Fund Democracy

March 15, 2012

BY EMAIL

The Honorable Carl Levin
Committee on Small Business
and Entrepreneurship
United States Senate
Washington, DC 20510

The Honorable Jack Reed
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, DC 20510

Dear Senators Levin and Reed,

In response to your request for comments from Fund Democracy[1] on the Jumpstart Our Business Startups Act ("JOBS Act") passed by the House last week, I have discussed below the three most significant provisions of the Act. In my view, each of Titles I, II and III of the JOBS Act would substantially undermine the essential structure of federal securities regulation in America.

Title I's exemption for emerging growth companies would exempt so many companies from key investor protection provisions that the world-leading brand that is the "U.S. public company" would be substantially weakened. Title II's unconditional exemption for general solicitation and advertising in connection with nonpublic offerings renders the very of idea of a "nonpublic" offering effectively meaningless. Finally, Title III's exemption for so-called "crowdfunding" offerings would, by eliminating virtually all regulation of intermediaries in the crowdfunding market, substantially increase the incidence of securities fraud and undermine the integrity of our markets.

I strongly encourage you and your Senate colleagues to offer a reasonable alternative to the JOBS Act, such as the reforms that I suggest below and/or in the form of the crowdfunding exemption set forth in the Capital Raising Online While Deterring Fraud and Unethical Disclosure Act of 2012 ("CROWDFUND Act").

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[1] Fund Democracy is a nonprofit investor advocacy group. I am the president and founder of Fund Democracy, a securities law professor at the University of Mississippi School of Law, a Vice President with the financial planning firm Plancorp LLC, a former Assistant Chief Counsel at the Securities and Exchange Commission, and a former securities law practitioner with the law firm WilmerHale. On September 15, 2011, I testified on one part of the JOBS Act – an early draft of the House crowdfunding exemption – before the House Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs.

TITLE I: EXEMPTION FOR EMERGING GROWTH COMPANIES

The "public company" is a brand that has established the U.S. securities markets as the world leader. A "public company" is different from other companies by reason of the complex set of rules that regulate, among other things, its governance, capital structure, disclosure, and financial reporting, as well as the terms of the enforcement of these rules. The individualized negotiation of these rules and their enforcement between issuers and investors would be prohibitively costly. This efficiency benefit is an essential element of the success of the brand that the markets know as the "U.S. public company."

This does not mean that public company regulation should be static. In fact, the constant updating of public company rules has been critical to maintaining the value of the public company brand. Public company regulation has been and should continue to be subject to constant reconsideration as business practices and markets evolve. This has become more important to maintaining the relative value of the U.S. public company as foreign markets adopt their own public company standards, many of which are modeled on the U.S. example.

Title I of the JOBS Act would substantially weaken the value of the U.S. public company brand. It would exempt companies with less than $1 billion in annual gross revenues ("emerging growth companies") from the following public company requirements, among others:

- Exchange Act Section 14A's requirement for a nonbinding shareholder vote on executive compensation at least every three years ("say-on-pay") (shareholders also vote at least every six years on whether to hold the say-on-pay vote every 1, 2 or 3 years);
- Exchange Act Section 14A's requirement for a nonbinding shareholder vote on executive compensation paid in connection with a merger or acquisition;
- Exchange Act Section 14(i)'s requirement that issuers disclose the relationship between executive compensation actually paid and the financial performance of the issuer;
- Any requirement under Securities Act Section 7 that more than 2 years of audited financial statements in an effective registration in an initial public offering; and
- Sarbanes-Oxley Act ("SOXA") Section 404(b)'s requirement that a company's auditor attest to the effectiveness of internal financial controls.

The effect of these provisions would be to make the exempted requirements inapplicable to *virtually all new public companies*. Almost all companies that went public in the U.S. from 1980 – 2011 had annual sales of less than $1 billion at the time.[2]

[2] *See* Testimony of Jay Ritter before the Senate Committee on Banking, Housing, and Urban Affairs (Mar. 6, 2012) *available at*

One can reasonably disagree about whether public companies should be subject to the Dodd-Frank Act's say-on-pay vote, SOXA's Section 404(b) attestation requirement, or other requirements listed above, but it unreasonable to resolve disagreements about such issues through a Solomonic destroying the integrity of the public company brand. There is a fundamental difference between changing what triggers public company regulation – *e.g.*, the number of shareholders that requires registration under the Exchange Act – and rendering the very concept of a "public company" meaningless. If a firm's status as a U.S. public company becomes only the beginning of a complex inquiry into what set of rules governs the firm, then the public company brand will have little or no value.

