June 27, 2012

FILED ELECTRONICALLY

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

Re: JOBS Act Rulemaking: Titles I, II, III

Dear Ms. Murphy,

As individual investors, we are concerned that the JOBS Act lowers the bar for the vast majority of companies going public and re-exposes Americans to some of the worst financial abuses in recent memory. We believe it is incumbent on the Commission to mitigate these abuses and protect the integrity of our capital markets.

To this end, please consider the following recommendations that expand on our senate testimony. The first section contains our recommendations associated with Title III of the JOBS Act -- the creation of a crowdfunding market. The second section contains our recommendations related to Title I -- the exclusion of "emerging growth companies" from the prevailing regulatory regime. The third section contains our recommendations associated with Title II of the JOBS Act -- the removal of Regulation D's general solicitation ban for Rule 506 offerings.

I. Title III Recommendations -- Crowdfunding

A. Introduction

In principle, we're not opposed to crowdfunding. However, the opportunities for misuse and abuse are enormous due to the inherently speculative nature of start-ups, as well as what will certainly be weaker accounting scrutiny and corporate governance.

As the SEC designs the rules governing the crowdfunding market, it will need to focus on investor education; liability and accountability for intermediaries, issuers, and key persons; clear and comprehensible disclosure; and prohibitions on scams.

B. Investor education

As the statute makes clear, brokers and portals must verify that investors understand the risks of investing in crowdfunding.

No matter which figures you look at, the failure rate for start-ups is high. According to Harvard Business School, 30% to 40% of start-ups lose most or all of their money, 70% to 80% fail to meet projected returns on investment, and 90% to 95% fail to meet declared projections.[1]

Kate Mitchell, former managing director of the National Venture Capital Association and head of the IPO Task Force, recently noted that 40% of her venture capital investments lose their money, 40% basically

[1] Carmen Nobel, "Why Companies Fail – and How Their Founders Can Bounce Back," *Harvard Business School*.

break even, and only 20% make money.[2] Crowdfunding will presumably have a lower success rate than Ms. Mitchell's fund, given that, among other things:

1. crowdfunded companies are far earlier in their development life cycle than venture capital investments,
2. many of the best ideas will already have been poached by venture capital firms,
3. non-professional individual investors may not have the opportunity or expertise to conduct venture-capital-level due diligence, and
4. criminals are obviously aware of No. 3.

Title III charges the Commission with designing a quiz that would be made available by portals or brokers that investors would need to pass before investing in crowdfunded ventures. Among other things, investors would need to demonstrate that they understand the rate of start-up failures and the risks inherent to crowdfunding:

> [Brokers and funding portals must] ensure that each investor ... reviews investor-education information, in accordance with standards established by the Commission ... [;] *answers questions demonstrating an understanding of the level of risk generally applicable to investments in startups* ... [;] [and] an understanding of such other matters as the Commission determines appropriate. (emphasis added)

This suggests a different, and more involved process, than simply checking a box ostensibly verifying the reader has reviewed a series of terms and conditions. There should be several multiple-choice questions tailored to testing whether prospective investors understand the nature of crowdfunding risk, the potential for fraud, their legal rights and issuer responsibilities, and the probability of losing the entirety of their investment in speculative, early stage ventures, among other things.

C. Liability and accountability

If crowdfunding is to succeed as a start-up funding mechanism rather than as a backwater for hucksters and frauds, the Commission will need to ensure that there is sufficient transparency, liability, and accountability such that quality issuers are distinguishable from low-quality issuers.

A few examples:

1. **Background checks:** Sec. 4A(a) requires brokers and funding portals to obtain a background check and a securities enforcement regulatory history check.

   While obtaining these checks is an important step, the information could be even more effective at weeding out scammers if the Commission requires brokers and funding portals to prominently display the results of those checks, insofar as the information discovered bears on the honesty of the individuals checked. (We don't care about speeding tickets.)

[2] Bloomberg Washington Summit, May 1, 2012.

