MILKEN INSTITUTE
CENTER FOR FINANCIAL MARKETS

February 3, 2014

Via Electronic Mail at rule-comments@sec.gov

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

Re: Comments on Crowdfunding; Release No. 34-70741; File No. S7-09-13

Dear Ms. Murphy:

Thank you for the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") on its proposed Regulation Crowdfunding (the "Proposals").

The Milken Institute is a nonpartisan, nonprofit, public charity with a mission of improving lives around the world by advancing innovative economic and policy solutions that create jobs, widen access to capital and enhance health. At our Center for Financial Markets, we believe that well functioning financial markets, accessible to all, can expand opportunities to develop human and social capital, magnify productive investment, and dramatically improve global prosperity. The following guiding principles and recommendations[1] are intended to aid the Commission in responsibly implementing Title III of the Jumpstart Our Business Startups Act (the "JOBS Act") – or the "crowd investing" provisions.[2]

I. Guiding Principles

What follows are guiding principles that we believe are useful in undertaking an analysis of the Proposals. The following take into account: (i) the likely motivations of crowd-investors; (ii) the nature of crowd-driven online due diligence; (iii) the importance of calibrating legal and regulatory compliance costs with the small sums being raised under Title III; and (iv) the effectiveness of investor caps in limiting investor exposure to downside risks.

- ***Many crowd-investors will be motivated to invest based on a mix of altruistic and self-interested factors.*** Unlike with standard investments, it is reasonable to assume that investors in "crowd investing" may be motivated to a greater extent by a number of non-financial factors, including personal passion or affinity for the company or project, the desire to support friends and family, and the opportunity to participate and engage with the entrepreneurs and a like-minded community of investors.[3] Of course, many investors will also be motivated by self-interested factors, including the potential receipt of rewards and perks, and now, the potential for financial return.[4] While it remains an open question whether this mix of motivating factors will result in successful investments,[5] consideration of what will

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[1] The following guiding principles and recommendations were discussed at a recent Milken Institute Center for Financial Markets roundtable discussion. We thank our diverse group of participants for providing valuable feedback and suggestions, and for contributing to many of the ideas presented here. [*Excerpts of this letter are from the written testimony of Daniel Gorfine, Director, Financial Markets Policy at the Milken Institute before the Subcommittee on Investigations, Oversight, and Regulations, Committee on Small Business, "SEC's Crowdfunding Proposal: Will it Work for Small Businesses?" (Jan. 16, 2014), available at* http://www.milkeninstitute.org/publications/publications.taf?function=detail&ID=38801457&cat=Arts].

[2] In order to differentiate non-financial-return "crowdfunding" (or the donation and rewards model) and the financial-return model envisioned by Title III of the JOBS Act, the term "crowd investing" will be used when referring to the capital-raising model created by the law.

[3] *See* Elizabeth M. Gerber, Julie S. Hui, and Pei-Yi Kuo, "Crowdfunding: Why People Are Motivated to Post and Fund Projects on Crowdfunding Platforms," Northwestern University, Creative Action Lab (2012), available at http://www.juliehui.org/wp-content/uploads/2013/04/CSCW_Crowdfunding_Final.pdf (noting that funders of crowdfunding projects seek rewards, support creators and causes with similar values, and enjoy engaging with and contributing to a creative community); Liat Clark, "How to Get Your Crowdfunded Indiegogo Campaign to the Top," Wired (Oct. 19, 2012), available at http://www.wired.com/design/2012/10/how-to-get-your-crowdfunded-indiegogo-campaign-to-the-top/.

[4] While pure profit-motive will certainly motivate some investors, it is likely that the lack of robust secondary markets in crowd-securities will deter those looking to make large returns in a short period of time from participating in this market.

[5] *See* Matthew Iglesias, "The Kickstarter Recession," Slate (June 17, 2012), available at http://hive.slate.com/hive/10-rules-starting-small-business/article/the-kickstarter-recession.

likely motivate investors does help to inform investor expectations and preferences when making a crowd-investment. The non-financial motivations may indicate higher risk-tolerance for potential loss of investment, and demonstrate the appeal of local, friends and family, impact, or affinity/cause-based ventures.