The JOBS Act's exemption for emerging growth companies will significantly weaken the value of the public company brand and U.S. competitiveness in world markets. It will do so, in part, by eliminating high-value investor protection standards. In my view, SOXA's 404(b) attestation requirement has created demonstrated value for the public company brand and strengthened the competitive position of U.S. markets. But one can reasonably disagree about the particular standards that are necessary for public companies without threatening the intrinsic integrity of the public company brand.

In contrast, exempting a significant segment of public companies from a requirement such as the 404(b) attestation standard directly threatens the integrity of the public company brand. The emerging growth company exemption rejects the very premise on which the idea of a public company is based. For the public company brand to have value, it must stand for something. It must be a credible proxy for a consistent set of rules. These rules may themselves strengthen or weaken the value of the public company brand; this is often difficult or impossible to know with certainty. But what is certain is that a brand will become worthless if it tells the market nothing about the product being sold.

Under the emerging growth company exemption, some public companies will be subject to the prudent requirements of Section 404(b), and some will not. For some public companies, executive compensation will be subject to the disciplining effect of a say-on-pay vote; for other public companies it will not. Some public companies will be subject to new accounting rules; some will be exempt. The approach taken in the emerging growth company exemption ensures that investors cannot be confident that investing in a public company will afford them the benefits of any particular rule.

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http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=a5ded25c-135d-484a-943a-bfa52fba3206; *see also* Testimony of Lynn Turner before the Senate Committee on Banking, Housing, and Urban Affairs at 12 – 14 (Mar. 6, 2012) (tables showing share of $1-billion-revenue IPOs and active filers) *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=5aaabb66-36eb-4b1e-8195-3cbeda832814.

Section 404(b) Exemption

The negative effect of the emerging growth exemption will be exacerbated by its elimination of investor protection provisions for the public companies where these protections create the greatest shareholder value. This follows the unfortunate precedent of exempting non-accelerated filers from Section 404(b). At least one could argue that the fixed costs of 404(b) compliance affected such non-accelerated filers differently. No such argument can reasonably be made as to emerging growth companies.

Indeed, the SEC recently considered and rejected the extension of the Section 404(b) exemption to larger companies. Dodd-Frank Act Section 989G(b) directed SEC to conduct a study of the burdens of Section 404(b) compliance for companies with a market capitalization of $75 to $250 million. In its exhaustive study, the SEC recommended that such firms continue to be subject to Section 404(b), in part based on "strong evidence that the auditor's role in auditing the effectiveness of ICFR improves the reliability of internal control disclosures and financial reporting overall and is useful to investors."[3]

The SEC's 2011 404(b) Study follows closely on the SEC's 2009 study of Section 404(b) compliance costs.[4] The 2009 study found that Section 404(b) reforms adopted in 2007 had successfully reduced compliance costs and documented an overall trend in declining compliance costs over time. Section 989I of the Dodd-Frank Act requires that the GAO conduct a study, due in July 2013, on how the applicability of Section 404(b) affects the frequency of accounting restatements and the cost of capital. The JOBS Act's Section 404(b) exemption directly contradicts the findings of the SEC and takes no account of the pending GAO study, notwithstanding that the GAO's conclusions are likely to support the current coverage of Section 404(b).[5]

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[3] *See Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between $75 and $250 Million*, Securities and Exchange Commission at 112 (April 2011) ("2011 404(b) Study") *available at* http://www.sec.gov/news/studies/2011/404bfloat-study.pdf.

[4] *See Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements*, Office of Economic Analysis, Securities and Exchange Commission (Sep. 2009) *available at* http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

[5] *See*, *e.g.*, *The Errors of Their Ways*, Glass Lewis & Co. at 2 (Feb. 27, 2007) (finding that restatements by Section 404 companies declined by 14% while restatements by non-404 companies rose by 40%) *available at* http://www.section404.org/UserFiles/File/Website%20-%20Misc/GlassLewis-Errors%20of%20their%20ways.pdf; *see also Restatement Trends Alert*, Glass Lewis & Co. (Mar. 19, 2009) (finding that restatements by companies with $250 million or greater market capitalization declined to five-year low) *summary available at* http://www.glasslewis.com/downloads/1059-101.pdf.

