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JOBS Act: The Terrible Twos- General Solicitation & Crowdfunding, The Next Frontier of Securities Regulation

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SYMPOSIUM

JOBS ACT: THE TERRIBLE TWOS

GENERAL SOLICITATION & CROWDFUNDING, THE NEXT FRONTIER OF SECURITIES REGULATION

Editors' Forward

We are pleased to present this Symposium on Title II and Title III of the JOBS Act. This is the annual symposium hosted by the *Fordham Journal of Corporate & Financial Law* on significant topics in the realm of business law.

The format for the symposium is as follows. It begins with an introduction by Professor Sean Griffith, followed by edited transcripts of the opening remarks, the two panel discussions, and the closing address.

The first panel discusses Title II of the JOBS Act, which has changed the general solicitation restrictions applicable to private funds. The panel focuses on the implications of Title II, in particular the effect private fund advertising may have on investment companies. The second panel discusses Title III of the JOBS Act, which creates equity crowdfunding. The panel focuses on finding the balance between the competing interests of protecting investors and encouraging capital formation under the crowdfunding providing of the JOBS Act.

We are grateful to our sponsor for the symposium: The Corporate Law Center.

SYMPOSIUM

JOBS ACT: THE TERRIBLE TWOS

GENERAL SOLICITATION & CROWDFUNDING, THE NEXT FRONTIER OF SECURITIES REGULATION†

WELCOME AND INTRODUCTORY REMARKS

Sean Griffith[i]
Fordham University School of Law

OPENING REMARKS

Congressman Patrick McHenry[ii]
Deputy Republican Whip (NC-10)

PANEL I: GENERAL SOLICITATION

MODERATOR

Emily Chasan[iii]
The Wall Street Journal CFO Journal

† The symposium was held at Fordham University School of Law on March 24, 2014. It has been edited to remove minor cadences of speech that appear awkward in writing and to provide sources and references to other explanatory material in respect to certain statements made by the speakers.

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ii. Patrick McHenry is the Republican Chief Deputy Whip member of the U.S. House of Representatives and represents North Carolina's 10th District.

iii. Emily Chasan is a senior editor at the Wall Street Journal CFO Journal, where she writes about finance, corporate governance, tax, accounting, auditing, and regulation.

PANELISTS

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Hedge Fund Association

Andrew J. Donohue[v]
Goldman Sachs Asset Management

Robert C. Grohowski[vi]
Investment Company Institute

James P. Jalil[vii]
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PANEL II: CROWDFUNDING

MODERATOR

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PANELISTS

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viii. Catherine Clifford is a senior writer at Entrepreneur.com.

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WELCOME AND INTRODUCTORY REMARKS

SEAN GRIFFITH: Welcome everyone and good morning. My name is Sean Griffith. I'm the T.J. Maloney Chair and Professor of Law here at Fordham Law School. I also have the honor and pleasure of directing the Corporate Law Center and advising the *Fordham Journal of Corporate & Financial Law*.

I'm delighted to welcome you to this symposium entitled "JOBS Act: Terrible Twos - General Solicitation and Crowdfunding, the Next Frontier of Securities Regulation," sponsored by the *Fordham Journal of Corporate and Financial Law*, as well as the Fordham Corporate Law Center. I'd like to thank the editors of the *Journal of Corporate and Financial Law* for their outstanding efforts in organizing this symposium. So, in particular, I'd like to thank Noelle Indelicato, the Journal's Symposium Editor and Alex Zozos, the Journal's Symposium Committee Chair. And of course, I also need to thank, who I always thank, Ann Rakoff, without whom nothing would really happen here at Fordham.

This symposium focuses on the JOBS Act, which was passed in 2012. This is the Act's second anniversary. As any parent in the crowd knows, the second year is a difficult one. The JOBS Act is no different, as its policies are implemented and as rules continue to be passed under it. The purpose of the JOBS Act is to increase job creation and improve access to the capital markets.

Today's Symposium will feature two panel discussions, each focusing on a different aspect of the Act.

The first panel will focus on Title II of the JOBS Act. This part of the Act removed restrictions on general solicitation for hedge funds and other private funds. Now, here's the argument: removing this restriction might spur investment, but it might also leave the investing public susceptible to different types of fraud. Additionally, it may create an unlevel playing field for certain managed funds that are subject to many more restrictions and a more prescriptive rule regime. Panel I will be moderated by Emily Chasan, Senior Editor at The Wall Street Journal's CFO Journal, whose award winning investigative journalism focuses on Wall Street and the financial sector. The panel will focus on how rule changes will and have affected the market and on finding the correct balance between investor protection and ease in capital formation.

Panel II will focus on Title III of the JOBS Act. That section of the Act created equity crowdfunding. This is a completely new type of capital formation, the hope of which is to democratize funding for start up businesses, while offering an opportunity of financial return for investors. This new type of security and fundraising has created a cultural phenomenon. Some believe that crowdfunding will be a panacea, opening up funding for businesses that are stymied by the current level of regulation. Others believe that new type of security is a pariah, opening up the Wild West and leaving the investing public susceptible to fraud. Panel II will be moderated by Catherine Clifford, a senior writer at Entrepreneur.com, whose recent work has focused on the impact and trends within crowdfunding. This panel will separate the fact from the hype, analyzing the recently released rulemaking to see where the new securities will lead the market.

Both panels are "bookended" by two distinguished commentators. Today's opening remarks are going to be delivered by United States Congressman Patrick McHenry, who is unable to travel to us due to congressional meetings, which is proof that Congress actually does do work. And then there will be a keynote address delivered by former SEC Commissioner, Troy Paredes.

