likely to be able to make good use of the disclosures. The Commission's recent financial literacy study documents the degree to which investors struggle to understand the disclosures they receive. This is likely to be all the more true of the unsophisticated investors expected to participate in crowdfunding. In areas where there is a significant risk of investor harm and no basis for concluding that disclosures will be effective in mitigating that risk, the Commission has an obligation to look beyond disclosure and adopt prohibitions against the most serious potentially abusive practices.

a. The proposal fails to adequately protect investors from the risk that the value of their shares will be diluted.

The promise of crowdfunding is that it provides an opportunity for average, unsophisticated investors to get in on the ground floor of the next big thing and profit when the company grows and prospers. Unless the Commission adopts appropriate protections, however, there is a very real risk that many crowdfunding investors who provide the seed money for successful companies will be denied a fair share of that company's future profits. This derives from two main risks: 1) that the crowdfunding shares will not be fairly valued and 2) that the investor will purchase shares through crowdfunding that can be diluted such that they do not gain in value to match the growing prosperity of the company.

The proposed rule requires the issuer to disclose "how the rights of the securities being offered may be materially limited, diluted or qualified by the rights of any other class of security of the issuer." But as the Commission acknowledges in the Proposing Release, crowdfunding investors are unlikely to have the experience or market power "to negotiate various anti-dilution provisions … that have been developed by institutional and angel investors." While requiring the disclosures may benefit some investors, the Commission has no basis for concluding that a majority of crowdfunding investors will be sufficiently financially sophisticated to make an informed decision with regard to these vitally important issues. We believe a more investor-protective approach is therefore warranted. Specifically, the Commission should require shares offered through crowdfunding to incorporate the protections against dilution that institutional and angel investors are typically able to negotiate to protect their interests. There is no reason to believe such restrictions would hamper capital formation. On the contrary, as the Commission acknowledges, if crowdfunding investors learn that they are unlikely to share in the upside of crowdfunded companies, they may be less likely to participate in this market. Even legitimate issuers who are willing to protect the interests of crowdfunding investors are likely to be affected if crowdfunding's reputation becomes tarnished.

Similarly, on the issue of valuation risk, the Commission proposes to require only that the issuer disclose how the securities offered are being valued. As the Commission acknowledges in the Proposing Release, the required disclosures with regard to valuation "may be insufficient for investors to determine an appropriate price." We agree. Given the significance of this issue, we urge the Commission consider whether additional standards are needed to ensure that the shares are fairly valued and that approaches to valuation that put investors at a disadvantage are prohibited.

b. The Commission should require shares in over-subscribed offerings to be allocated on a pro rata basis.

Disclosures regarding allocation of shares in over-subscribed offerings are precisely the sort of complex, technical disclosures that investors are least likely to be able to assess knowledgeably. Accordingly, the Commission has no basis for concluding that crowdfunding investors will be able to make an informed decision based on such disclosures. Moreover, this approach specifically anticipates allowing issuers to make allocations on a first-come, first-served basis, an approach prohibited under the Williams Act because of its potential to create a stampede effect. This concern is particularly relevant in the context of crowdfunding, where issuers will have an incentive to use this approach precisely because of its potential to pressure investors to act quickly and without sufficient deliberation. The Commission provides no basis for concluding that allowing issuers the "flexibility" to allocate shares on a first-come-first-served basis is either necessary or beneficial. To counteract the potentially harmful stampede effect of this approach, the Commission should require that oversubscribed offerings be allocated on a pro rata basis, as required under the Williams Act.

* * *

The proposed rules fail to deliver the key investor protections adopted by Congress when it enacted the JOBS Act. In addition, the Commission has failed to use its authority to adopt additional protections needed to ensure that crowdfunding works to the benefit of investors and issuers alike. Remedying the proposed rule's defects in these key areas should be a Commission priority. Failure to fix these serious deficiencies all but ensures that crowdfunding will be an unmitigated disaster for investors which will ultimately render it a failure for issuers and intermediaries as well.

III. Other Aspects of the Rule Proposal Are a Mixed Bag for Investors

The proposed rules address a number of issues, beyond those discussed in the previous section, that also have the potentially to materially impact the quality of protections afforded to crowdfunding investors. This section of our comment letter walks through those provisions in roughly the order in which they arise in the Proposing Release.

A. Limits on the Availability of the Exemption

In drafting Title III of the JOBS Act, Congress imposed significant limits on the availability of exemption. These limitations were designed to ensure that crowdfunding serves its intended purpose of filling a perceived "funding gap" for start-up and very small companies, potential losses to investors are minimized, and regulators can provide effective oversight of this market. Specifically, the statute limits availability of the exemption to issuers who: have sold no more than $1 million in securities in aggregate to investors over the previous 12-month period; comply with individual investment limits based on income and net worth of the investor; and conduct the transaction through a registered broker-dealer or a registered crowdfunding portal. As discussed further above, the proposed rules faithfully implement only the last of these three requirements.[7] In addition, we urge the Commission to carefully considering the following issues related to the proposed limits on the availability of the exemption.

