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before the

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on

SEC's Crowdfunding Proposal:

Will it Work for Small Businesses?

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Chairman Schweikert, Ranking Member Velazquez and members of the Committee, thank you for the opportunity to appear before you today to discuss the SEC's rulemaking on crowdfunding. It is an honor and a privilege to appear before the Committee today.*

I am the Founder and President of Fund Democracy, a nonprofit investor advocacy group, and a MDLA Distinguished Lecturer, Associate Professor of Law and Director of the Business Law Institute at the University of Mississippi School of Law. I am also a Vice President of the financial planning firm, Plancorp LLC; a member of the PCAOB's Investor Advisory Group; and an Accredited Investment Fiduciary. I was formerly a member of the SEC's Investor Advisory Committee and chaired its Investor as Purchaser Subcommittee; an Assistant Chief Counsel in the SEC's Division of Investment Management; and an attorney in the securities practice of Wilmer, Cutler & Pickering (now WilmerHale).

This testimony is based on my general experience over a number of years as an investor advocate, journalist, academic, regulator, financial planner, private practitioner and expert witness and consultant. I have been engaged in securities regulation issues from a variety of perspectives and attempt to provide testimony that reflects the interests of investors, diverse views of various constituents, and the practical exigencies of real-world legal practice and compliance.

I. Introduction

This is the second occasion on which I have testified on crowdfunding. On the first occasion in 2012, a bill had not gotten out of Committee. Two years later, implementing rules have been proposed. Some have complained about how much time this rulemaking has taken, but it is extraordinary how quickly the crowdfunding concept has taken on concrete form. On the whole, the Commission and its staff should be applauded for their hard work on this rulemaking.

*I would like to thank University of Mississippi law student Justin Bouchard for his assistance in preparing this testimony.

The title of this hearing poses the question: SEC's Crowdfunding Proposal: Will it Work for Small Businesses? I am afraid that the answer is probably "no." However, the question is somewhat unfair. Much of what is normally left to agency rulemaking has been set in stone by the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 ("Crowdfund Act" or "Act"). The Act is as extraordinary in its level of detail as it is extraordinary in the speed of its evolution. It specifically imposes numerous disclosure requirements that permit no leeway in their application. The Commission has very little wiggle room to make the Act work better for small businesses.

However, in many respects the Commission has asserted authority to change the law where no such authority exists. There are many instances in which the Commission proposes something different from the very specific requirements of the Act. In some cases, the Commission asserts the authority to dilute investor protections, in other cases to impose additional burdens on small businesses, and in each case its approach would contravene specific directions from Congress. For example, the Commission is considering requiring CEO-certified financials for issuers with more than $100,000 in crowdfunding offerings,[1] whereas Congress specifically directed that this requirement apply only to issuers that have raised $100,000 or less.[2] The Commission is considering lowering the $2,000 minimum for investors with very low income and net worth,[3] but it does not have the authority to amend the $2,000 minimum chosen by Congress.

To illustrate the same over-reaching with respect to specific investor protections prescribed by Congress, the Commission is considering eliminating investment limits for

[1] Proposing Release at 83.

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

[3] Proposing Release at 29.
[2] Securities Act § 4A(b)(1)(D)(i)(II).
[4] *Id.* at 28 – 29.
[3] Proposing Release at 29.
[5] In the SEC's words: "The integration doctrine seeks to prevent an issuer from improperly avoiding registration by artificially dividing a single offering into multiple offerings such that Securities Act exemptions would apply to multiple offerings that would not be available

accredited and institutional investors.[4] This might be good policy, but it is flatly inconsistent with the Act's purpose of permitting greater access to investment opportunities for small investors, not to mention the very specific dollar amounts set forth in the Act.

There is no authority in the Act for the Commission to supplant Congress's judgment with the SEC's own. The provisions of the Act reflect a reasoned compromise among members of Congress. Members voted for or against the Act based on its specific terms, but they might have voted differently on the amendments being considered by the Commission. Thus, one general concern regarding the SEC's rulemaking is that often it does not respect the limits of its authority and upsets the compromise negotiated by the legislative branch.

Another concern is that the Commission ignores the dark side of crowd behavior, choosing instead only to laud its strengths and virtues. The Commission praises the potential to tap the "wisdom of the crowd," but does not acknowledge, much less discuss, the negative behavior that is often associated with crowds. As the Commission knows, crowds are often destructive, particularly with respect to markets.

In fact, the most-cited work on destructive crowd dynamics in markets is entitled: Extraordinary Popular Delusions and the ***Madness*** of Crowds. The book discusses, among other things, the crowd dynamics underlying the Dutch tulip mania, Mississippi Company bubble, and South Sea Company bubble. If its author, Charles MacKay, were alive today, he would most certainly be writing about the behavior of the crowd during the recent Internet and subprime bubbles. When thinking of crowd dynamics, Citigroup CEO Chuck Prince's widely quoted comment made in 2007 seems apropos: "As long as the music is playing, you've got to get up and dance." Will investors actually discuss hot crowdfunding offerings and think about them before investing? Or will they simply "get up and dance"?

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[4] *Id.* at 28 – 29.

This is not to say that the promise of crowdfunding is a false one. Rather, it is to say that the Commission should approach rulemaking with its eyes open to the potential downside of crowd dynamics, especially in a market where the data show that one-third to one-half of investments are likely to become worthless. Instead, the Commission seems to see crowdfunding through rose-colored glasses. It rarely discusses how things might go wrong, so one wonders whether its rulemaking adequately reflects that possibility. Crowdfunding will not work for small businesses if a minority of crowdfunding issuers are allowed to give it a bad reputation.