2. **Crowdfunding history:** Quality leadership is vastly more important for the fate of small companies than large ones. What's more, crowdfunding scammers are vastly more likely to repeatedly escape prosecution and regulatory enforcement than those at the small-cap level, given their lower profile and the smaller amounts of money involved.

   The Commission should therefore also require brokers and portals to perform and disclose checks on the crowdfunding history of officers, directors, and people holding more than 20% of outstanding equity of the offered securities.

   "History" here means their record of crowdfunded issues and each issue's status: proposed (pending), proposed (dropped), active (with link to most recent financial performance report), and terminated (with final shareholder return). Such a check shouldn't be too expensive, as the crowdfunding intermediary industry will have already collected all the data it needs.

   This is important for allowing investors to have the material information they need to make informed investing decisions and for weeding out and apprehending repeat scam artists. Brokers and portals could flag suspiciously prolific individuals to potential investors and enforcement officers. It's one thing to seek funding for a variety of ideas -- it's another to raise $300,000 for 20 different ventures and continually "lose" the money.

3. **Residency requirement:** In order to ensure access to legal recourse and enforcement actions, the Commission may need to require that all issuers' officers, directors, or holders of more than 20% of outstanding stock be residents or citizens of the United States, or of some country where the Commission would be able to easily pursue enforcement actions.

D. Prospectus disclosure

The Commission should create and mandate a simple, uniform, easy-to-understand yet comprehensive template prospectus that is similar in principle to the mutual fund industry's summary prospectus.

Doing so would streamline the filing process for issuers, most of whom won't be able to afford a team of lawyers. A web-based template filing would also make it easier for portichs to collect and display the key information about each issuer that investors would need to know when screening for and analyzing issuers.

It would also partially alleviate the need for the Commission to create a slew of rules that would otherwise be necessary to contain the potential for scams to proliferate in the fine print. It would clearly be abusive, for instance, for a start-up to raise $1,000,000 in exchange for 0.001% of its shares. In the absence of checks provided by underwriters and financial media, it would be relatively easy to scam investors in the crowdfunding market by hiding such information in the fine print of a 100-page legalistic prospectus.

Among other things, the prospectus should disclose: issuer and individual backers' identities including executives, directors, and persons holding more than 20% of outstanding equity; business plan; financial

statements (if applicable); proposed valuation; amount being raised; related party transactions; executive, director, and employee compensation; and any payments made for lead generation and solicitation (if applicable).

In short, creating and mandating a fill-in-the-blank prototype (and providing an example of a good prospectus) would streamline the crowdfunding process by ensuring that issuers know what information they need to provide, help portals and brokers comply with their oversight role, protect investors, and save the Commission from having to consider and ban every possible scam that the traditional IPO process would have ordinarily caught.

E. Wanton dilution and other tantalizing scams
Given the lack of traditional corporate governance enforcement mechanisms, the Commission will need to ban certain abusive practices outright.

Here are three examples, though there will undoubtedly be more:

1. As noted earlier, it would be possible for an issuer to raise up to $1,000,000 in exchange for only a negligible ownership interest. While the statute sets a maximum aggregate issue amount at $1,000,000 per issuer and requires disclosure of valuation, it does not specify a maximum issuer valuation. The Commission will need to set one -- perhaps at something two, five, or 10 times the aggregate issue limit -- and each issuer's proposed valuation should be prominently communicated to potential investors via the prospectus.

2. Similarly, unscrupulous issuers might sell a special class of shares to the crowdfunding public that they eventually dilute in future offerings, leaving insider shares undiluted. Unlike venture capital firms, crowdfunding investors won't have the ability to negotiate protection from potentially abusive dilution. The Commission should therefore implement a rule to protect investors from excessive dilution.

3. Unsavory issuers may seek to pay outsized salaries, bonuses, dividends, or other perks to officers, directors, or outstanding shareholders. Such payments could be an effective *and* legal means of embezzlement.