- ***The central hypothesis of crowd-investing is that in an interconnected Internet-centric world there is "wisdom in the crowd."*** The success of crowd-investing will largely be based on the ability of the crowd to employ new vetting methodologies and criteria. Much like financial innovators are looking at Internet-based methods of assessing an individual's credit-worthiness beyond traditional FICO scores,[6] the same can be said for crowd-investors looking at Title III investment opportunities. Basic disclosures are essential, though ultimately the concept of the "wisdom of the crowd" is based on the belief that technology-driven tools and platform-based communication channels may provide innovative forms of transparency and investor protection.

- ***Given the small size of Title III capital-raises, it is paramount that disclosure and ongoing compliance costs are properly calibrated.*** As the Commission notes in its Proposals, "[t]he crowdfunding provisions of the JOBS Act were designed to help provide startups and small businesses with capital by making relatively low dollar offerings of securities *less costly*."[7] If the overall costs to crowd-investing issuers and intermediaries are too great relative to the fundraising limit of $1 million (and the likely lower amounts many issuers will seek to raise), then crowd investing will not be an economically viable capital-raising mechanism. Unfortunately, as currently proposed, the disclosure and ongoing compliance requirements may, in aggregate, impose too great a burden on many issuers.[8]

- ***The most effective way to limit the downside risk of early-stage investing is through investment caps.*** Investing in startups and small businesses is an inherently risky enterprise. The Commission in its proposing release highlights a number of sobering studies, including one from the Kauffman Foundation in 2010 that found that out of 4,022 high-tech startups founded in 2004, nearly one-third had failed by 2008.[9] Research also finds that venture-capital-backed companies may not fare much better, despite the involvement of professional investors.[10] Given the inherent riskiness of startup or small-business investing, the most efficient way to limit downside risk to investors is through an admittedly paternalistic emphasis on investor caps – at least until the crowdfunding innovation has a chance to develop and demonstrate its ability to, on a relative basis, effectively vet investment opportunities.

II. Comments on Proposed Rules

To the extent that the Commission is inclined to act on the rules as proposed, and guided by the above principles, please find below specific comment on the Commission's release:

A. *Investor Caps*

The Proposals envision an investor self-certification mechanism whereby issuers will be able to rely on the affirmative representations of the investors. This approach properly imposes responsibility for compliance on the investors, but

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[6] *See* Katie Lobosco, *Facebook friends could change your credit score*, CNNMoney, Aug. 27, 2013, available at http://money.cnn.com/2013/08/26/technology/social/facebook-credit-score/.

[7] Proposal Release at 6-7 (italics added).

[8] *See Davis* Polk Client Memorandum, *SEC Proposes Rules for Crowdfunding Intermediaries*, Nov. 18, 2013, at 1, available at http://www.davispolk.com/sites/default/files/11.18.13.SEC_.Proposes.Rules_.Crowdfunding.Intermediaries.pdf ("While the crowdfunding exemption under the JOBS Act was intended to make it less costly for small businesses to raise relatively small amounts of capital, the statutory requirements and Proposed SEC Rules would condition the Securities Act exemption on compliance by issuers and intermediaries with a significant number of potentially costly regulatory obligations . . . [leading some to question] whether the benefits of raising capital through crowdfunding or acting as a crowdfunding intermediary would be great enough to justify the compliance costs and potential liability risks.").

The investment platform SeedInvest has created a useful spreadsheet tool that can be used to project/estimate the anticipated cost to an issuer of a Title III capital raise over a period of time. *See* http://www.seedinvest.com/blog/crowdsourcing-title-iii-crowdfunding-cost-model/. The assumptions can be changed within the spreadsheet, but even applying conservative numbers and time horizons demonstrates high costs to issuers with questionable benefit to investor protection.