The JOBS Act's Section 404(b) exemption also ignores the SEC's continuous re-evaluation of the costs and benefits of Section 404(b). In acknowledgment of industry concerns, the SEC has repeatedly extended compliance deadlines for Section 404(b). In 2007, it took two major steps to reduce Section 404(b) compliance costs. The SEC issued management guidance that, among other things, reduced costs by directing companies to adopt a risk-based approach to internal controls. The SEC also approved PCAOB Accounting Standard No. 5, which reduced compliance costs by allowing auditors greater discretion in (1) implementing internal controls, (2) eliminating unnecessary procedures, and (3) scaling of internal controls to reflect the size of the company.

The emerging growth company exemption will deny investors other important rights in addition to the lost protections afforded by Section 404(b). The say-on-pay requirement already has had a salutary effect on CEO compensation. For example, Janus reduced its CEO's compensation by 40% in 2011 after losing a say-on-pay vote.[6] The exemption from providing three years of audited financials will deprive investors of *one-third* of the audited financial performance that historically has been available for a new public company. This exemption directly contradicts the principle that a company should have sufficiently documented performance history to justify its participation in the public securities markets. The exemption from new accounting standards flies in the face of the fact that it may be precisely the problems more likely to arise in the context of emerging growth companies that are the *raison d'être* of the very reforms from which they are exempt.

The number of companies that would be able to rely on the emerging growth company exemption, as well as the exemption's evisceration of key investor protection provisions, will undermine the goodwill that U.S. public companies have accrued over many decades. If such an exemption is inevitable, I strongly urge the Senate to drastically narrow its scope.

TITLE II: UNRESTRICTED GENERAL SOLICITATION AND ADVERTISING

Section 4(2) of the Securities Act exempts from registration requirements any "transactions not involving a public offering." Rule 506 establishes a safe harbor exemption under Section 4(2) for private offerings that are generally limited to accredited investors[7] and do not involve general solicitation or general advertising activities. By any measure, Rule 506 has been an extraordinary success. More than $900 billion was raised in Reg D offerings in 2010 – an amount exceeding the total raised in public debt

[6] Ross Kerber, *Janus Cuts CEO Pay 40 pct after Shareholder Vote*, Reuters (Mar. 1, 2012) *available at* http://www.reuters.com/article/2012/03/01/janus-ceopay-idUSL2E8E1H4N20120301.

[7] Accredited investors generally include, among others, individuals with annual income in excess of $200,000 ($300,000 for married couples) or net worth in excess of $1 million, and a variety of institutions. *See* Reg D Rule 501(a). Purchases by up to 35 non-accredited, financially sophisticated investors are permitted as well. *See* Reg D Rule 506(b)(2)(i).

offerings.[8] More than 37,000 Reg D offerings have been made since 2009 with a median size of approximately $1 million.[9]

The JOBS Act would put at risk Reg D's demonstrated record of success by substantially undermining the regulation of private offerings under the Securities Act. Title II of the Act would amend Section 4(2) and Rule 506 to permit general solicitation and advertising of securities offerings ("GS&A") conducted pursuant to those exemptions.[10] These amendments would permit unrestricted GS&A activities with respect to investors who are not even eligible to purchase securities in private offerings.

The GS&A amendments contradict a fundamental premise of the Securities Act's registration regime. The Act relies primarily on the regulation of offering activities by prohibiting all offers prior to the filing of a registration statement and strictly regulating all written offers once the registration statement has been filed. General solicitation and advertising activities therefore are generally permitted only if a registration statement has been filed, which provides a strong practical constraint on the ease with which fraudulent offers can reach their victims.

The GS&A amendments would remove this constraint by allowing the broad dissemination of securities offers with no requirement that any information, much less a standardized registration statement, be made available. Regulators will no longer be able to implement the Securities Act's approach of public offers through the simple, efficient mechanism of taking immediate action with respect to public offers of unregistered securities. Because public offering activities as to unregistered securities would no longer be an automatic, actionable red flag for regulators, that monitoring mechanism will have been eliminated.