   What's more, due to the limited liquidity of crowdfunded shares, even if a reasonable salary is disclosed in a prospectus, investors will have little recourse if the issuer changes its compensation in later years, say, to the entire equity of the company.

   In light of the unique features of the crowdfunding market, while we understand that the SEC is traditionally a disclosure-based organization, we believe it should set a maximum aggregate compensation amount for officers, directors, and dividends at some percentage of the issuer's tangible book value.

E. Keeping it all organized
One final note to consider as the Commission designs the framework for the equity crowdfunding

market: Since there's no central crowdfunding-exchange-like mechanism, it may be helpful for the Commission, a private company, or a portal consortium to establish some kind of central data repository. Such a mechanism could help:

1. Reduce the cost of background check and crowdfunding history check duplication and other data storage and collection costs,
2. investors and intermediaries access information on issuer financial performance,
3. improve pricing transparency and liquidity for shares of crowdfunded issues,
4. ensure that fewer bad actors manage to fall through the regulatory cracks, and
5. make enforcement much easier.

II. Title I Recommendations -- IPO "On Ramp" for Emerging Growth Companies

A. Introduction

Title I presents two major challenges to the Commission.

First, emerging growth company exemptions are likely to increase the level of fraud and issuer abuse of individual investors. Second, these abuses have the potential to reduce trust in emerging growth companies and public markets in general.

It's critical that the Commission addresses these two challenges both for investor protection and for the Act's stated intent of improving access to capital.

B. Fraud potential

As you know, Title I overturns several successful investor protections that were created to correct conditions that led to the Enron, WorldCom, and Tyco frauds. The exemption is exceptionally broad. According to data from S&P Capital IQ, some 90% of IPOs fit the rather broad criteria for an "emerging growth company" as defined by the Act.

It's widely believed among financial experts that through the JOBS Act overturning these protections, there will be an increase in investor abuse, fraud, and the cost of capital for issuers.

- Former New York Attorney General Eliot Spitzer wrote that the Act should be called the "Return Fraud to Wall Street in One Easy Step Act."[3]
- SEC Commissioner Luis Aguilar noted that by reducing transparency and investor protection and making securities law enforcement more difficult, the JOBS Act will harm ordinary Americans, reduce confidence in capital markets, distort capital allocation, and harm the economy.[4]
- Indeed, a joint study by *The Wall Street Journal* and AuditAnalytics.com found that "104 companies that have had issues with their anti-error, anti-fraud procedures ... would have been exempt from auditor scrutiny of those procedures if the JOBS Act had been effect [since 2004]."[5]

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[3] Elliott Spitzer, "Kill the JOBS Act!," *Slate.*

[4] Commissioner Luis A. Aguilar, Securities and Exchange Commission, Public Statement by Commissioner: Investor Protection is Needed for True Capital Formation: Views on the JOBS Act.

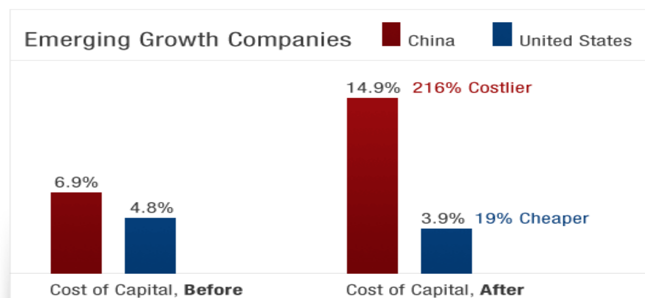
[5] Michael Rapoport, "Investors' Prying Eyes Blinded by New Law," *The Wall Street Journal.*

- Arthur Levitt, the Commission's longest-serving chairman, called the JOBS Act "the most investor-unfriendly act in the history of America." He contends that "it will destroy jobs."[6]
- Even criminals -- for whom the JOBS Act provides regulatory relief -- agree. Sam Antar, the convicted CFO of Crazy Eddie who helped refine various accounting scams, told me that the audit, internal control, and crowdfunding provisions of the "License to Steal Act" will obviously increase fraud: "Criminals are laughing."[7]

But we don't even have to consider hypothetical examples, the recent U.S banking crisis, or the collapse of the 1990s IPO market to see the costs of loose accounting.