1. The proposed approach to the limitation on capital raised is legally indefensible.

While other aspects of the statute may be open to interpretation, the language limiting availability of the exemption based on the amount of capital raised is clear and unambiguous. There is simply no basis in logic or in law for the Proposing Release's interpretation that this $1 million limitation applies only to the amount raised through crowdfunding. By referencing the statute's rule of construction, which simply clarifies that the crowdfunding exemption does not prevent issuers from also raising capital through other means, the Commission staff finds an "ambiguity" when none exists. Contrary to the tortured logic adopted in the Proposing Release, the $1 million capital raised limitation explicitly imposed by Congress does not "prevent" issuers from raising capital through other means nor would it limit the total amount that they could raise. It would simply limit their ability to do so during a given12-month period. It cannot be used to overturn a clear directive in the statute, but that is precisely what the Commission proposes. We therefore urge the Commission to correct this clearly erroneous reading of the statute and to impose the $1 million limit on capital raised, as Congress clearly intended, to all securities sold by an issuer in a 12-month period.

2. The Commission should strengthen its disqualification standards for non-compliant issuers.

The Commission appropriately proposes to disqualify issuers from relying on the crowdfunding exemption if they fail to comply with certain of the Act's disclosure requirements. But disqualification is only triggered under the proposed approach where the issuer has not filed "the ongoing annual reports required by Regulation Crowdfunding during the two years immediately preceding the filing of the required new offering statement." Such an approach appears to allow issuers up to two full years of non-compliance with fundamental reporting requirements during which they could continue to rely on the crowdfunding exemption. We see no reason why issuers who cannot comply with a legal requirement that is entirely within their control should be allowed to avail themselves of the exemption. Instead, their ability to rely on the exemption for additional offerings should be halted until the issuer comes into compliance with regard to any ongoing offerings.

3. The Commission should retain the prohibition on offerings that lack a specific business plan.

On the other hand, we strongly support the proposal to exclude any issuer "that has no specific business plan or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies." These sorts of "blank check, blind pool" offerings are inherently subject to abuse. As the Proposing Release acknowledges, they are also inconsistent with the premise behind crowdfunding, which hinges on a robust discussion among investors regarding the relative merits of a particular offering. No such discussion is

[7] As discussed further above, even that aspect of the rule proposal is undermined by the Commission's failure to adopt a reasonable policy regarding integration with other offerings.

possible where there is no project or business plan to discuss. Moreover, the legislation itself specifically requires that information filed with the Commission by the issuer and disclosed to investors include "the anticipated business plan" of the issuer.

In general, the Commission appears to have struck an appropriate balance, prohibiting offerings where this is no business plan while accommodating the realities of early-stage companies, including the fact that business plans for crowdfunding companies "could encompass a wide range of project descriptions, articulated ideas, and business models: and "may be less defined or detailed than the plan associated with larger issuers." The Commission should consider whether business plan requirements should be scaled to match the size of the offering. Logically, a company that is seeking to raise $1 million from investors should be better able to hash out the details of its business plan than a company raising just $50,000 or $100,000. Also, given the importance of this information to investors, it will be important for the Commission to monitor practices in this area to ensure that this requirement is sufficiently robust to result in meaningful disclosure to crowdfunding investors.

B. Requirements on Issuers

The statute imposes a number of disclosure and other requirements on issuers. While some commenters have complained that the proposed disclosure requirements are too burdensome, they are mandated by the statute. Requiring less extensive disclosures would undermine the ability of the "crowd" to vet offerings, as well as the individuals standing behind those offerings, and would increase risks to investors. Issuers who are unable to provide this most basic of information frankly have no business raising money from the public, even through a market specifically designed for start-up companies. Moreover, crowdfunding intermediaries have it in their power to significantly ease compliance with these reporting requirements, and improve the comparability and reliability of issuer disclosures in the process, by providing a standardized, online question-and-answer form for issuers to use in providing the required information.

1. Issuer Disclosures

In general, the Commission has done a reasonably good job of implementing the proposed disclosure requirements both with regard to content and with regard to format. We support, for example, the Commission's discussion with regard to the level of detail that would be required in disclosing use of proceeds, a particularly important factor for investors to consider when providing seed capital to an early stage start-up company, as well as its proposal to require enhanced disclosures with regard to risks. We also strongly support the proposed requirement to file the information in the standard format of eXtensible Markup Language (XML), which is consistent with both the online nature of these offerings, the role that the crowd is intended to play in vetting these offerings, and the recommendation of the Investor Advisory Committee on data tagging. In its effort to be flexible, however, the Commission has left issuers with significant leeway with regard to these disclosures. It is therefore imperative both that the Commission monitor practices in this area to assure that its flexible regulatory approach is not being abused and that it adopt strong standards with regard to intermediary responsibility for issuer compliance.[8]

a. We commend the Commission for proposing additional disclosures, and in particular for proposing to require issuers to disclose the material factors that make an investment in the issuer speculative or risky.

One of the threats posed by crowdfunding is that unsophisticated investors will be swept up in the enthusiasm of the "crowd" and fail to adequately assess the very real risk that they could lose some or all of their money. Thus, ensuring that investors get good information about the risks of any such investment should be a high priority. We therefore commend the Commission for proposing additional disclosures with regard both to the general risks of crowdfunding investing and the particular risks of the issuer seeking funding. The additional proposed disclosures with regard to indebtedness of the issuer and certain significant related-party transactions also would help to provide a more complete picture of the company, its financial status, and its risks.

b. The Commission's proposed approach to financial disclosure allows for the provision of stale and limited financial information.