As a result, regulators' only enforcement mechanism regarding unregistered offerings' compliance with Rule 506 will be: (1) review of GS&A activities in unregistered securities offerings under general antifraud principles, and (2) *ex post* inspections of sales records to determine whether investors were eligible accredited investors. The first approach – regulation through aggressive antifraud enforcement -- is an inefficient way to regulate the securities markets. Judgments about what constitutes fraudulent GS&A activities will necessarily bleed into a form of merit regulation, turning enforcement personnel into *de facto* legislators. This enforcement approach will apply to *bona fide* and fraudulent Rule 506 offerings alike, thereby subjecting *bona fide* offerings to regulatory costs that may outweigh the benefits of being able to reach accredited

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[8] *See Unregistered Offerings and the Regulation D Exemption*, Presentation by Craig Lewis, Chief Economist, Securities and Exchange Commission (Oct. 31, 2011) *available at* http://www.sec.gov/info/smallbus/acsec/acsec103111presentation-regd.pdf.

[9] *Id.*

[10] The ban on general solicitation and advertising appears in Rule 502(c) and is referred to herein as a Rule 506 requirement for convenience.

investors more easily. Most fraudulent offers will go unheeded, which will lead to a higher incidence of fraudulent sales.

The second approach of inspecting sales records *ex post* will also increase costs of *bona fide* offerings with little benefit to investors. Fraudsters will abscond with the proceeds of their offerings long before regulators can determine that investors were not eligible purchasers. To address this problem, the SEC is likely to create additional investor verification procedures to facilitate the identification of illegal sales activities that will result in increased compliance costs for private offerings.[11]

There will inevitably be further collateral effects of the GS&A amendment that are difficult to predict or control. The SEC's amendment of Rule 506 will necessarily be accompanied by proposals to address, and a request for comment on, the potential for increased fraud that would result from unrestricted GS&A of private offerings. For example, the SEC may require that the Form D filing under Rule 503, which is currently only required within 15 days of the first sale of securities, be made at least 15 days prior to the first offer of securities. Form D could require disclosure regarding the means of payment for the securities or other information that would facilitate the identification of fraudulent offerings. This would also enable to the SEC to identify and target for closer scrutiny the GS&A activities of private offerings before they begin.

Alternatively, the SEC could entirely eliminate the exemption for sales to up to 35 non-accredited investors[12] and, as noted, enhance recordkeeping requirements for accredited investors. The criteria for non-accredited investors and the reasonable belief standard for accredited investors are the kind of soft compliance factors that cannot be expeditiously evaluated. Eliminating non-accredited investors and enhanced recordkeeping would facilitate enforcement efforts by expediting and simplifying tests for compliance with sales restrictions. Both would likely increase enforcement and compliance costs for Rule 506 offerings[13] at a time when regulatory resources are constrained and legislators seek to reduce the cost of raising capital.

Thus, the GS&A amendments could actually increase the cost of capital formation if the new enforcement and regulatory approaches necessitated by an increase in fraud

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[11] The GS&A amendment specifically authorizes the SEC to adopt rules that "require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission." JOBS Act Section 201(b).

[12] Although the GS&A amendment applies only where sales are limited to accredited investors, *see* Section 201(b), it may be appropriate to exclude non-accredited investors for *all* Rule 506 offerings because of the impracticability of continuing to prohibit GS&A activities where securities are ultimately sold to non-accredited investors under Rule 506(b)(2).

[13] However, eliminating non-accredited investors from Rule 506 eligibility might *not* increase net compliance costs. Issuers and intermediaries may prefer not to have the option of selling to non-accredited investors (*e.g.*, friends and family of accredited investors) because of the increased compliance risk and costs (*e.g.*, the Rule 502(b) disclosure document) that such sales pose. Many issuers and intermediaries therefore might prefer to have their hands tied in this respect.

results in a net increase in compliance costs for *bona fide* private offerings. The SEC is required to consider the additional costs of the GS&A amendments in its rulemaking and, especially under the extra-statutory standard recently applied by a panel of a U.S. Court of Appeals, it will not be able to adopt the amendments without implementing some offsetting measures. The SEC will be bound, for example, by its finding that the elimination of GS&A prohibition in Rule 504 in the 1990s (see below) resulted in an unacceptable increase in fraud. Unless Congress clearly articulates that an increase in fraud is specifically what it intends the GS&A amendment to accomplish, the SEC will be legally bound to enact counterbalancing measures.