The remainder of this testimony discusses specific aspects of the SEC's proposed rules. One aspect that should be of particular concern to small businesses is the SEC's position that the aggregate, 12-month $1 million limit on offerings applies only to crowdfunding offerings (as discussed in Part III at page 14). The SEC's position not only contravenes the plain meaning of the Act, it also risks allowing large- and medium-size companies to enter the crowdfunding market and squeeze out the startups and small businesses for which it was created.

The SEC's interpretation would permit, for example, a large issuer to sell $1 billion in securities, then sell $1 million in crowdfunding securities, and then sell another $1 billion in securities, because the Commission would subject only the crowdfunding securities to the $1 million limit. Crowdfunding will not work for small businesses if it becomes a market for all businesses, regardless of size. Members of Congress who voted for the Act did so on the assumption that it was intended to help small businesses and not to create a social media opportunity for medium- and large-size businesses. Congress ensured that the crowdfunding market would be a market for small businesses precisely by limiting ***total*** securities offerings within any 12-month period to $1 million. The Commission has proposed to repeal this requirement, which will allow businesses of unlimited size to fill out the crowdfunding space, notwithstanding that they have no difficulty raising capital. The crowd will not be the investors, it will be the issuers, and as always is the case, the large will crowd out the small, just as the large currently crowd out the small in the securities offering space at large. Congress did not write the Act to allow large businesses to capture a marketplace that was designed for small businesses. The Commission may hear from crowdfunding intermediaries that amending the $1 million limit would improve crowding, but that it because they naturally prefer the largest possible crowdfunding market, which would generate the largest revenue. The Committee should listen closely to small business's thoughts on their becoming incidental players in a market that Congress created for them.

Other concerns go to the kind of reputation that crowdfunding is likely to develop under the SEC's rules. Various proposals would allow crowdfunding issuers to use stale financial statements, intermediaries to accept investment from ineligible investors, and issuers to engage in public advertising under the guise of a concurrent private offering. Each of these proposals will degrade the quality of the crowdfunding marketplace. They will also create an unfair advantage for less scrupulous issuers over small businesses that play by the rules.

The overriding issue for crowdfunding is likely to be how the narrative of investors frequently losing their entire investment plays out. If investors are perceived as losing only a small part of their portfolios because of business failures rather than fraud, or if their crowdfunding losses are set off by gains in other investments through diversification, the crowdfunding market could weather large losses and thrive. However, if fraudsters are easily able to scam investors under the cover of a crowdfunding offering, or stale financial statements routinely turn out to have hidden more recent, undisclosed financial declines, or there are investors who can't afford the losses they incur, resulting in stories of personal financial distress – then crowdfunding markets will never become a credible tool for raising capital.

The remainder of this testimony highlights some, but by no means all of the SEC's specific proposals. I expect to submit a complete comment letter on the proposals, which I hope the Committee will consider in its oversight of this rulemaking. The sections of the remainder of this testimony are paginated as follows:

II. Integration with Other Offerings

The problem of "integration" arises because concurrent offerings under different exemptions can allow an issuer to engage in permitted activities under one exemption that are not permitted under the other.[5] For example, one exemption might permit public advertising and allow sales only to accredited investors, while another prohibits public advertising but allows sales to any investor. Without integration rules, public advertising in the first offering could be used, in effect, to engage in indirect, illegal advertising of the second. In other words, by publicly advertising under the first exemption, the issuer would be able to reach potential nonaccredited investors where the issuer was prohibited from using public advertising to reach them. Unfortunately, the foregoing problem is exactly what the Commission would permit with respect to crowdfunding offerings.

Crowdfunding offerings are subject to strict limits on advertising. The Act provides that issuers may "not advertise the terms of the offering, except for notices which direct

[5] In the SEC's words: "The integration doctrine seeks to prevent an issuer from improperly avoiding registration by artificially dividing a single offering into multiple offerings such that Securities Act exemptions would apply to multiple offerings that would not be available for the combined offering." Proposing Release at note 27.

investors to the funding portal or broker."[6] Even within the context of communications on the website for an offering, that is, "communication channels provided by the intermediary on the intermediary's platform,"[7] issuers may not compensate any person for promoting an offering unless the receipt of the compensation is disclosed "upon each instance of such promotional communication."

The restrictions are necessary because, unlike private offerings in which public advertising is permitted,[8] issuers may sell crowdfunded securities to anyone. Congress believed that, if a desperate investor with no income and $2,000 in savings was to be permitted to invest their last penny in crowdfunded securities, then issuers should not be allowed to lure them by running ads in public media. Public advertisements using exaggerated pitches -- "LAST CHANCE," "SALE ENDS SOON," "EVERYTHING MUST GO" – may be allowable in the marketplace at large, but America's century-long dominance of the world's securities markets is substantially attributable to prohibitions against this kind of misleading sales practices.[9] Nothing is more likely to expose the madness of crowds than permitting public advertising to infiltrate the crowdfunding space.

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

[7] Proposed Rule 204(c).

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

[9] The kind of public advertising that has begun to emerge in the wake of rules permitting such advertising in private offerings illustrates what unrestrained crowdfunding advertising might look like. For example, a slide deck for a private offering by a fund that invests in Bitcoins includes a chart ("Bitcoin Upside") that shows the value of bitcoins rising to equal the value of 5 percent of the world's gold supply ($340 billion). *See* Investor Presentation, Bitcoin Investment Trust (Jan. 2014) available at http://www.bitcointrust.co/. *See also* Gail Liberman, Palm Beach Discussion Group Invests in Single Bitcoin (Jan. 12, 2014) (after initially approving investments in the Bitcoin Investment Trust in self-directed IRAs, Fidelity reversed its position). In the Act, Congress decided to limit crowdfunding issuers to making this type of claim only on crowdfunding platforms and their disclosure documents.