The financial information that issuers are required by statute to provide is critical to an informed evaluation of the investment opportunity presented by particular issuers. For the most part, the Commission proposal faithfully implements this disclosure requirement. But it suffers from one serious shortcoming. The Commission proposes to allow issuers to provide financial statements from the end of the issuer's most recent fiscal year and, during the first 120 days of an issuer's fiscal year, from the end of the preceding fiscal year. In certain circumstances, this would allow issuers to submit financial statements that are more than a year out of date and that cover only a very limited portion of the issuer's existence.

This is particularly troubling in the context of crowdfunding, where the financial status of companies can be expected to change dramatically in a short period of time and where the investors evaluating the financial disclosures are likely to lack extensive expertise and sophistication. While the Commission makes clear that issuers would be required to disclose any material changes that have occurred since the date of the financials, it does not ensure that these disclosures would be clear and in a format that is consistent with the financial statements. Moreover, it is likely that in some circumstances disclosures of material changes would overshadow the financial statements themselves as the most important source of relevant information about the company's financial status. Absent effective oversight (which the Commission lacks the resources to provide), there is a significant risk that issuers will rush to report positive changes in their financial status but delay or avoid reporting negative changes.

We urge the Commission to revisit this issue to ensure that investors receive the most recent financial information feasible. One possible approach would be to require that issuers

[8] Unfortunately, as discussed in greater detail above, the Commission's proposed standards in this area have no reasonable likelihood of being effective. This is a particularly troubling gap in the regulatory requirements, since the Commission itself lacks the resources necessary to provide effective oversight.

making offerings subject to the audited financial statement requirement provide audited financial statements for the two most recently ended fiscal years (where the company has been in business for such a period), supplemented with non-audited but CEO-certified financial statements through the end of the month ending no more than two months before the offering begins. A different approach may be appropriate for smaller offerings not required to submit audited financial statements. The goal of the policy in this area should be to ensure that investors are able to base their investment decisions on information about the financial status of the company that is as complete and up to date as is possible for such early stage start-up companies. We do not believe the current Commission proposal meets that standard.

c. The Commission unnecessarily and inappropriately allows audits to be conducted based on industry standards that have proven to be inadequate in the past.

We are also concerned that the Commission proposes to allow audits of financial statements to be conducted based on industry (AICPA) rather than independent (PCAOB) auditing standards. The Sarbanes-Oxley Act gave PCAOB authority to set auditing standards precisely because, as we noted at the time, the industry standards were so weak as to be unenforceable. They served primarily to protect auditors from liability rather than to promote reliable financial reporting. While we could wish that the PCAOB had moved more quickly to update and strengthen those standards, the changes adopted since PCAOB took over the standard-setting responsibilities have been significant. The Commission has failed to demonstrate that requiring audits to be conducted based on PCAOB standards would create an undue problem for issuers. Absent any evidence that such a requirement would create a barrier to capital formation, the Commission should adopt the standards for audits of crowdfunding issuers that are appropriate for issuers selling their shares to the public and those are the standards promulgated by PCAOB.

2. Advertising Prohibition

The legislation includes an explicit prohibition against advertising the terms of the offering except through notices that direct investors to the funding portal or broker. While a number of commenters urged the Commission to ignore this clear statutory mandate, the Commission's specific proposals with respect to advertising restrictions are generally faithful to the statute. Moreover, we agree in principle with the Commission's willingness to provide flexibility to allow issuers to communicate with investors through the funding portal, so long as they clearly identify themselves, and to continue to provide information that does not constitute a notice of the terms of the offering. While we believe this is an area with many potential pitfalls for unwary and inexperienced issuers, it is consistent with the nature of crowdfunding envisioned by its creators. Given the potential for abuse, however, this form of communication can only function appropriately if the rules include strong standards governing funding intermediaries' responsibilities for helping to insure issuer compliance.

Unfortunately, the Commission's otherwise faithful implementation of the statute's advertising restrictions are fatally undercut by two other serious shortcomings in the rule proposal. The first is the Commission's failure to adopt a reasonable policy with regard to integration of offerings. As a result, issuers will be free to conduct simultaneous offerings that include public advertising, thus rendering the crowdfunding advertising restrictions meaningless. The comments from industry urging the Commission to ignore the advertising restrictions highlight just how prevalent such evasion is likely to be. The second shortcoming is the proposal's appallingly weak standards with regard to intermediary responsibility for issuer compliance. If intermediaries aren't incentivized to keep a close eye on issuer communications, the flexibility the Commission proposes to provide with regard to communications between issuers and investors on funding platforms and with regard to information that does not constitute notice of the terms of the offering is all but certain to result in inappropriate communications by inexperienced issuers who do not fully understand their obligations under the securities laws. As discussed above, these failings in the rule proposal must be fixed if the advertising restriction is to function as intended.