Lessons Learned from the Rule 504 Amendments

The SEC's experience with its Rule 504 amendments illustrates the potential for increased fraud that the GS&A amendments will create. In 1992, the SEC eliminated the GS&A prohibition for offerings under Rule 504, which permits offerings of up to $1 million. It subsequently found that the elimination of the GS&A contributed to an increase in microcap fraud. The SEC restored the GS&A prohibition, in part because its was concerned that "small businesses could be unfairly impacted by the taint that might attach to Rule 504 offerings."[14]

The potential for GS&A activities to facilitate fraud are even greater today than in 1990s. In restoring the Rule 504 GS&A prohibition, the SEC specifically noted that "market innovations and technological changes – most notably, the Internet – have created the possibility of nationwide markets for these exempt securities that were once thought to be sold only locally."[15] Since the SEC expressed this view, the Internet – and its power to disseminate false information – has grown exponentially.

The potential for GS&A activities to facilitate fraud is also greater in the context of Rule 506 offerings. Rule 504 offerings are limited to $1 million, whereas there is no limit on the amount of a Rule 506 offering. A fraudulent Rule 506 offering therefore will be able to invite unlimited investment through general solicitations and advertising that will be actionable only if they are fraudulent on their face. Only the filing of Form D will be required and only 15 days after the first sale. Form D requires no disclosure of any substantive information about the issuer's business or the expected use of the proceeds of the offering. As discussed above, the SEC may seek to balance the increased costs of fraud resulting from the GS&A amendments by requiring earlier filing of Form D; the SEC may also require that additional information about the business be provided.

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[14] *Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption*, Securities Act Rel. No. 7541 (May 21, 1998) ("If the microcap market, or offerings under Rule 504, become stigmatized as unsavory, legitimate small businesses may become less able to raise money as investors lose confidence in the market and in the integrity of those making such offerings.") *available at* http://www.sec.gov/rules/proposed/33-7541.htm.

[15] *Id.*

Real Concerns Regarding the GS&A Prohibition

The foregoing is not meant to suggest that there is no reasonable way to modify Rule 506's GS&A prohibition. Rather, it is meant to explain why modifying the prohibition for the purpose of permitting the soliciting of *ineligible* investors is not a reasonable reform. There is no conceivable social value to solicitations and advertisements targeted at persons who are not even legally eligible to invest in an offering. The only conceivable purpose of such GS&A activities would be to sell to such investors, which is exactly what will result with much greater frequency if the amendments are adopted as currently framed.

The GS&A amendments make no attempt to address genuine concerns about issuers' and intermediaries' ability to communicate with eligible investors. This was illustrated in the recent failed private offering of Facebook shares in the United States last year. Facebook's investment banker, Goldman Sachs, stated that the U.S. segment of the offering had been canceled because it "concluded that the level of media attention might not be consistent with the proper completion of a U.S. private placement under U.S. law." Although neither the SEC nor any of the offering participants were forthcoming about exactly what "media attention" Goldman was referring to, it may have included the appearance in the Wall Street Journal of the text of an email to Goldman clients regarding the offering.

At the time, I argued that the Facebook fiasco showed that the "idea of non-public dissemination of information no longer has practicably definable boundaries."[16] Information technology has removed traditional communication barriers such that the ultimate dissemination of a communication no longer has any necessary connection to the scope of the audience for which it was intended. If Rule 506's ban on GS&A could be violated by the unintentional publicizing of an email sent only to eligible investors, then the GS&A prohibition is, indeed, in need of substantial reform.

In my view, it only general solicitation and advertising targeted at ineligible investors that should be subject to Rule 506's ban. The current blanket GS&A ban certainly achieves this goal, but it may unnecessarily interfere with issuers' and intermediaries' ability to reach eligible investors. It would be appropriate to revise the GS&A prohibition so as not to restrict genuine attempts to reach only accredited investors.

The SEC has been sensitive to the balancing of Section 4(2)'s fundamental "no public offering" condition and the evolution of marketing in the technological age. One example is the SEC's requirement that solicitations be based on a preexisting relationship with the investor in order to comply with the GS&A prohibition. Over time, the SEC has

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[16] *Facebook Fiasco Reveals Flaws in Private Offerings*, Morningstar.com (Feb. 10, 2011) *available at* http://news.morningstar.com/articlenet/article.aspx?id=369342&t1=1331416180.

relaxed the requirements for establishing a preexisting relationship in the context of websites and matching services. Although these positions have demonstrated flexibility on the SEC's part, they cannot alone remove the inherent uncertainty that continues to surround *bona fide* efforts to communicate solely with persons who are or are reasonably likely to be eligible investors.