Nonetheless, the Commission would allow issuers to make exaggerated claims in public advertisements during a crowdfunding offering. Issuers need only conduct their public advertising campaign under cover of a concurrent "private" offering. Crowdfunding issuers would be able to say anything, subject only to general antifraud rules, about the issuer's prospects in precisely the public context that Congress specifically proscribed for crowdfunding. Integration rules are designed to prevent precisely this method of circumventing the requirements of offering exemptions. Integration rules also provide clarity to issuers and intermediaries that have legitimate reasons for raising funds under different exemptions but are concerned that permitted activities under exemption might be viewed as violating another exemption under which they are not permitted. Clear rules save money while providing the foundation for a reputable, albeit risky market.

Integration problems are addressed in a variety of ways under the securities laws. For example, when issuers raise funds through public and private offerings, and the private offering does not opt to engage in public advertising,[10] the public registration statement could be viewed as a form of public advertising. Conversely, private communications made pursuant to the private offering could be viewed as offers that violate investor communication rules governing the public offering. The Commission has adopted a safe harbor that generally provides that a private offering that ceases at least 30 days before a registration statement is filed in a public offering will not be considered part of (be integrated with) the public offering. A public offering that is withdrawn at least 30 days before a private offering commences will not be considered part of the private offering.

The integration safe harbor is nonexclusive; concurrent offerings will not necessarily be integrated. For example, the Commission has taken the position that a non-advertised private offering could be undertaken concurrently with a public offering if the issuer could

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

demonstrate that the investors in the private offering were reached by means other than the registration statement.[11]

It is worth noting here that concerns regarding a registration statement serving as a form of illegal public advertising are not nearly as great as when public advertising occurs in connection with a private offering. The content of registration statements and other permissible public communications in public offerings are severely constrained, and these communications often would be impracticable for a billboard or advertisement in a newspaper, magazine or similar public media. The advertising concern is also mitigated by the fact that only accredited (presumably more sophisticated) investors can invest in a private offering, and they are less likely to be misled by publicly available information. Indeed, this is precisely the argument for the JOBS Act's recent elimination of the blanket prohibition on public advertising of private offerings -- that sophisticated investors can fend for themselves.

In contrast, the problem of public advertising in private offerings being used to communicate with potential crowdfunding investors is heightened. Anyone can invest in a crowdfunding offering, regardless of their income or net worth. The potential for investor losses is greater with start-ups than for any other category of businesses, and low- or no-income and low- or no-net-worth investors are those who are least able to bear losses. These factors argue for ***greater*** integration restrictions that ensure that crowdfunding rules are not circumvented through the use of concurrent offerings under other exemptions. In addition, the ability of a business to raise capital through a private offering generally is not the kind business for which crowdfunding was intended; crowdfunding was intended to enable access to capital when not otherwise practicable, *i.e.*, to close the "funding gap."[12]

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

[12] Proposing Release at 17 (crowdfunding is intended to promote "the goal of alleviating the funding gap faced by startups and small businesses"). In fact, recent data published by the Commission itself shows that the claim that crowdfunding is needed because small amounts of capital cannot be efficiently raised under private offering rules is patently false. *See infra*

Where the Commission should be ***most*** concerned about fraudulent securities offerings, it has chosen the ***least*** protective approach. Despite the greater fraud risk in concurrent private and crowdfunding offerings than in concurrent private and public offerings, and the greater investor harm that fraud in the crowdfunding will impose, the Commission has proposed to impose a ***less*** restrictive standard for the former. In fact, it is not just a less restrictive standard; the Commission has proposed that no integration restrictions apply whatsoever. The only limitation that the Commission proposes to apply is that any "concurrent exempt offering for which general solicitation is permitted could not include an advertisement of the terms of an offering made in reliance on Section 4(a)(6) that would not be permitted under Section 4(a)(6) and the proposed rules."[13] This "restriction" would provide no impediment to publicly advertising a crowdfunding offering under cover of a private offering.

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

> [l]imiting the advertising of the terms of the offering to the information permitted in the notice is intended to direct investors to the intermediary's platform and to make investment decisions with access to the disclosures necessary for them to make informed investment decisions.[14]

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

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note 17. The JOBS Act's elimination of the ban on public advertising in private offerings will make private offerings even more amenable to small issuances.

[13] Proposing Release at 19.

[14] *Id.* at 109.

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

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

> Nothing in this section or section 4(6) shall be construed as preventing an issuer from raising capital through methods not described under section 4(6).[15]

Rather than suggesting that integration concerns be entirely ignored by the Commission, the Integration Proviso actually assumes that some degree of integration is likely, if not inevitable. The Proviso warns the Commission not to impose integration tests that would "prevent" offerings under exemptions because Congress was well aware that the Commission would find that some integration restrictions would be necessary to ensure compliance with, for example, the restriction of crowdfunding advertising to the intermediary's platform. Yet rather than taking the Proviso as a warning not to apply integration restrictions too broadly, the Commission has distorted its meaning into a command that no integration restrictions be applied at all. Despite the patently obvious loophole that permitting general solicitations in concurrent private offerings -- and even somewhat less problematic communications in a concurrent public offerings[16] -- would create, the Commission has proposed to repeal, in effect, the crowdfunding restriction on advertising.

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[15] Securities Act § 4A(g).

[16] As noted above, concurrent public offering is arguably of less concern because the content of a public information made available in a concurrent public would be more regulated that public information in a private offering. However, a concurrent public offering, in which any investor could invest an unlimited amount, might beg the question of why a crowdfunding offering that adds investor investment limits was appropriate at all. However, this is mitigated by the fact that public companies are not permitted to rely on the crowdfunding exemption and crowdfunding may not raise more than $1 million in any 12-month period. *See infra* Part III.

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

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

Members of Congress should urge the Commission to ensure that crowdfunding rules do not effectively repeal the restrictions on crowdfunding advertising by permitting public advertising in offerings that are concurrent with a crowdfunding offering. Moreover, Congress should urge the Commission to prohibit the initiation of a crowdfunding offering less that 60 days after a public communication in an offering by the same issuer.