3. Compensation of Persons Promoting the Offering

The ability of the "crowd" to independently assess the merits of an offering would be seriously impeded if paid promoters could participate surreptitiously in the discussion without clearly disclosing their role as paid promoters. The Commission is absolutely right when it states that "it would be important for potential investors to know whether persons using these communication channels are the issuer, persons acting on behalf of the issuer or persons receiving compensation from the issuer to promote the issuer's offering because of the potential for self-interest or bias in communications by these persons." Frankly, we question the wisdom of allowing paid promoters to participate in this process at all, since evidence suggests that disclosures of the type anticipated here are particularly ineffective at putting investors on the alert with regard to these sorts of conflicts of interest. However, we commend the Commission for adopting a strict interpretation of the statutory requirements and applying it broadly to anyone acting on behalf of the issuer. Similarly, we strongly support the proposal to prevent issuers from circumventing the advertising restrictions by prohibiting from compensating third parties to promote their offerings outside the communication channels provided by the intermediary, unless the promotion is limited to notices that comply with the advertising rules.

C. Requirements on Intermediaries

While the Commission has in certain areas done a good job of implementing the statute, in other important areas the rules are woefully inadequate. We are particularly concerned that the proposed rules would render essentially meaningless the requirement that intermediaries take steps to ensure issuer compliance and to verify investor eligibility. As discussed above, this fatal flaw in the proposed regulations undermines the central components of the investor protection scheme that Congress intended to put in place when it adopted the crowdfunding title of the JOBS Act. The following discusses other key issues with regard to proposed requirements for intermediaries that are likely to affect whether the interests of crowdfunding investors are adequately protected.

1. Limitations on activities of non-broker-dealer funding portals

The statute allows for crowdfunding transactions to be conducted either through a broker-dealer or through a funding portal. Funding portals are exempt from some aspects of broker-dealer regulation so long as they refrain from engaging in certain activities, in particular those that would move them out of the relatively passive or neutral role of a portal and into the more active role of broker-dealer. These include: offering investment advice or recommendations; soliciting purchases, sales or offers to buy the securities offered or displayed on its platform or portal; and compensating employees, agents or other person for such solicitation or compensating them based on the sale of securities displayed or referenced on its platform or portal. In addition, funding portals that wish to hold, manage, possess or otherwise handle investor funds or securities would have to be subject to the appropriate broker-dealer regulatory requirements.

The Proposing Release asks whether any of these limitations on funding portal activities should be removed or modified. We would strongly oppose any such action. The statute clearly and appropriately identifies the activities that would justify full-scale broker-dealer regulation. Crowdfunding portals that wish to engage in any of these activities would be free to do so as long as they were registered and appropriately regulated as broker-dealers. In other words, they are not being precluded from engaging in these activities, but simply being precluded from engaging in them without being subject to the appropriate regulatory requirements. Thus, we see no need or justification for changing these requirements.

2. Financial Interests

We strongly support the Commission's interpretation of the statute's requirement that an intermediary "prohibit its directors, officers or partners (or any person occupying a similar status or performing a similar function) from having any financial interest in an issuer using its services." We agree that this provision "is designed to protect investors from the conflicts of interest that may arise when the persons facilitating a crowdfunding transaction have a financial stake in the outcome." And we further agree that, to achieve its intended result, the prohibition must be extended to the intermediary itself.

An intermediary that is compensated through receipt of a financial interest in an issuer may have an incentive to take steps to ensure that the issuer reaches its funding target so that the offering can move forward or engage in other practices designed to artificially inflate the value of its securities. This is fundamentally at odds with the gatekeeper role that Congress intended intermediaries to play. Moreover, the Commission's own research has clearly shown that investors are unlikely to understand the risks associated with such conflicts based solely on disclosure of the conflict. The risk is greatest if the intermediary receives its financial stake in the issuer on different terms than other investors, but it is not limited to those circumstances. We therefore urge the Commission to retain this provision in the final rule.

We are concerned, however, that the definition of "financial interest" may be too narrow. At the very least, we would urge the Commission to monitor practices in this area once rules are adopted to ensure that the intended limits appropriate to intermediaries' gatekeeper functions are not being circumvented through the use of other types of payments or financial arrangements.

3. Account opening

The rule appropriately requires that investors open an account with an intermediary in order to invest in an offering. It is through this process that intermediaries could and should collect the information that would enable them to verify investor eligibility and investment limits. In an approach that is typical of this release, however, the Commission doesn't propose to set any standards for the types of information intermediaries would have to collect. Instead, it simply "anticipates" that intermediaries would "at a minimum … obtain basic identifying and contact information, such as full name, physical address and e-mail address." This is completely inadequate.

Setting aside for the moment the information that intermediaries should be required to collect to fulfill their obligation to verify investor eligibility (discussed further above), the Commission should adopt requirements for information collection at account opening that minimize the risk that investors seeking to evade those limits will adopt false identities in order to open multiple accounts. So, in addition to actually requiring (as opposed to anticipating) that intermediaries collect basic identifying and contact information, intermediaries should be required to collect a Social Security number or other similar information that would prevent an investor from establishing multiple accounts under different names. The intermediary should be required to use that information to verify that no multiple accounts exist. Investors who are found to be evading investing limits through such means should be subject to ban, either temporary or permanent depending on the seriousness of the violation, from investing in crowdfunding offerings.

In addition, intermediaries should be required to collect information at account opening that would enable them to determine whether the investor has an association with a particular offering or group of offerings. Unless intermediaries collect that information, they will have no basis for determining whether the individual in question is required to provide conflict of interest disclosures when commenting on a particular offering. And the intermediary and regulators will find it more difficult to track misleading statements that may justify a regulatory response.