If critics of the current, blanket GS&A prohibition intend to address the legitimate issue of the effects of the prohibition on solicitations of eligible investors, then they should revise their proposal to directly address this issue. The SEC could be instructed to amend Rule 506 to permit – *i.e.*, impose no unreasonable restrictions on – general solicitations and advertisements that are reasonably targeted at accredited investors or groups of accredited investors. This amendment would force the SEC to make it easier for *bona fide* private issuers and intermediaries to reach eligible investors without providing fraudsters with unlimited capacity to find victims for their scams.

For example, Rule 506's GS&A prohibition could be revised to provide that:

> no issuer or person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising directed at persons who are not accredited investors.

This provision would preserve the existing prohibition against scattershot communications in public media (see paragraph (c)(1) of Rule 502), while requiring that the ban on invitations to seminars or meetings be amended to apply only where it could be shown that the invitations were directed at accredited investors (see paragraph (c)(2) of Rule 502). While there is no doubt that such an amendment would create the potential for increased fraud and the sending of a significant amount of communications to ineligible investors, it would be a reasonable attempt to facilitate marketing to eligible investors.

In contrast, the JOBS Act's complete elimination of the GS&A prohibition is not a reasonable response to concerns regarding access to eligible investors under Rule 506. It permits unlimited marketing to individuals who are not legally eligible to invest in Rule 506 offerings. Such marketing has no social value and is likely to increase compliance costs while imposing significant social costs in the form of increased fraud and the resulting degradation of confidence in the securities markets. Concerns regarding issuers' and intermediaries' ability to reach eligible investors should be addressed by dealing with marketing activities that are reasonably targeted at such investors but are currently subject to unnecessary restrictions.

TITLE III: UNREGULATED CROWDFUNDING OFFERINGS

Title III of the JOBS Act would create an exemption from registration for securities offerings of up to $2 million ($1 million if audited financials are not provided). It would permit investors to invest up to the greater of $10,000 or 10% of their annual income, without having to meet any minimum wealth or financial

sophistication standards. Not only issuers are exempt, but also intermediaries who seek to profit from the operation of crowdfunding markets.

Although such a crowdfunding exemption could be crafted in a way that was reasonably consistent with basic principles of investor protection, the JOBS Act does not satisfy this standard. The terms of the crowdfunding exemption, particularly the blanket relief from broker-dealer regulation for crowdfunding intermediaries, are inconsistent with minimal investor protection standards and will undermine investor confidence in America's securities markets. The potential benefits of the crowdfunding exemption would likely be greatly outweighed by the increased fraud that it would facilitate.

It is quite possible that a reasonably designed crowdfunding exemption could generate net social benefits. Although it is questionable whether the exemption would create net new jobs, a properly designed crowdfunding exemption could reduce transaction costs for small businesses seeking funding for operations. The success of Prosper.com, LendingClub.com and other websites that use a crowdfunding model for debt offerings suggests that the model of distributive capital formation that the Internet has enabled has the potential to create net value for small U.S. businesses and investors.

Nonetheless, distributive capital formation also creates significant potential for fraud. Some commentators have argued that an increase in fraud would not be an automatic result of a crowdfunding exemption, noting that firms such as eBay and Craigslist have demonstrated the potential for effective communal policing in an online community.[17] I agree that crowdfunding sites could similarly create a environment in which the benefits of lower-cost capital-raising outweighed the increased risk of fraud. But the operation of eBay and Craigslist tell us nothing about the means by which crowdfunding fraud would be perpetrated. Such platforms would not be fraudsters' preferred vehicles for separating investors from their money.[18]

The public policy issue here is not whether there would be some group of crowdfunding portals that hosted only *bona fide* offerings. Rather, the public policy issue is the extent to which there would be crowdfunding portals designed solely to defraud investors. The issue is the extent to which a crowdfunding exemption would increase the amount of fraudulent securities offerings and whether such an increase is outweighed by the social benefits of non-fraudulent offerings. There can be no doubt that virtually *any* crowdfunding exemption would increase the amount of

[17] *See* Testimony of Jay Ritter, *supra* note 2, at 9.