[9] Proposal Release at 334 (citing Alicia Robb, E.J. Reedy, Janice Ballou, David DesRoches, Frank Potter and Zhanyun Zhao, An Overview of the Kauffman Firm Survey: Results from the 2004-2008 Data, Kauffman Foundation, available at http://www.kauffman.org/uploadedFiles/kfs_2010_report.pdf)).

[10] *Id.* at 334-35. Indeed, because early-stage investing is so risky, most professional investors pursue a fund approach whereby they invest in a large universe of companies with the expectation that many will fail and the hope that the few successes will more than compensate for those failures. For this reason, we would encourage lawmakers and regulators to consider ways to facilitate retail investor participation in funds that invest in startup companies.

should include requirements on the intermediary platforms to flag for investors the importance of compliance. More specifically, investors must be made aware that compliance with the investor cap is not optional (or simply a requirement that can be ignored), but is both required by law and intended to protect them from the potential downside risk of early-stage investing. To this end, intermediaries should be required to provide a detailed statement regarding the parameters and importance of the investor caps to investors at the point of – and before accepting – an investment commitment.

Additionally, in order to promote regulatory harmony within the JOBS Act,[11] the Commission should consider requiring investor wealth or income certification under penalty of perjury for all raises under Titles II-IV of the law. This would underscore the importance of the investor caps (or verification under Title II),[12] and properly place the burden of compliance on the actor who can verify income or wealth at the lowest cost -- the investor. Moreover, the Commission should consider precluding an investor who violates an investor cap from bringing a cause of action against an issuer to recover any invested funds found to be in excess of the permitted statutory cap for that investor.

B. *Intermediaries*

- <u>Curation and Investment Advice</u>

The Proposals currently create a safe harbor that would permit a funding portal to filter and select offerings for listing based on objective criteria (for example, by geographic region or industry sector).[13] The Proposals also recognize that an overly broad interpretation of the investment advice/recommendation ban could -- to the detriment of investor protection -- prevent funding portals from excluding highly suspicious investment offerings. As a result, the Proposals interpret the duty of a platform to exclude offerings that could be fraudulent or that raise investor protection fears broadly.

While this approach is a step in the right direction, the rules nevertheless leave an ambiguous gap where a funding portal could have serious doubts about the viability of an offering, but not to the level that it is permitted to exclude the offering from its platform.[14] Additionally, as proposed, the rules may prevent platforms from sharing data and information with investors that would assist the development of crowd-based vetting methods. Accordingly, the Commission should create the following additional safe harbors or issue guidance enabling the following activities:

- First, the Commission should permit funding portals wider leeway in excluding offerings when an offering technically satisfies objective platform criteria and cannot be said specifically to raise concerns of fraud or investor protection. It is troubling that the proposals note that "a funding portal may not use criteria based on an assessment of the merits or the shortcomings of a particular issuer or offering,"[15] especially when, as discussed below, the Commission goes on to envision potential intermediary liability for issuer missteps.

  To require a platform to list an offering that it has a strong conviction will fail is contrary to promoting investor protection. Instead, portals should have the ability to go further in curating offerings, including by way of algorithms, so long as they do not advertise or make statements that offerings listed on their platform are somehow safer or better than other platforms. If the market determines based on results that certain platforms are indeed yielding better investment outcomes, then presumably there is no harm and only benefit to investors.

- Second, as we have seen with the development of e-commerce platforms, such as eBay and Amazon, there is significant opportunity for intermediaries to glean and analyze data about offerings on the platform, develop

[11] Absent regulatory harmony, a number of odd outcomes and unintended effects are likely. For example, under the Proposals, an accredited investor can self-certify income or wealth with a $100,000 investment in a Title III deal, but would be required to verify accredited status when investing $2,000 in a Title II offering.

[12] We believe that self-certification under penalty of perjury should alone satisfy the verification requirement under Title II of the JOBS Act.

[13] *See* Proposal Release at 229-231; Proposed 17 CFR § 227.402.

[14] We recognize that merit-based review of securities listings by exchanges is precluded, but consider the funding portal model to be distinguishable. Here, to prevent a portal from having the discretion to turn away particular offerings will be to the detriment of investor protection.