We therefore urge the Commission to return to the drawing board on this set of rule proposals. It should begin by thinking clearly about exactly what information intermediaries will need to fulfill their various obligations, including their obligation to reduce the risk of fraud and to protect investors. And it should then adopt regulatory requirements designed to ensure the intermediaries collect and, as necessary, verify that information.

4. Education Materials

The statute calls on the Commission to adopt rules with regard to the disclosures, including risk disclosures, as well as educational materials that crowdfunding intermediaries would be required to provide to investors. The rule proposal specifies a series of topics that would have to be covered in educational materials delivered to investors at account opening and made available on the intermediary's funding portal. The Commission has in our view generally done a good job of identifying key topics that should be covered in the educational materials.

For example, the proposed requirement with regard to information about risks associated with particular types of securities is absolutely essential, particularly since the Commission has failed to take any meaningful steps to restrict sales of securities that allow minority shareholders to be disadvantaged, that allow the value of shares to be diluted, and that therefore offer little hope that investors will share in any eventual gains of the issuer. While we do not think investor education of this type can substitute for affirmative investor protections, as discussed above, we nonetheless support inclusion of such educational materials in the hopes that they can be at least marginally beneficial. The Commission could significantly increase that likelihood if it were to require issuers to link information on the shares they are offering to the educational materials describing the particular risk associated with that particular type of securities (*e.g.*, callable securities). This sort of linkage is easy to accomplish in a world of online and electronic delivery of disclosures.

Similarly, while we strongly oppose the Commission's proposal to allow intermediaries to reasonably rely on investors' representations with regard to investment limits, we certainly agree that this is a topic that should be covered in educational materials. Here again, however, the fact that these transactions will be conducted over the Internet allows for much more effective protections than will be provided by investor education alone. As discussed above, portals could and should be required to collect the underlying data upon which calculations of income and net worth would be based and to perform the calculations. Simple interactive forms could be used for this purpose, minimizing the burden on portals and investors alike.

We are also generally supportive of the flexibility the Commission has provided with regard to format and presentation of educational materials, with two caveats. First, we encourage the Commission and FINRA to closely monitor practices in this area to ensure that educational materials fulfill their intended purpose. Toward that end, we believe it would be beneficial for the Commission to require that the materials be provided to FINRA, the Commission or both, at least during an initial period after the regulations are adopted. Alternatively, portals could be required to submit educational materials they propose to provide as part of their registration application. Second, we believe investors, issuers, and portals alike could benefit if the FINRA and/or the Commission were to develop model educational materials that intermediaries could use in lieu of developing their own materials, at least in certain general areas common to all portals. This would save intermediaries the cost of developing their own materials unless they chose to do so, and could provide a model that others could follow.

The Commission also proposes to require intermediaries to inform investors that paid promoters are required to disclose their conflict of interest in all communications on the funding portal. We commend the Commission for attempting to ensure that investors are alerted to this potential conflict. However, disclosures about conflicts of interest have been shown to be particularly tricky, sometimes having a counterintuitive effect on behavior. We therefore encourage the Commission to engage in testing to determine what the best means of conveying this information is. We support the Commission's proposal to require intermediaries to disclose how they are compensated and, in particular, any conflicts of interest that may result from such compensation practices. To be clear, however, we do not believe such disclosure would provide sufficient protection to justify eliminating the Commission's separate proposal prohibiting intermediaries from having a financial stake in the issuers that raise funds through their portal.

5. No prior review of offering materials

The Commission allows private offering documents to be made available to investors at the same time that they are made available to the Commission and other regulators. As a result of the Commission's proposed approach, inexperienced issuers, some with no prior experience in the offering process, will often be making information available to investors without any prior review by regulators, by a securities professional, by a compliance expert, or by legal counsel. The potential for compliance violations even by well-intended, legitimate issuers is enormous. Concerns about this simultaneous disclosure to investors and regulators are somewhat ameliorated by the fact that information would have to be made publicly available for at least 21 days before any securities are sold. Thus, regulators will at least theoretically have an opportunity to review the material – perhaps conducting spot checks – before any sales are actually made. However, we question whether the Commission will have the resources to provide meaningful oversight.

The Commission dismisses this concern regarding no prior review of offering materials on the grounds investors are adequately protected by its proposed requirement that intermediaries have a reasonable basis for believing the issuer is in compliance. As noted above, however, the Commission renders this requirement meaningless by allowing intermediaries to rely on representations by issuers that they are in compliance. Unless this requirement is strengthened, there is every reason to expect that this "compliance verification" will devolve into a simple check-the-box requirement. The Commission's reliance on intermediary oversight as justification for excusing crowdfunding issuers from any additional prior review of offering materials further emphasizes the need to strengthen that central requirement, as it is the foundation on which other investor protections in the statute rest.

6. Communications Channels

We agree with the Commission's view that allowing communication among members of the crowd is a fundamental characteristic of crowdfunding and that it is therefore appropriate for the Commission to propose rules with regard to the channels through which that communication will occur. We also support the Commission's proposal to restrict issuer communications with investors to communications through the intermediary. Requiring that crowdfunding be conducted through intermediaries was one of the most significant improvements made to the bill during Senate consideration. It is only this centralization of the process on funding portals that allows for effective regulatory oversight. It is particularly important that communications between issuers and investors be subject to such oversight.