[18] The eBay and Craigslist comparison also ignores a century of securities regulation that is premised on the principle that transactions in securities should be subject to greater regulation than transactions in the kinds of products that take place on eBay and Craigslist. In other words, would eBay or Craigslist as currently operated and regulated provide an appropriate platform for securities offerings?

securities fraud in the markets. Any practicable crowdfunding exemption would permit new means of engaging in fraud that pose significantly lower enforcement risk to fraudsters than exists under current law. As NASAA President Jack Herstein stated, "If I'm a crook, I'd be licking my chops over this."

A crowdfunding exemption will increase fraudulent activities primarily because of the absence of any restriction on general solicitation and advertising for many of the same reasons discussed above in regard to the proposed elimination of the GS&A prohibition in Rule 506 (*see supra* pp. 5-10). Under current law, a public offer generally is permitted only if a registration statement has been filed for the offering. This means that regulators generally can take action against persons making public offers of securities solely on the basis of the offering being public. Regulators need not make the case that the offering was substantively fraudulent.

A crowdfunding exemption would make it far more difficult to police fraudulent offers because the mere act of making the offer publicly would not be actionable. Fraudulent offers can easily be designed to comply with the appearance of a *bona fide* offering, which will make them immune to regulatory action. Only after the sale has been made and the loss incurred, at which point the crowdfunding fraudster will have already absconded with the proceeds, will regulators have a basis for bring an enforcement action.

There is a reason that the Securities Act regulates public offerings, despite the fact that no investor ever lost money as the sole result of having been made an offer. The reason is that it is the *offer*, far more than the *sale*, that provides the practical hook for effective policing of the securities markets – especially with the advent of the Internet. If regulators have no basis for stopping offers that are not facially fraudulent, then they can only take action after the fraud has occurred.

Fraudulent offers have been analogized to the NBA's "no harm, no foul" approach to infractions[19] on the ground that no investor is directly harmed by a fraudulent offers. This may be true in a very narrow sense, but the "no harm, no foul" analogy ultimately fails in the context of a securities offering. Unlike securities fraud, the immediate effect of a basketball foul is just as transparent and observable as the foul itself. The advantage gained through the foul (the harm to the opposing team) can be immediately reversed.

In contrast, payment for securities sold in reliance on a crowdfunding exemption is not immediately or easily observable in the wake of a fraudulent offer. Crowdfunding fraudsters will make every effort to ensure that actual sales are not only difficult to observe, but impossible to trace. A fraudulent public offer may not

[19] Testimony of John Coffee before the Senate Committee on Banking, Housing, and Urban Affairs (Dec. 1, 2011). I note my agreement, however, with Professor Coffee's characterization of the House crowdfunding bill as "The Boiler Room Legalization Act."

itself directly harm investors, but the fraudulent public offer is the only pre-fraud conduct that regulators can practicably police.

This is not to say that general solicitation and advertising of crowdfunding offerings should not be allowed. Indeed, any exemption that is reasonably designed to accommodate the concept of distributive capital formation would have to permit some form of broad dissemination of information about the offering. The exemption also cannot work if it makes public offering activities contingent on overly burdensome registration requirements. The key to crowdfunding regulation therefore is the means by which the risks created by excluding crowdfunding from much of the basic structure of the regulation of securities offerings are offset through enhanced regulation of crowdfunding intermediaries.

The Importance of Intermediary Regulation

However, the JOBS Act crowdfunding exemption would have the effect of exacerbating the potential risks of crowdfunding offerings rather than mitigating them. The most effective means for reducing the increased fraud risk that crowdfunding creates would be through tailored enhancement of the regulation of intermediaries through which crowdfunding offerings are conducted. Yet the JOBS Act would do the *opposite* by using a bill that weakens the regulation of issuers as a basis for *also* weakening the regulation of intermediaries.

One of the mainstays of federal securities regulation is the mandatory registration of brokers under the Exchange Act. As a general matter, a person who provides a marketplace for crowdfunding would be required to register as broker-dealer. However, it is not clear this applies to someone participating in a single distribution of crowdfunding interests.[20] Nor is it clear that the operator of a crowdfunding site that facilitates occasional, but not "regular" crowdfunding offerings would be a broker-dealer.[21] Congress should consider asking the SEC to do so and clarify that crowdfunding marketplace operators must register as broker-dealers (as appears to be the SEC's current position). Broker-dealer regulation will play a particularly critical role in protecting investors in the context of exempt crowdfunding offerings.