III. $1 Million Cap on Funds Raised

Congress intended that crowdfunding offerings remedy perceived difficulties encountered by issuers when raising small amounts of capital.[17] The crowdfunding exemption was not intended to cover large offerings, much less issuers that routinely raised substantial amounts by other means. Congress accordingly limited the aggregate amount of securities raised by a crowdfunding issuer in any 12-month period to $1 million. It also required that the Commission adjust this limit at least once every five years to reflect inflation.[18] Thus, an issuer that was able to raise $1 million through a private offering, for example, would not be able to avail itself of the crowdfunding exemption during the 12 months following the private offering, but it would be able to raise up to $1 million every year.

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

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

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

[18] Securities Act § 4A(g)(1).

This $1 million cap is not limited to non-crowdfunding offerings. Congress makes that expressly clear in the Act. The relevant provision Act states as follows:

> (6) transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that—
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> (A) the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12- month period preceding the date of such transaction, is not more than $1,000,000; . . ..[19]

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

However, there is a potential ambiguity. The limit might be viewed as ensuring that issuers that are able to raise $1 million by ***other*** means should not be able to avail themselves of the crowdfunding exemption. Under this interpretation, an issuer could, consecutively within a 12-month period, issue $500,000 in crowdfunding securities, $500,000 in privately offered securities, and $500,000 securities. If the $1 million in crowdfunding securities were not aggregated with the private offering, the second $500,000 offering would be permitted. Congress intended that crowdfunding securities be included in applying the $1 million cap. It intend that the issuer be free to raise additional capital through noncrowdfunding means, but if it was able to raise $1 million in a 12-month period it should not be allowed to exploit the crowdfunding's lowered investor protection at least until 12 months has passed.

[19] Securities Act § 4(a)(6).

Congress decided to make it absolutely clear that crowdfunding securities were to be included in the aggregate $1 million cap[20] and accordingly added the clarification that is italicized and bolded below:

> (A) the aggregate amount sold to all investors by the issuer, ***including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction,*** is not more than $1,000,000 . . .[21]

In the event that it was not clear that the "aggregate amount sold" included crowdfunding securities, Congress stated expressly that these securities were included. There was no need to explain that the "aggregate amount sold" included securities issued in other offerings. Indeed, the fact that Congress believed it necessary to note that crowdfunding securities were "included" must mean that Congress also believed that other securities were included in the "aggregate amount sold." It is an obvious rule of statutory construction, easily understood by any lay person, that the term "including" means "illustrative of," and not, for example, "limited to."[22]

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

[21] Securities Act § 4(a)(6)(A).

[22] *See, e.g.,* Fed. Land Bank of St. Paul v. Bismarck Lumber Co., 314 U.S. 95, 99-100, 62 S. Ct. 1, 4, 86 L. Ed. 65 (1941) ("We recently had occasion under other circumstances to point out that the term 'including' is not one of all-embracing definition, but connotes simply an illustrative application of the general principle. (citing Phelps Dodge Corp. v. National Labor Relations Board, 313 U.S. 177, 189, 61 S.Ct. 845, 850, 85 L.Ed. 1271, 133 A.L.R. 1217; Helvering v. Morgan's, Inc., 293 U.S. 121, 125, 55 S.Ct. 60, 61, 79 L.Ed. 232); Stansell v. Revolutionary Armed Forces of Colombia, 704 F.3d 910, 915 (11th Cir. 2013)("When a statutory definition declares what a term "means" rather than "includes," any meaning not stated is excluded. Colautti v. Franklin, 439 U.S. 379, 392–93 & n. 10, 99 S.Ct. 675, 684 & n. 10, 58 L.Ed.2d 596 (1979). This is because the term "means" denotes an exhaustive definition, while "includes" is merely illustrative. United States v. Probel, 214 F.3d 1285, 1288–89 (11th Cir.2000)."); Citizens for Responsible Gov't State Political Action Comm. v. Davidson, 236 F.3d 1174, 1190-91 (10th Cir. 2000) ("Colorado is among "the overwhelming majority of jurisdictions" that read the word "includes" as "a term of extension or enlargement when used in a statutory definition." *Colorado Common Cause v. Meyer,* 758 P.2d 153, 163–64 (Colo.1988) (en banc)."); Dong v. Smithsonian Inst., 125 F.3d 877, 880 (D.C. Cir. 1997) ("We recognize, of course, that the word "includes" normally does not introduce an exhaustive list but