[15] *See* Proposal Release at 231; Proposed 17 CFR § 227.301 and 17 CFR § 227.402.

algorithms to detect fraud or issuer best practices, and collect user feedback about transactions. Applied to funding portals, these capabilities could enable a platform to share with investors data on crowd investing raises and outcomes, information learned about an issuer, or even a crowd-based rating system of specific entrepreneurs/issuers. Without further guidance from the Commission, however, there is a risk that such information-sharing might be deemed the provision of impermissible investment advice.

- Finally, the Proposals do imply that a partnership between a registered broker/dealer and funding portal could allow a funding portal to go further in providing information to investors.[16] However, the parameters of what is allowable here are unclear. For example, the Commission should explicitly state that a funding portal is allowed to provide offering information from a properly licensed and/or registered third-party broker/dealer or credit rating agency on the portal website. In this way investors would be provided with important information -- for example, a credit rating on a debt security.

- <u>Portal Liability</u>

  We understand that questions regarding intermediary liability are typically resolved by the courts, and that there is precedent supporting issuer liability for certain intermediaries that promote offerings.[17] That said, as envisioned in the JOBS Act and in the Proposals, funding portals are arguably distinguishable given strict limits on offering curation, promotion, and advertising, as well as the fact that funding portals simply lack full discretion to decide with whom they will do business. Put simply, as currently framed, funding portals are technology-based platforms that are in many respects more akin to a bulletin board or eBay than they are to a registered broker/dealer.

  If funding portals are indeed held liable for issuer missteps, it will likely decrease the number of portals willing to participate in this marketplace, as well as increase overall systemic costs due to the risk of litigation. Accordingly, the Commission could take the formal position that funding portals as envisioned in the rules may not be liable for issuer missteps, or consider the following options:

  - As noted above, the Commission could permit funding portals to engage in broader forms of curation so long as they do not advertise or make statements that offerings listed on their platform are somehow safer or better investments than those listed on other platforms. The Commission would also permit funding portals to make some subjective judgments in deciding which offerings to list that can include "an assessment of the merits or the shortcomings" of an offering. This ability would *enhance* investor protection. Ultimately, portals should have some discretion to decide with whom they will do business without necessarily crossing the line of affirmatively providing investment advice or making recommendations to investors. Based on a sliding scale of curation powers, liability for funding portals may become appropriate.

  - The Proposals generally discuss a potential funding portal due diligence defense, but provide little detail. To the extent that funding portals are liable for issuer missteps, the Commission should articulate the reasonable steps a portal must take in reviewing an offering. More specifically, funding portals should not be required to "look behind" every material statement in an offering, but rather should be held to a standard of satisfying the statute's and proposed rule's steps for ensuring that an offering does not invoke concerns of fraud or investor protection. To require more of a funding portal could foreclose its economic viability given its anticipated high-volume, low-margin business.

- <u>Financial Participation</u>

  The Proposals prohibit an intermediary from having a financial interest in an issuer listed on its platform. While we recognize that the syndicate models being employed on Title II platforms are distinct, they provide an opportunity to analyze how co-investment may help to align a platform's and investors' interests.[18] Applied to Title III intermediaries, permitting intermediary financial participation may similarly align interests. It should be noted,

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[16] *See id.* at 238; Proposed 17 CFR § 227.402.

[17] *See Pinter v. Dahl*, 486 U.S. 622 (1988).

[18] We encourage the Commission to explore further the syndicate and SPV models being employed by Title II platforms, and consider whether issuers and crowd-investors would benefit from a similar deal-structure.

however, that a platform taking a financial interest in certain listed offerings likely should be registered as a broker/dealer given what may look like an investment recommendation. There may, however, be appropriate exceptions to the broker/dealer requirement; for example, CDFIs should be permitted to co-invest alongside crowd-investors in what would be a novel and potentially scalable approach to social and community impact investing.