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[20] They would not be required to register as "exchanges" because sites that facilitate the distribution of an issuer's securities, where there is only one seller and no "bringing together of orders among multiple buyers and sellers," are exempt from the definition of "exchange" under the federal securities laws. *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws* at 34 (Aug. 24, 2011) *available at* http://ssrn.com/abstract=1916184. However, sites that facilitated a secondary market in crowdfunding securities generally would be exchanges. Crowdfunding operators also would not be investment advisers in reliance on the broker-dealer exclusion in Section of the Investment Advisers Act. If they were not broker-dealers, there is a good chance that they would be regulated as investment advisers. *See generally id.* at 45 - 54.

[21] *See generally Guide to Broker-Dealer Regulation*, Division of Trading and Markets, Securities and Exchange Commission (April 2008) *available at* http://www.sec.gov/divisions/marketreg/bdguide.htm.

Nonetheless, Section 301(b) of the JOBS Act amends the Securities Act to provide that registration as a broker shall not be required solely as a result of a broker's participation in crowdfunding transactions. This would mean that crowdfunding brokers, unlike persons engaged in effecting transactions in virtually every other type of security, whether or not subject to registration, would be exempt from the entire regulatory scheme under which registered broker-dealers operate. This exemption would create the extraordinary situation where both issuers and securities professionals were exempt from both of the principal regulatory regimes under which their securities-related activities are regulated.

As noted above, the crowdfunding exemption militates for *greater*, not *less* regulation of intermediaries. The nature of crowdfunding is particularly well-suited to a primarily intermediary-based approach to regulation. Historically, the regulation of intermediaries has, over time, expanded as an indirect means of regulating the conduct of issuers. Where issuer exemptions have created gaps in the investor protection regulatory scheme, broker-dealer regulation has been enhanced in response. For example, the regulation of municipal securities, which are substantially exempt from issuer regulation under the securities laws, is conducted primarily through the regulation of intermediaries who distribute them.

Intermediary regulation offers significant efficiency benefits for small offerings. To the extent that responsibility for crowdfunding compliance is placed on the intermediary, compliance can be accomplished at lower cost. Compliance would be implemented by repeat-player, securities professionals, rather than one-time-participant small businesses or marketplace web sites. Intermediaries can thereby spread fixed compliance costs over many crowdfunding offerings, which can mitigate the adverse effect of relieving issuers of certain compliance requirements. For example, responsibility for compliance with information filing and delivery, investor eligibility, offering limits, custody of funds, among other types of requirements, can be more efficiently assumed by an intermediary when fixed costs of such compliance are large in relation to the size of the offering and the issuer.

None of the foregoing is meant to suggest that the full panoply of broker-dealer regulation is necessarily warranted for firms whose securities-related business is limited to non-custodial crowdfunding operations. The development of a kind of "broker-dealer lite" model under the Exchange Act solely for crowdfunding intermediaries would be appropriate. By comparison, the definition of "exchange" under the Act includes a complete exemption for securities markets that facilitate only the sale of securities by a single seller (the issuer). Similar relief (but not a complete exemption) from broker-dealer regulation, such as proposed in the CROWDFUND Act, may be appropriate for crowdfunding-only operators. Until that happens, however, crowdfunding intermediaries should be required to register as broker-dealers.

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In conclusion, Titles I, II and III of the JOBS Act go far beyond reforms that lie within the reasonable bounds of disagreement regarding the implementation of the existing federal securities law regime. They undermine the fundamental structure of federal securities regulation and thereby present a significant threat to the integrity of the U.S. securities markets. With respect to each Title, I have offered alternatives to the extreme approaches taken in the JOBS Act that, while not necessarily reforms that I would support in isolation, would achieve the essential goals of the JOBS Act without the unnecessary damage to our regulatory system that the current version of the Act would cause.

Thank you for your consideration of my comments. Please let me know if I can assist in any way in your efforts to improve the federal securities laws consistent with the protection of investors and the integrity of U.S. securities markets.

Sincerely,

Mercer Bullard
President and Founder