merely sets out examples of some "general principle." *Federal Land Bank of St. Paul v. Bismarck Lumber Co.,* 314 U.S. 95, 100, 62 S.Ct. 1, 4, 86 L.Ed. 65 (1941)."); Federal Election Com'n v. Massachusetts Citizens for Life, Inc., 769 F.2d 13, 17 (1st Cir. 1985) ("'A term whose statutory definition declares what it 'includes' is more susceptible to extension of meaning by construction than where the definition declares what a term 'means.' It has been said 'the word "includes" is usually a term of enlargement, and not of limitation." . . . It, therefore, conveys the conclusion that there are other items includable, though not specifically enumerated . . . (*quoting* N. Singer, 2A Sutherland Statutes and Statutory Construction 133 (4th ed. 1984) (*quoting* Argosy Ltd. v. Hennigan, 404 F.2d 14, 20 (5th Cir.1968))); United States v. Mass. Bay Transportation Authority, 614 F.2d 27, 28 (1st Cir.1980) ("Includes is not a finite word of limitation."); Bautista v. Star Cruises, 286 F. Supp. 2d 1352, 1360 (S.D. Fla. 2003) aff'd, 396 F.3d 1289 (11th Cir. 2005) ("Plaintiffs' interpretation of the Convention Act overlooks the significance of the word "including" in § 202. "A term whose statutory definition declares what it 'includes' is more susceptible to extension of meaning by construction than where the definition declares what the terms 'means.' " Singer, *supra,* § 47:07. In fact, "the word 'includes' is usually a term of enlargement, and not of limitation ... It, therefore, conveys the conclusion that there are other items includable, though not specifically enumerated by the statutes." *See Argosy Limited v. Hennigan,* 404 F.2d 14, 20 (5th Cir.1968) (internal citations omitted). Based on these principles of statutory construction, the term "including" instructs that the transactions, contracts and agreements described in § 2 of the FAA are covered by the Convention Act, as well as other arbitration agreements that arise out of commercial legal relationships."); Argosy Ltd. v. Hennigan, 404 F.2d 14, 20 (5th Cir. 1968) ("In both of these statutes, we think the word 'including' is not to be restricted to the 'rate and amount of duties chargeable,' but read in relation to the phrase, 'all decisions entering into same.' 'The word 'includes' is usually a term of enlargement, and not of limitation.' United States v. Gertz, 9 Cir. 1957, 249 F.2d 662, 666. It therefore conveys the conclusion that there are other items includable, though not specifically enumerated by the statutes."); United States v. Gertz, 249 F.2d 662, 666 (9th Cir. 1957) ("The word 'includes' is usually a term of enlargement, and not of limitation. As stated in Federal Land Bank of St. Paul v. Bismarck Lumber Co., 314 U.S. 95, 100, 62 S.Ct. 1, 4, 86 L.Ed. 65, "including' is not one of all-embracing definition, but connotes simply an illustrative application of the general principle."); Braun v. Wal-Mart Stores, Inc., 2011 PA Super 121, 24 A.3d 875, 963-64 (Pa. Super. Ct. 2011); ("With respect to the term "include," "[t]he term 'include' is to be dealt with as a word of 'enlargement and not limitation.' " *Pa. Human Relations Comm'n v. Alto–Reste Park Cemetery Ass'n,* 453 Pa. 124, 130–31, 306 A.2d 881, 885 (1973) (alterations omitted); *accord Samantar v. Yousuf,* —— U.S. ——, —— n. 10, 130 S.Ct. 2278, 2287 n. 10, 176 L.Ed.2d 1047, 1062 n. 10 (2010)."); Vassiliu v. Daimler Chrysler Corp., 178 N.J. 286, 295, 839 A.2d 863, 868-69 (2004) ("Rather, "the word 'includes' is usually a term of enlargement, and not of limitation.... It, therefore, conveys the conclusion that there are other items includable, though not specifically enumerated [.]" 2A Norman Singer, Sutherland Statutory Construction § 47:07 at 231 (6th ed. 2000) (internal quotation marks and footnote omitted); accord Fraser v. Robin Dee Day **869 Camp, 44 N.J. 480, 485, 210 A.2d 208, 210–11 (1965)."); Brown v. Scott Paper Worldwide Co., 143 Wash. 2d 349, 359, 20 P.3d 921, 926 (2001) ("RCW 49.60.040(3) contains the word "includes," which is a term of enlargement."); Ornelas v. Randolph, 4 Cal. 4th 1095, 1101, 847 P.2d 560, 563 (1993) ("The statutory definition of 'recreational purpose' begins with the word 'includes,' ordinarily a term of enlargement rather than limitation." (citing People v. Western Air Lines, Inc. (1954) 42 Cal.2d 621, 639, 268 P.2d 723; 2A Sutherland, Statutory Construction (4th ed. 1973) § 47.07, pp. 81–82.)); Matter of Estate of Corwin, 1987-NMCA-100, 106 N.M. 316, 317, 742 P.2d 528, 529 ("This appeal requires us to apply principles of statutory construction. We find the correct approach in 2A N. Singer, However, the Commission interprets the term "including" to mean "limited to." Of course, if the only securities that Congress intended the $1 million to apply to were crowdfunding securities, then it would have said:

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

and not what Congress actually said:

> the aggregate amount sold to all investors by the issuer, ***including any amount sold in reliance on the exemption provided under this paragraph during the 12- month period preceding the date of such transaction,*** is not more than $1,000,000.[23]

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

Sutherland Statutory Construction Section 47.07 (Sands 4th ed. 1984): 'A term whose statutory definition declares what it "includes" is more susceptible to extension of meaning by construction than where the definition declares what a term "means." It has been said "the word 'includes' is usually a term of enlargement, and not of limitation. * * * It, therefore, conveys the conclusion that there are other items includable, though not specifically enumerated. * * *"' (Footnote omitted.) This rule has found support in other jurisdictions. Federal Land Bank of St. Paul v. Bismarck Lumber Co., 314 U.S. 95, 62 S.Ct. 1, 86 L.Ed. 65 (1941); Smyers v. Workers' Comp. Appeals Bd., 157 Cal.App.3d 36, 203 Cal.Rptr. 521 (1984); Schwab v. Ariyoshi, 58 Hawaii 25, 564 P.2d 135 (1977); Janssen v. Janssen, 331 N.W.2d 752 (Minn.1983).").

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

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

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

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

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

The Commission's interpretation of the $1 million cap provision also violates the spirit and intent of the Act. The Commission's interpretation would allow, for example, an issuer to raise $1 ***billion*** in a private or public offering and follow up with a $1 million crowdfunding offering. Conversely, a business could raise $1 million and immediately follow that with a $1 ***billion*** private of public offering. Every large issuer will consider whether it would be an effective social strategy to conduct a crowdfunding offering in order to "reach out" to their small shareholders while the issuer is a conducting a concurrent private offering from which small investors would be excluded.

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

> requiring aggregation of amounts raised in any exempt transaction – would be inconsistent with the goal of alleviating the funding gap faced by startups and small businesses because it would place a cap on the amount of capital startups and small business could raise.[24]

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

Moreover, the Commission also stated that the:

> offering exemption in Section 4(a)(6) was designed to help alleviate the funding gap and the accompanying regulatory concerns faced by startups and small businesses, many of which ***may not be familiar with the federal securities laws***.[25]

[24] Proposing Release at 17.