Since late 2010, the financial press and blogosphere have called into question the accounting and legitimacy of a number of small Chinese reverse mergers listed on U.S. exchanges.[8] The Commission even launched a probe to investigate whether various Chinese companies have been creating false financial statements while their U.S.-based auditors looked the other way.[9]

The panic began with reverse mergers, but went on to eviscerate trust in all Chinese emerging growth companies:[10]



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[6] Bloomberg Washington Summit, May 1, 2012.
[7] Discussion with Sam Antar at The Motley Fool, Mar. 22, 2012. *See also* Susan Antilla, "Ex-Con Man Says JOBS Law Makes Guys Like Him Rich," *Bloomberg*.
[8] Examples are innumerable, but see Bill Alpert and Leslie Norton, "Beware This Chinese Export," *Barrons*, and Muddy Waters, "Muddy Waters Initiating Coverage on RINO – Strong Sell."
[9] Joshua Gallu, "SEC Suspends Trades in Rino International Amid Fraud Allegations," *Bloomberg*.
[10] Data from S&P Capital IQ. "Cost of capital" here refers to a company's earnings yield.

What happened? Investors rightfully concluded that reporting and internal control transparency was so poor that it was impossible to separate the frauds from the non-frauds, thereby driving up the cost of capital for everyone.

This is incredible. During a period when more trustworthy U.S. emerging growth companies, the Dow, and the Xinhua China 25 (the Chinese Dow) actually *rose*, 93% of Chinese EGCs saw their shares decline in value. Confidence has not returned; their stocks continue to languish with P/Es down to 6.2 today.

Investors in Chinese emerging growth companies -- many of which weren't frauds -- lost $11 billion as a result. For these 219 small companies, $11 billion in lost market value was five times more costly than the most generous estimates of their initial and ongoing IPO compliance costs based on the NVCA's surveys.[11]

This isn't to suggest that weakening the quality of American accounting to be more closely aligned with China's will cause an equivalent increase in the cost of capital for American EGCs, although it could. I am told, for instance, by some institutional investors that they already plan to avoid EGCs in response to the JOBS Act.

But the costs -- particularly should frauds inevitably occur -- could vastly exceed the benefits that exempted EGCs accrue. And they will be borne not just by investors and exempted EGCs. They could extend to all EGCs, IPOs, and even all publicly traded companies.

C. What should the SEC do to mitigate a Tidal I wave of fraud?

The Commission has plenty of opportunities to protect investors and prevent fraud from undermining the stated goals of the Act without having a major impact on listing costs. In this case, we believe there are at least two such options.

First, the Commission can vastly reduce the incentive for weak internal controls and fraud by simply maintaining the status quo on lockups.

Prior to passage of the Act, lockups generally extended to 180 days after companies came into compliance with normal reporting requirements. One of the Act's dangerous side effects is to bring forward the date at which outstanding shareholders and insiders will be able to dump shares on the public, years before the EGCs come into compliance with normal reporting requirements. This side effect incentivizes fraud and is likely to raise issuer cost of capital without providing issuers any IPO savings.

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[11] According to data collected from S&P Capital IQ, there are 219 remaining U.S.-listed Chinese companies that fit the requirements of an emerging growth company as of August 1, 2012. The IPO Task Force estimates initial IPO compliance cost per company at $2.5 million and ongoing compliance costs at $1.5 million per year. The cumulative lost market cap of $11 billion exceeds the aggregate cost of even five years of compliance by nearly $9 billion. *See* IPO Task Force, Rebuilding the IPO On-Ramp.

The Commission should therefore codify a lockup period that would apply to outstanding (pre-IPO) insiders of issuers that wish to take advantage of the new EGC exemptions. The lockup period would last at least 180 days after the issuer is no longer subject to EGC reporting exemptions.