We also support the Commission's proposal to restrict participation in these communications channels to those individuals who have opened an account with the intermediary. While there is a benefit to having other independent parties participate in the discussion, investors are likely to be able to gain access to their views through other means (*e.g.*, a Google search). But, as the Commission suggests, the likelihood that fraudulent or abusive comments will find their way into the discussion increases significantly if the process is open to any and all comers. Since intermediaries will bear the burden of policing the comment stream to eliminate those comments that violate basic standards, the Commission could leave it up to individual intermediaries to decide whether they want to take on the added burden that comes with an open comment process. But, if that approach were adopted, intermediaries would have to be held to high standards for policing the comment stream to prevent fraud and abuse. We believe that process, in and of itself, is likely to pose problems, given the incentive portals may have to favor positive over negative views of available offerings.

As the Commission suggests, restricting commenting privileges to account holders has the potential to "help to establish accountability for comments," by enabling intermediaries "to track the origins of any abusive or potentially fraudulent comments made through the communication channels." Unfortunately, this process will unlikely to deliver the potential benefits unless the Commission requires intermediaries to collect more information at the time of account opening. The account opening requirements should be specifically designed to help intermediaries prevent potentially disruptive elements from opening accounts under false identities and using those accounts to spread false and misleading information.

7. Notice of Investment Commitment

The Commission proposes to require intermediaries, upon receipt of an investment commitment, to promptly send investors notification that includes the important basic information such as the dollar amount of the investment, the price of the securities, if known, and the date and time by which the investor may cancel the investment commitment, should they choose to do so. Unfortunately, because the Commission has proposed to allow electronic delivery through delivery of a message providing notice that the information is available on the website but no link, there is no guarantee that investors will actually receive the required disclosures. The Commission must fix this fatal flaw in its electronic delivery definition in order to ensure that the potential benefits of this regulatory proposal on notice of commitment receipt are realized.

8. Credit Card Payments

In its otherwise reasonable rules regarding maintenance and transmission of funds, the Commission notes that it is not proposing any restrictions on the payment mechanisms investors could use to fund an investment. It specifically mentions that it would permit use of credit cards to fund an investment. The Commission notes that one commenter had suggested prohibiting payment through credit cards because of the risk that investors could claim a charge-back after the security is sold. A greater concern, in our mind, is that allowing payment via credit card increases the risk that investors will make crowdfunding investments that they cannot afford. This risk is already heightened by the Commission's proposed rules maximizing the amount that investors can put at risk and minimizing enforcement of those investment limits. Investors who actually had to come up with the cash to make an investment would likely be more sensitive to the risk of loss. We urge the Commission to reconsider its position on this issue. Intermediaries have an inherent interest in maximizing investment amounts and are therefore unlikely to decide the issue based on the best interests of crowdfunding investors.

9. Transaction Confirmations

As the Commission has long stated, and once again acknowledges in the Proposing Release, "transaction confirmations serve an important and basic investor protection function by, among other things, conveying information and providing a reference document that allows investors to verify the terms of their transactions, acting as a safeguard against fraud and providing investors a means by which to evaluate the costs of their transactions." It is not sufficient to satisfy the delivery requirement for transaction confirmations through delivery of a message that contains a notice that the information is available on the intermediary's website. But that is precisely what the Commission's proposed definition of electronic delivery would allow. While most if not all intermediaries would be likely to deliver the actual confirmation to investors, the rule would not guarantee this. It therefore serves as yet another reminder of how inappropriate the Commission's proposed definition of electronic delivery is.

10. Investment Cancellations

In its proposed approach to investment cancellations, the Commission appears to have made a genuine attempt to adopt a pro-investor approach. By giving investors an unconditional right to cancel their investment up to 48 hours before the target date set by the issuer, the Commission maximizes the ability of investors to base their decision on the so-called "wisdom of the crowd." However, there is also a risk associated with this approach, which is that individuals associated with the issuer will commit money to the offering early in the process in order to stimulate interest and create a sense of urgency about investing, only to withdraw at the last minute. While at least one commenter called on the Commission to restrict the ability of individuals associated with the issuer to invest in their own crowdfunding offering, the Commission proposes instead to rely on intermediaries to police issuer participation and look for "red flags." We are skeptical that such an approach will provide adequate protection against abusive practices. This kind of gamesmanship by insiders has the potential to seriously discredit crowdfunding in the eyes of investors. We therefore urge the Commission to consider whether more meaningful restrictions on issuer participation are warranted. At the very least, regulators should closely monitor conduct in this area and take swift and decisive enforcement action against misconduct.

This aspect of the rule also highlights the inadequacy of the Commission's definition of electronic delivery. Specifically, with regard to the disclosures that are required when the material conditions of an offering have changed and the investor has not reconfirmed his or her commitment, the proposed rules would require an intermediary, within five business days thereafter, to: provide or send the investor a notification disclosing that the investment commitment was cancelled, the reason for the cancellation and the refund amount that the investor should expect to receive; and direct the refund of investor funds. Under the Commission's definition of electronic delivery, this crucial information would not have to actually be "delivered" to the investor. Instead, it would suffice to send an email containing notice that the information is available somewhere on the intermediary's website.