[25] *Id.* at 269.

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

The Commission stated further:

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

and:

> We understand that Title III was designed to help alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses in connection with raising capital in ***relatively low dollar amounts***.[26]

and:

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

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

It is not reasonable to read the Act as intended to help businesses that raise tens, hundreds or even thousands of millions of dollars by allowing them to raise an extra $1 million through crowdfunding. In contrast, it is entirely logical to read the statute to mean that

[26] *Id.* at 11.

Congress decided that $1 million was more than a "low dollar amount." Under the SEC's interpretation, billions of dollars would qualify as a "low dollar amount."

The effect of allowing medium-size and large businesses to engage in crowdfunding will be to squeeze out the small businesses for which it was intended. Crowdfunding intermediaries, which have actively lobbied Congress on crowdfunding would prefer the largest market possible. However, the effect of allowing any non-public company to engage in crowdfunding will be to perpetuate the competitive disadvantage of the smallest businesses that crowdfunding was designed to remedy. The Commission's interpretation of the provision benefits medium-size and large businesses, and crowdfunding intermediaries, at the expense of startups and small businesses.

The Commission attempts to support its interpretation by referencing the Integration Proviso, which, as discussed above, is clearly intended to address the problem of using one offering to circumvent the rules of another, concurrent offering. First, the $1 million limit is not ambiguous; it allows for only one reasonable reading. Second, the Integration Proviso refers to "preventing" offerings, whereas the $1 million cap would only limit the amount raised and even then for no longer than 12 months. It would "prevent" nothing. The Commission states:

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

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

The $1 million cap provision states that the "aggregate" amount of "securities" "sold to all investors" shall not exceed the $1 million limit in any 12-month period. These terms are unambiguous. The SEC's interpretation makes a mockery of Congress's plain English use of the phrase in the provision: "including any amount sold in reliance on the exemption provided under this paragraph." The only rational interpretation is that the term "including" means that the category of offerings to which the $1 million cap applies "includes" crowdfunding offerings. It is irrational to interpret the term "including" crowdfunding offerings to mean "only" crowdfunding offerings, just as it would be irrational to twist the meaning of a statute to enable billion-dollar businesses that conduct billion-dollar offerings the ability to rely on the crowdfunding exemption. Finally, the Commission's interpretation flatly contradicts its repeated characterization of the entities for which crowdfunding was intended as "small businesses" raising "small dollar amounts" in order to remedy existing "funding gaps."

Congress should communicate to the Commission that the Act was intended to provide a limited crowdfunding exemption for low dollar-amount offerings by startups and businesses that might otherwise experience a genuine funding gap. Congress should explain to the Commission that the $1 million "aggregate" limit on the "offer and sale of securities" (not only crowdfunding securities) to "all" investors (not just crowdfunding investors) reflects the understanding of Congress that a business that is able to raise more than $1 million within a mere 12 months is not the kind of funding-gap business or low-dollar amount offering contemplated by the Act.

IV. Limit on Investments by Investors

Virtually every member of Congress who has spoken about the Act has affirmed the importance of investor protection, and the Act's most important investor protection provision is its limit on the amount that investors may invest. This provision is critical because typically one-third to half of small businesses fail within the first few years of their founding.[27] Crowdfunding businesses may have a higher concentration of businesses that were rejected by angel investors, which suggests that their failure rate may be even higher,

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

a view with which the Commission agrees.[28] Thus, a substantial percentage of investments made in small businesses will be worthless within a few years. Investors in these firms will lose their entire investment.

Small business failures are not typically the result of fraud. They are *business* failures that result from incompetence and/or inexperience. This means that, no matter what disclosures are provided, sophistication tests are applied, or intermediary rules are adopted, about half of crowdfunding investments in crowdfunded startups may be a total loss. This would not necessarily reflect negatively on crowdfunding, although one hopes that crowdfunding would result in improved survival rates. The only way to protect investors from excessive losses is to limit the amount that they are permitted to invest.

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

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

In each case the dollar limit is the same: between $2,000 and $100,000, depending on the investors' wealth and net worth. Thus, the limits protection investors against the two primary risks: (1) issuer risk (the risk that a single crowdfunding issuer will fail), and (2) crowdfunding risk (the risk of investing in crowdfunding offerings by multiple issuers). In addition, the limits are generally based on a percentage of net worth/income, which more closely aligns the dollar amount at risk on one hand, with the ability of the investor to bear the loss on the other. This is a significant improvement over the application of investment limits in other scenarios. In contrast, the SEC's Reg D allows an investor with $1 million in

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

new worth to bet all of it on a single offering, while an investor with only $999,999 can invest nothing. While the particular dollar limits that Congress chose are questionable (they allow someone with no income and $2,000 in assets to invest their last penny in a crowdfunding offering), and over a number of 12-month periods any crowdfunding invesors could experience devastating losses, Congress should be applauded for designing a structure that provides greater protection against financially devastating losses.

The Commission recognizes the investor protection purpose of the limits on crowdfunding investments by investors. It stated in the Proposing Release:

> Congress provided important investor protections for crowdfunding transactions under Section 4(a)(6), including individual investment limits. [29]

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

This approach is reflected in the SEC's position on the investment limits in Section 4(a)(6)B), in which there is a flat contradiction in the application of the investment limits. Subparagraph (B)(i)'s limit applies "if ***either*** the annual income or the net worth of the

[29] *Id.* at 12.