Such a rule would dramatically curtail the incentive for unscrupulous directors or investors taking advantage of the new IPO "on ramp" to dump shares of issuers with material weaknesses or fraud on public markets, thereby defrauding the public and raising costs of capital for all issuers. And it would protect investors and reduce costs of capital for issuers *without increasing IPO burdens for issuers*.

Second, it's crucial that investors clearly distinguish between EGCs that have chosen to opt in to Title I's disclosure exemptions and those that haven't.

If the purpose of Title I is to create an on-ramp option--— a liminal point between non-public and fully fledged public companies -- that status should be prominently disclosed. Otherwise investors will naturally assume that a listed issuer is in full compliance with ordinary accounting rules.

It's dishonest for issuers to mislead investors into believing they are purchasing assets of higher accounting quality than they actually are. It's also important that revelations of internal control weaknesses and fraud at opt-in EGCs don't cause investors to sour on other classes of stocks, including compliant EGCs.

Therefore, an easy-to-understand boilerplate disclosure that an EGC has chosen to opt in to Title I exemptions and a list of what those exemptions are should be displayed prominently at the beginning of prospectuses, quarterly filings, and annual filings. At the very least, this would help to clarify that an opting-in EGC is still in on-ramp stage.

III. Title II Recommendations -- Elimination of Regulation D's General Solicitation Ban

A. Introduction

Of all the legal and regulatory bodies in the country, the Commission is uniquely qualified to understand the problems associated with removing Regulation D's general solicitation ban for Rule 506 offerings.

In 1992, the Commission relaxed the same ban under Rule 504, which permitted non-registered offerings of up to $1 million. This decision unleashed a wave of micro-cap fraud schemes, the best known of which was memorialized in the book *The Wolf On Wall Street*, a tale of excess and riches amassed by the founders of Stratton Oakmont, a now-defunct Long Island brokerage firm.

In their guilty pleas, the founders admitted to manipulating the stocks of at least 34 companies, using pump-and-dump schemes, and costing investors hundreds of millions of dollars. It was because of this and similar frauds that the Commission reinstated the general solicitation ban for Rule 504 offerings in 1998.

With this history in mind, we believe the Commission should take two steps to try to mitigate the likely proliferation of similar schemes coming from the JOBS Act's repeal of the general solicitation ban for larger Rule 506 offerings.

B. Update the definition of "accredited investor"
First, the Commission should update the definition of an "accredited investor" by increasing the net worth and income thresholds necessary to qualify.

For an individual to be considered an accredited investor under current law, he or she must have a net worth of only $1 million, excluding the value of his or her primary residence, or have made at least $200,000 each year for the last two years. While these limits are nothing to shake a stick at, they were nevertheless set in 1982 and are accordingly out of date. As the Commission noted when considering a limited relaxation of the general solicitation ban in 2007, the net worth requirement should be increased at a minimum to $2.5 million as a result of inflation alone.[12]

This is also supported by the growth in the number of millionaires. In 1980, various estimates put the number of millionaires in the U.S. between 2 and 3 million people.[13] Today, that number is 10.5 million people, and it's expected to grow to over 20 million by 2020, according to Deloitte Center for Financial Services.[14]

Today, the definition of accredited investors captures millions of seniors who have saved $1 million over the course of their lives. Many rely on these savings for necessities and are about to become prime targets of predatory solicitation.

A simple Google search turned up a website titled accreditedinvestorlists.com, which sells state-by-state lists of accredited investors by email, phone number, and physical address. In Utah, for example, this company's list already includes 21,032 physical addresses, 1,573 email addresses, and 1,606 phone numbers. Numerous other websites from investormarketinglists.com to ethnictechnologies.com helpfully break the information down into lists by ethnicity, gender, and lifestyle -- presumably to make is easier for scammers to relate to marks -- and, ominously, "seniors."