11. Registration Requirements

Important gatekeeper responsibilities entrusted to intermediaries include ensuring compliance by issuers, educating investors about risks, and enforcing investment limits. As noted above, the Commission's proposed regulations in each of these areas are woefully inadequate. Because the Commission provides so much "flexibility" to funding portals regarding how they fulfill these functions, there is likely to be a wide disparity in funding portal conduct. Alternatively, there could be a race to the bottom that results in fairly uniform but substandard practices. However, we continue to hold out hope that at least some intermediaries will seek to distinguish themselves from the competitors by providing a higher level of compliance services. Thus, different funding portals are likely to pose significantly different compliance risks.

Regulatory oversight of portals could be enhanced if intermediaries were required to provide a narrative description of their methods of enforcing investment limits and ensuring issuer compliance along with the investor education materials they propose to provide to investors. Where the Commission or other regulators identify inadequacies in intermediaries' compliance practices, they could act quickly to require the intermediary to strengthen those practices before significant harm to investors occurs. Such an approach would be more effective, of course, if the Commission were to impose meaningful compliance requirements on intermediaries for regulators to enforce. Under the Commission's "anything goes" approach to intermediary compliance practices, it is difficult to see how regulators could assert that even the laxest of compliance practices was insufficient to satisfy the proposed rule.

12. Safe Harbor for Certain Activities

Funding portals are exempt from broker-dealer registration and from various aspects of broker-dealer regulation so long as they refrain from engaging in certain types of broker-specific conduct. Among these are offering investment advice and making recommendations. One of the questions that has arisen as the regulations were being developed is whether funding portals would be deemed to be giving investment advice if they "curated" portal offerings, for example by: providing access to the portal's platform to certain issuers and rejecting or removing others, based on criteria such as the "type" or "market characteristics" of the offerings; removing an issuer for failing to provide documents responsive to the funding portal's due diligence or qualification standards, including standards other than those established by Commission rules; highlighting, or otherwise making more prominent, the offering(s) of one or more issuers; organizing issuers listed on the funding portal's platform into groups based on the funding portal's view of the riskiness of the investment; providing a "valuation framework" that could guide investors in determining a fair valuation for securities listed on the funding portal's platform; or hosting on its website postings reflecting the views of third parties or the portal itself with regard to a particular issuer.

The Commission proposes to respond to these and other questions about permissible activities for funding portals by providing a non-exclusive, conditional safe harbor for funding portals that engage in certain limited activities. In interpreting these restrictions with regard to investment advice and recommendations, the Commission has generally done a good job of drawing the line in a way that preserves the utility of portals and promotes their ability to engage in potentially beneficial curating of offerings. We believe investors stand to benefit from the proposed approach, which would permit a funding portal to apply objective criteria to limit the offerings on its platform without being deemed to be providing investment advice, so long as the criteria are "reasonably designed to result in a broad selection of issuers offering securities through the funding portal's platform" and are "applied consistently to all potential issuers and offerings." The criteria could not be structured to recommend or implicitly endorse one issuer or offering over others. In order to promote transparency and investor understanding, the criteria also would be required to be clearly displayed on the funding portal's platform. We agree with the Commission that requiring the criteria to be disclosed would "help investors better appreciate any niche focus of a funding portal and the scope of the offerings available on the funding portal's platform."

However, we are concerned that the proposed approach may unnecessarily restrict the ability of issuers to use factors based on issues such as the viability of the issuer or the issuer's business plan to narrow their selection of offerings. It seems to us that, while the line may not always be easy to draw, there is a difference between internal screening standards and advice. Traditionally, advice has been construed as being "personalized" to a particular investor or group of investors. Just as brokers are not deemed to be giving personalized advice if they simply narrow the range of offerings they make available to investors, it does not seem appropriate to limit portals' ability to narrow the range of offerings they make available based on their views about the inherent quality of those offerings. Investors and intermediaries alike could benefit from a more nuanced approach to this issue.

In addition to being overly restrictive, we believe the proposed approach could place intermediaries in an ambiguous position. As noted above, the release states that a funding portal may not use criteria based on an assessment of the merits or the shortcomings of a particular issuer or offering. On the other hand, it notes that a funding portal is required to deny access if it believes that the issuer or its offering has potential for fraud or "otherwise raises concerns regarding investor protection." The question arises over what would raise a concern with regard to investor protection but not constitute an assessment of the shortcomings of a particular offering. Presumably, the Commission is attempting to draw a line between an assessment of the company's prospects and an assessment of its legal compliance. While we appreciate the Commission's efforts to tightly define conduct that could be deemed to constitute investment advice or recommendations, it is not clear to us that simply excluding offerings based on such factors as the likelihood that the company will fail constitutes either advice or a recommendation. And we believe the proposed approach raises potential problems that outweigh any perceived benefits. We therefore urge the Commission to reconsider how it draws this line and what approach is in the best interests of investors.

13. Compliance Policies and Procedures

The Commission proposes to require funding portals, as a condition of their exemption from registration as a broker-dealer, to implement written policies and procedures reasonably designed to achieve compliance with the federal securities laws and regulations thereunder, relating to its business as a funding portal. This is good, as far as it goes. However, the

Commission provides only the most cursory discussion of this topic. It fails to address at all the areas that should be covered by such policies and procedures, or what a funding portal's responsibilities to monitor compliance would be.