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

Normally, one would resolve such a contradiction in way that furthers the goal of the particular provision. The Commission states expressly that this is an investor protection provision, yet it has interpreted it to provide less investor protection rather than more. The Commission's justification for its position is that "this clarification would give effect to the provision and would be consistent with Congressional intent in providing investment limitations."[30] However, taking the opposite position would *also* be consistent with this intent. Virtually *any* interpretation would impose investment limitations, which renders the SEC's explanation is meaningless. The question is what the limit should be when an investor has less than $100,000 in income but at least a $100,000 net worth, or vice versa.

More precisely, the primary investor protection concern is for the investor with a small income or no income who has managed to save $100,000. This person may be a retiree living exclusively or primarily on Social Security who is particularly vulnerable to investment scams and has no means of recovering from losses.[31] Thus, the Commission's interpretation would allow such a retiree with an annual income of $25,000 and $100,000 in assets to invest $10,000 in a crowdfunding offering, whereas an investor-protection

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[30] *Id.* at 24.

[31] In contrast, a person who earns more than $100,000 in three consecutive years is likely to be in much better position to absorb a 100 percent loss. There is no basis, however, in interpreting Subparagraph (B) differently for income and net worth.

oriented interpretation would limit her investment to $5,000. Admittedly, Congress clearly decided that it is appropriate for a retiree living on Social Security with only $100,000 saved to make a $5,000 investment, which certainly makes the SEC's position seem benign in comparison. But that is not the rulemaking issue. What is difficult to understand is why the Commission would choose to exacerbate an already bad situation by interpreting a contradiction in an investor protection provision in a way that further ***reduces*** investor protection.[32] This is difficult to understand, in part, because the Commission provides no discussion of the potential harm to investors from its position. The more that vulnerable crowdfunding investors experience financial distress as a result of crowdfunding, the less likely it is that the crowdfunding market will succeed. The SEC's position is not doing small businesses any favors.

Congress should amend the Act to clarify that if either an investor's net worth or income is below $100,000, then the $2,000 / 5 percent investment limit applies, or communicate to the Commission that, pending clarification by Congress, the contradiction in the Act should be interpreted consistent with its investor protection purpose.

V. Investor Qualifications and Knowledge

The Commission has proposed that intermediaries be permitted to rely on the representations of investors regarding their eligibility to invest. The Commission must be mindful of imposing unnecessary burdens on crowdfunding, but in this respect it is imperative that stronger procedures be required when confirming investors' eligibility. One problem is that investors will routinely consider the value of their home in calculating their net worth, and may even neglect to reduce that amount by any outstanding mortgage. Intermediaries should be required to obtain specific confirmation regarding the investors'

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[32] In a belated letter to Congress, former SEC Chairman Shapiro expressions her concerns regarding the inadequacy of investor protections under crowdfunding. If this did not include minimizing the investment amounts made by the most vulnerable Americans, it is hard to imagine to what she was referring. It appears that the SEC's position seems to have taken sharp turn since 2012.

calculation, such as an account statement that shows the value of an investor's securities account or one or more pay stubs that show their income. These documents can be sent electronically without an unreasonable burden on the investor. At minimum, investors should be asked specifically about whether they have included the value of their home in their calculation.

A second problem is that investors will have an incentive to inflate their net worth or income both to establish their eligibility and to increase the amount they are permitted to invest. For example, an investor with a $90,000 net worth may represent that the investor has a $1 million net worth in order to be allowed to invest at the 10% level and invest all of it, rather than $5,000 allowed under the Act. The total reliance on self-certification ignores the fact that these are not just limits on issuers; the limits also effectively constrain investors ability to invest in certain offerings. Self-certification does not take investor eligibility because it imposes absolutely no controls on investors' ability to circumvent the limits, and it imposes no obligation on the part of issuers or intermediaries that they are not being circumvented. This approach creates a mutual incentive to require as little information as possible so as to provide the greatest freedom to both sides.

In view of the likelihood that investors will lose their entire crowdfunding investment, the Commission should implement procedures to ensure that investors can afford to lose their entire investment.

VI. Investors' Review of Investor-Education Material

The Act requires that intermediaries "ensure that each investor reviews investor-education materials," which the Commission appears to have suggested may be satisfied by having the investor check a box that they have reviewed the material. However, the investor-education provision imposes a direct requirement that investors "review" information, whereas Congress require only that investors "positively affirm" their understanding of the risk of a total loss and their ability to bear such a loss. Allowing an investor to check a box stating that the investor has reviewed investor-education materials applies a "positively affirms" that Congress chose not to apply in this case.

Anyone who uses a computer routinely checks boxes stating that they have read licensing terms and other disclosures when they know that they have not. They will do the same with respect to investor-education materials. The check-the-box approach is especially odd because an intermediary could easily determine whether the relevant document had been opened or the investor has actually scrolled past the first few lines. This would demonstrate that the investor had ***not*** reviewed the information, but the intermediary would be allowed to ignore this information. The Commission should not accept this approach as satisfying the "review" requirement.

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

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

The investment limit under the Act applies to the "aggregate amount sold to ***any investor***."[33] The same provision refers in subparagraph (B)(i) to "the annual income or the net worth of the investor." Subparagraph (B)(ii) also refers to "the annual income or the net worth of ***the investor***." In each case, the term "investor" is singular. None of the foregoing provisions refers to "investors." None of the foregoing provisions states or even implies that the term "investor" should be interpreted to mean and "investor" ***and their spouse***.

[33] Securities Act § 4(a)(6)(B).

Nonetheless, the Commission chose to interpret the singular "investor" to include the "investor's" spouse.[34] The SEC's only justification for interpreting a singular noun to represent a couple is that it:

> believe[s] that this approach is consistent with the rules for determining accredited investor status because the accredited investor definition contemplates both individual and joint income and net worth with a spouse as methods of calculating annual income and net worth.[35]

This explanation might make sense but for the fact that it is ***not*** the accredited investor standard that is being applied. It is the investment limit for investments in crowdfunding offerings, where Congress chose to use the singular term "investor."