C. Articulate "reasonable steps"
Second, the Commission should articulate specific steps that an issuer must take under Rule 506 to verify that all eventual investors are indeed "accredited" for the purposes of Regulation D.

This requirement is expressly mandated by the section 102(a)(1), which states that issuers must "take reasonable steps to verify that purchasers of the securities are accredited investors, *using such methods as determined by the Commission*" (emphasis added).

We believe the Commission is best situated to articulate the most prudent methods and thus urge you to make them ardent, numerous, and specific enough to ease the showing of negligence or fraud at a potential trial. Simply being included on accreditedinvestorlists.com shouldn't be sufficient.

D. Regulate content of solicitations
Beyond investor-focused rules, we also urge the Commission to adopt regulations governing the content of Rule 506 solicitations and advertisements themselves. Beyond blatant fraud, a subsidiary concern is that the typical investor isn't familiar with the type of alternative investment vehicles, such as hedge funds, that will predictably advertise and solicit for funds under Rule 506 in the post-JOBS-Act era.

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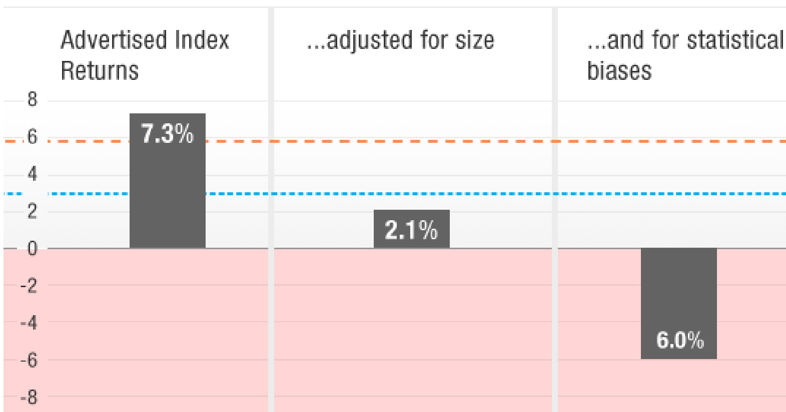
[12] SEC, Revisions of Limited Offering Exemptions in Regulation D.
[13] Robert Samuelson, Washington Post Writers Group, Getting A Handle On Our Decades of Greed.
[14] Andrew Freeman & Val Srinivas, Deloitte, The Next Decade In Global Wealth Among Millionaire Households.

To the non-initiated, the traditional exclusivity of hedge funds creates the illusion that they are superior investment vehicles. Yet nothing could be further from the truth:

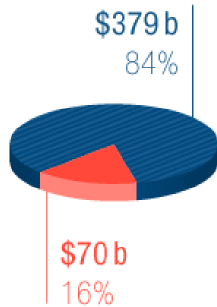
The Hedge Fund Mirage, Simon Lack

S&P 500 average of 5.9% Treasury Bills average of 3.0%

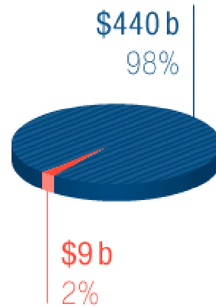


Fees vs. Investor Returns Hedge Fund Investing Fees Investor Returns

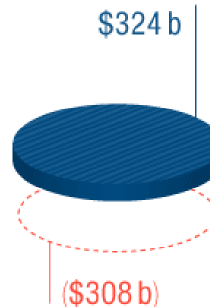
Estimated after-fee returns



...adjusted for "Fund of Funds"



...and for statistical biases



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The Commission should therefore mandate that Rule 506 solicitations reveal historical performance relative to an appropriate benchmark, the investing strategy employed, and the general risks of investing in alternative investment vehicles, among other things.

IV. Conclusion

We appreciate the opportunity to comment on the JOBS Act rule-making process. Thank you for consideration of our comments.

Respectfully submitted,

Ilan Moscovitz and John Maxfield