C. *Issuers*

- Disclosure Requirements and Ongoing Compliance

Title III includes a number of statutory issuer disclosure requirements that reflect a minimized version of traditional Regulation A or public offering registration statements. There is little doubt that certain baseline issuer disclosures are necessary for investors to make sound investment decisions, and that well-prepared disclosures may provide a signal to the crowd about the competence and credibility of an issuer and its management team. The difficulty is in determining the right balance of required disclosures (both initial and ongoing) that materially assist investors but that do not add undue cost and burden to issuers.

With respect to the SEC proposed rules, there are a number of requirements that go beyond those specified by statute. While each one – in and of itself – may appear reasonable and intended to provide investors with more information, in aggregate these requirements impose substantial cost without clear benefit to investors. Accordingly, the Commission should consider the following recommendations:

- Title III specifies accounting review and audit levels based on the size of a raise, but leaves the Commission to alter those levels at its discretion. Many commenters have already noted that maintaining an audit requirement for raises above $500,000 will result in significant additional cost to issuers. It is unclear whether this cost is justified when the existing Regulation A exemption generally permits review of financial statements for raises up to $5 million. Accordingly, the Commission should consider increasing the threshold level for requiring a full audit, and at the very least reduce the burden for satisfying the *ongoing* annual financial statement disclosure requirement by accepting a CPA review as opposed to audit for raises in excess of $500,000.

- With respect to non-statutory disclosure requirements, the Commission should err on the side of minimizing the burden on issuers – at least until the marketplace has had a chance to develop and the need for specific types of additional disclosures is identified. Most notably, the Commission should consider limiting the *ongoing* annual disclosure requirement to include little, if anything, beyond a discussion of financial performance, plans for the coming year, and financial statements (subject at most to a CPA review requirement). We anticipate that many issuers will go beyond these disclosures as a best practice emerges, but for smaller issuers this requirement will be properly scaled. At the very least, the Commission could scale required ongoing disclosures based on the size of the initial offering or the size of the issuer (as measured by revenues or total capitalization).

- The Proposals currently call for financial statements to be prepared in accordance with U.S. GAAP accrual accounting standards. But, as the IRS notes when discussing acceptable accounting methods, "many small businesses use the cash method of accounting,"[19] and a switch to accrual when not required by the IRS will be costly and time-consuming. That said, we recognize that larger companies – especially those interested in securing additional rounds of private financing – are encouraged to transition to accrual accounting. One suggested solution could be to create a revenue threshold that determines accounting standard requirements: perhaps useful here as a guide, the IRS requires a switch to accrual if a company has revenues greater than $5,000,000.[20] For earlier stage companies, however, cash accounting may better suit the issuer's needs and be less costly. Alternatively, the Commission could explore potential application of "other comprehensive bases of accounting" such as the AICPA's Financial Reporting Framework for Small-and Medium-Sized Entities.[21]

[19] *See* IRS Publication 538, Accounting Periods and Methods (Dec. 2012), at 9, available at http://www.irs.gov/pub/irs-pdf/p538.pdf.

[20] *Id.* at 10 (the "gross receipts test").

[21] *See* American Institute of CPAs, FRF for SMEs, available at http://www.aicpa.org/INTERESTAREAS/FRC/ACCOUNTINGFINANCIALREPORTING/PCFR/Pages/Financial-Reporting-Framework.aspx.

- <u>Testing the Waters</u>

    - The Proposals do not provide a mechanism for an issuer to 'test the waters' before listing a formal offering on a platform. We recognize that there are many considerations that go into creating an effective 'testing the waters' regime for crowd-investments. That said, the existing Reg A exemption allows for such practice, and can be successfully managed through an online platform. Given the significant potential sunk costs an issuer might face in the event of a failed Title III fundraise, we suggest that the Commission consider permitting an issuer to 'test the waters' through a registered funding portal or platform prior to filing a Form C offering.

We again thank you for the opportunity to present these recommendations as the Commission continues its important work on implementing the JOBS Act. We appreciate the Commission's efforts to date, and hope that this letter is helpful. Please let us know if we can provide any additional information, and we would be honored to have the opportunity to continue this discussion in person.

Sincerely,

Daniel Gorfine
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