The Commission justifies this laissez-faire approach on the grounds that "it is important to provide this flexibility in order to accommodate the various business models funding portals may have." This strikes us as a cop out on the part of the Commission which will inevitably result in adoption of inadequate policies and procedures at some if not most funding portals. Past experience should have taught us that vague requirements such as this do not result in effective implementation. Moreover, it is possible to provide guidance while maintaining flexibility, and the Commission should do so here. Intermediaries would benefit from the added clarity, and investors would benefit from improved compliance. If the Commission fails to act, it will be incumbent on FINRA to fill this glaring gap.

14. Disqualification of "Bad Actors"

The Commission proposes to disqualify certain "bad actors" from participation in crowdfunding offerings. We agree that this is necessary, and we understand why the Commission has chosen to adopt an approach that is consistent with the approach it took in adopting "bad actor" restrictions for offerings under Regulation D. But we were frankly shocked by how weak those rules were when the Commission adopted them. They appear to reflect greater concern for protecting the rights of past lawbreakers than for protecting investors. The risks are amplified when this approach is applied in the context of crowdfunding, which is open to unsophisticated investors. We encourage the Commission to monitor whether individuals with a record of past violations are migrating into this field and to take appropriate actions to protect investors if it finds that this is the case.

IV. Conclusion

As the above comments doubtless make clear, we believe the Commission has utterly failed to fulfill its responsibility to develop a regulatory framework for crowdfunding that will work for investors, intermediaries, and issuers alike. What can explain this lack of focus on investor protection? While the statute poses significant challenges, it is not the primary culprit. Congress recognized the risks associated with crowdfunding and included a number of provisions in the crowdfunding title of the JOBS Act to minimize those risks. The proposed rules eviscerate key protections for investors that Congress intended to provide. Time after time, when the Commission faced a choice about how to implement the statute, it chose to prioritize promoting crowdfunding over protecting investors.

Creating a regulatory framework for a market that brings together inexperience issuers with unsophisticated investors is a daunting challenge. Nonetheless, the Commission cannot justify its lack of concern for investor well-being on the claim that it faced an impossible regulatory task. In a number of areas important to investor protection, alternative approaches exist that would offer significantly stronger safeguards for investors than those proposed by the Commission without imposing insupportable costs on issuers and intermediaries. Nor is the problem that the Commission failed to understand the enormous potential risks to investors. As the discussion in the economic analysis makes clear, the Commission is well aware that many if not most crowdfunding investors are likely to some or all of their money. There is simply no evidence anywhere in the rule proposal that the Commission's identification of significant risks to investors led it to adopt a regulatory approach designed to minimize those risks.

One problem is the Commission's one-sided view of the role that crowd dynamics are likely to play in this market. Viewing the world through rose-colored glasses, the Commission appears to see only the upside and none of the potential downside of crowd dynamics in an online marketplace. Thus, for example, the Commission touts the likelihood that members of the online community will engage in additional investigation and due diligence regarding offerings, posting relevant adverse information "on chat sites, message boards, and other communications channels," thereby helping to ensure the accuracy of the information relied on by all members of the crowd. In an unaccountable oversight, the Commission ignores the potential for those same methods to be used to spread false information about an offering, whether to increase interest in the offering, inflate the value of shares, or for other purposes. And because it ignores the potential dark side of crowd dynamics, the Commission fails to propose regulations designed to limit those harmful effects.

Perhaps more to blame, however, is the way in which the Commission has transformed economic analysis into a single-minded focus on reducing compliance costs without regard to the impact on investor protection or market integrity. In theory, economic analysis is designed to ensure that the Commission adopts the regulatory approach that is both affordable and effective. Compliance costs are important, but only within the context of regulations that have a reasonable chance of being effective in achieving the intended regulatory goal. Cost-benefit analysis has always seemed to us to promise more than it can deliver for the simple reason that it is easier to measure industry compliance costs than to measure costs to investors or the relative benefits of alternative regulatory approaches. At best, such analysis will always be highly speculative.

This fundamental shortcoming of economic analysis is exacerbated when any effort to adopt effective regulations is greeted with the threat of an industry lawsuit and scathing criticism from members of Congress and others intent on rolling back regulations. In such an environment, the path of least resistance is to omit any consideration of whether a proposed regulatory approach is likely to be effective and to instead focus exclusively on minimizing compliance costs. That one-sided approach to economic analysis is all too evident in this rule proposal, which time and again proposes regulatory approaches, based on self-certification in some cases on disclosure in others, with no basis for believing that the proposed regulatory approach is likely to be effective.

The most obvious effect of this flawed regulatory approach is that the rules fail to provide the investor protections intended by Congress when it adopted the JOBS Act. That alone should be sufficient cause for concern. But legitimate issuers are also likely to suffer if investors are driven off by the market's excessive risks, if the big headlines from crowdfunding are not about entrepreneurs making it big but about investors losing it all in failed crowdfunding offerings, or if the market is overrun by fraud. Based on the Commission's proposed rules, this is all too likely to be the case. Unless key provisions of the rules are strengthened, therefore, there is every reason to believe that crowdfunding will join the penny stock market of the 1980s and micro-cap market of the 1990s on a growing list of failed experiments in small company capital formation.

Respectfully submitted,

Barbara Roper

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Director of Investor Protection

cc: The Honorable Mary Jo White, Chair
The Honorable Luis Aguilar, Commissioner
The Honorable Daniel Gallagher, Commissioner
The Honorable Michael Piwowar, Commissioner
The Honorable Kara Stein, Commissioner