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

Rather than recognizing that Congress clearly chose ***not*** to adopt this aspect of the approach to joint net worth and income that appears in the definition of accredited investor, the Commission seems to have decided that Congress ***should have*** adopted this approach.

[34] On a related matter, the Commission asks whether the 5 percent limit should apply to the higher or lower of the investor's income or net worth. The Commission is correct that is not expressly stated in subparagraphs (B)(i) and (ii). It would be reasonable, if not necessary,§ to interpret the placement of the phrase "the greater of" immediately preceding the $2,000 and 5 percent limits to mean that the phrase also applies to "the annual income or the net worth."

[35] Proposing Release at 25

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

Congress should reiterate to the Commission that the singular term "investor" means a single investor and urge the Commission not to exceed its authority by amending the Act to create a crowdfunding standard for the net worth or income of couples until and unless Congress has directed it do so.

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

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

However, the Commission has proposed to disqualify issuers only if they have not filed and delivered their ***two*** most recent reports. Under this standard, an issuer could go 23 months and 30 days without having filed a report; indeed, it might ***never*** have filed a report. There is no reason that an issuer that is currently delinquent on the filing or delivery of one report, much less two should be allowed to avail itself of the crowdfunding exemption. Permitting such issuers to participate in the same market as small businesses that do comply with the law will only degrade investor confidence in the crowdfunding market and create an unlevel playing field by imposing costs of some issuers that are not imposed on others.

Congress should endorse the SEC's exclusion of certain issuers that are delinquent on their annual reporting obligation under the Act and encourage the Commission to prohibit an issuer from relying on the crowdfunding exemption until the issuer is current on its annual reporting obligation.

IX. $500,000 Trigger for Audited Financials

The Act requires that a crowdfunding issuer provide audited financial statement if the amount of the offering exceeds $500,000. However, it also authorizes the Commission to establish some other amount. This means that the Commission could raise or *lower* this amount, yet the Commission describes this authority as permitting only an increase in the amount.[36] The Commission should acknowledge that this authority also allows for a reduction in this amount and that it will, in fact, reduce the amount if subsequent events warrant such a reduction.

Such an increase or reduction may be appropriate in the future, but the Commission does not currently have any analytical or empirical basis to do so. Debt crowdfunding, such as offered by Prosper.com and LendingClub.com, has been operational for years, may offer insight into the relevance of financial statement standards in the crowdfunding context. Gift-based crowdfunding sites have enough of an operating history they also might shed light on this question. However, the only current basis for the audited financial trigger is the specific dollar amount of $500,000 provided by Congress. In view of the current lack of

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

any basis for second-guessing this standard, the Commission should neither raise nor lower the $500,000 trigger. However, it should promptly establish information collection and analysis procedures in order to ensure that it has the capacity to evaluate changes in the $500,000 trigger in the future.

X. Oversubscribed Offerings

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

> will accept investments in excess of the target offering amount and, if so, the maximum amount that the issuer will accept and whether oversubscriptions will be allocated on a pro-rata, first come-first served, or other basis.[37]

Read literally, this provision would permit an issuer to disclosure that it will allocate oversubscriptions on a basis other than pro rata or first-come, first-served and provide no other guidance.

This is a rather minor point relative to the more important question of whether to prohibit allocations based on a first-come, first-served basis. The Williams Act and rules thereunder specifically prohibit tender offers for public companies from being made on a first-come, first-served basis. Rule 14d-8 requires that tender offers be made on a pro rata basis because first-come, first-served offers have the potential to create a stampede effect.[38] This would be an appropriate standard to apply to crowdfunding oversubscription allocations.

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[37] Proposed Rule 201(h).

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

The stampede effect is, of course, a reflection of a less appealing form of crowd dynamics. As Senator Merkley has stated, the Act's provisions "are designed to allow investors the chance to carefully consider offerings, permitting the 'wisdom of the crowd' to develop, rather than perhaps just the 'excitement of the crowd.'" The Senator was referring here to withdrawal rights, which are also important in mitigating the stampede effect (the Commission has proposed a withdrawal right up to 48 hours before the deadline for an offering[39]). However, issuers will have an incentive to use a first-come, first-served approach to allocating oversubscribed offering to pressure investors to act quickly without thinking. This could be mitigated by requiring pro rata allocations.

Congress should encourage the Commission to require that oversubscribed offerings be allocated on a pro rata basis, as is required under the Williams Act, in order to prevent the stampede effect that allocation on a first-come, first-served basis may create.

XI. Stale Financial Statements

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

The Act does not indicate how current the financial statements must be. The Commission has proposed that financial statements need only be as recent as the end of the issuer's

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

most recent fiscal year. During the first 120 days of an issuer's fiscal year, the financial statements need only be as recent as the end of *preceding* fiscal year. In the latter scenario, the issuer with a calendar fiscal year that began operations in December in Year 1 could submit financials covering only that month for a crowdfunding offering beginning as late as April of Year 3. The financials would be 16-months stale and cover only one month in the issuer's 17-month lifespan.

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

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

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

The Commission should require that crowdfunding issuers provide truly ***current*** financials. These need not necessarily meet the same degree of formality. For large offerings, the Commission could require that issuer provide their audited financial statements for the two most recently ended fiscal years plus non-audited (*e.g.*, CEO-certified) financial statements[40] through the end of the month that ends no more two months before the month in which the offering begins (*e.g.*, an offering any day in March would require financials ending in January). It should not be burden for an issuer what is otherwise providing audited financial statements.

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

Congress should inform the Commission that requiring only financial information as of the end of the most recent fiscal year, which may be 16-months stale at the time of the offering, will provide investors with inadequate information to evaluate investments and undermine confidence in the crowdfunding marketplace. Congress should encourage the Commission to require that issuers provide the most current financial information practicable, even if the most current information complies with a lower standard.

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

XII. Extension of Time to File Taxes

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

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

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