It's now my pleasure, with the help of Alex Zozos, to introduce to you U.S. Congressman Patrick McHenry, who will provide a comment on the JOBS Act. Congressman McHenry, former Special Assistant to U.S. Secretary of Labor under the Bush Administration in 2004, was elected to the U.S. Congress at the age of twenty-nine, representing North Carolina's Tenth Congressional District. He serves as current Deputy Republican Whip, garnering support for legislative priorities that are currently being considered on the U.S. House floor. He also serves as a member of the House Financial Services Committee and a member of the House Oversight and Government Reform Committee. In 2011, Congressman McHenry authored the primary legislation to equalize equity crowdfunding in the United States, which included the JOBS Act, and was signed into law in April 2012.

First we'll have Congressman McHenry deliver remarks, and then we'll have a brief question and answer session moderated by Alex Zozos from the *Journal of Corporate & Financial Law*. Thank you.

OPENING REMARKS

CONGRESSMAN McHENRY: I want to thank you for giving me a moment to speak to you and thank you for gathering. I was just joking that the last time we were scheduled to do this, we were snowed out and tomorrow they're calling for snow in Washington. So while you have a great school of law, you are not the best on weather conditions.

Today, I wanted to mention to you two sections of the JOBS Act: Title II and Title III. I was very involved with the writing of the JOBS Act, and am glad we were able to get it passed and have a bipartisan success in updating the securities regulations and laws that we so vitally need. I do have some great concerns about Title II, one example being the lifting of the ban on general solicitation.

Congress' intent was very clear. We were supposed to make the regulation less onerous, not more. Unfortunately, the SEC's proposed regulations are of deep concern, because they, in many respects, go against Congress' intent. In particular, the idea of self-certification for high net worth individuals, so called accredited investors, needed to be preserved. Self-certification is very important. The onus should fall on those doing the investing, rather than those making the offering. It is also important that we preserve what is currently permissible, whether it is demonstration days or the current period that does not trigger a public offering or public mentioning. I think it is important that we preserve these permissible activities and protect them. Those are two items in particular for Title II that I have concerns with, just like many of you do about the SEC's proposal.

Title III was my FINRA piece of legislation. The rest of the world and many states in the United States are moving forward with equity crowdfunding. However, we are no longer known as the world leader when it comes to crowdfunding. With certain technology platforms, doing debt based crowdfunding and shareholder-based crowdfunding, we are on the cutting edge in the United States. But when it comes to equity crowdfunding, regimes around the world have caught up and surpassed us. I've shared my concern about the SEC's over 600-page regulation of equity crowdfunding. They've made things more onerous and complex than they need to be. I think it's important that we have investor protection front and center when it comes to equity crowdfunding, as well as with all securities regulations. But it's also important that we keep the other very important part of this in mind, capital formation.

We have, in my view, capital deserts. Just like in urban areas and even suburban America when we talk about food deserts, there is a desperate need for capital and those are the areas we are trying to nourish. Equity crowdfunding is a great opportunity to address those deficiencies. In terms of the concerns I have about equity crowdfunding, mine align with the SEC. The primary concern for everyone should be who bears the legal responsibility—the issuer or the platform. You need to have legal responsibility on the issuer, rather than the platform, and you have to provide the platform with the ability to weed out fraudsters.

Another concern that I have is with the amendments that made it into the JOBS Act that make dealing with equity crowdfunding more complicated. You have three tiers of investment making it really cost prohibitive for those that want to do a \$500,000 or \$600,000 raise. This tiering will basically cause additional expense, and will also, I believe, prevent folks from doing a sort of lower dollar offering in the next year. So, it will prevent somebody from doing a \$150,000 to \$550,000 raise. I think making lower raises accessible and feasible for lower dollar offerings will need bipartisan support in terms of changing the law as it exists now.

So those of you who have contacts with other members of Congress or the Senate, I am certainly all ears for opportunities to work with them to finish the law as it exists. I know our time is brief, so I just wanted to check off a few of the concerns I had and wanted to leave plenty of time for questions.

ALEX ZOZOS: Thanks again for joining us, Congressman. I just have a few brief questions. Where do you see or what do you think the short-term and long-term potential is for Title II of the JOBS Act regarding general solicitation?

CONGRESSMAN McHENRY: Well, if the SEC follows Congressional intent, we'll have a wider, more vibrant marketplace and it will enable folks to actually know more about offerings than they currently have for private offerings. It will open that market up for greater access and greater opportunity for those to find out more about it. I think that holds the greatest potential of all the sections of the JOBS Act. If we get that right, we can have a greater flow of capital to businesses that need it and actually really enhance our ability to compete around the world with the lower cost of capital.

ALEX ZOZOS: Do you think the SEC should revisit the metrics used to determine who is an accredited investor?

CONGRESSMAN McHENRY: Well, not based off what they're talking about, what I hear out of the SEC. I think they're going in the opposite direction than the one Congress has really sent a message to them about. I know you have Troy Paredes coming in, and he can talk more about the politics of the Securities and Exchange Commission. But, if you look at the JOBS Act, and if we're just being very frank about it, the Securities and Exchange Commission could have done through regulation what Congress had to force them to do. That was, in my view, a bipartisan response to the SEC's unwillingness to update the regulations.

If you look at Reg A offerings, they basically withered on the vine and the Securities and Exchange Commission didn't do anything to address it or provide access to capital or opportunity for issuing. So, if we're just being honest about it, Congress has not really been known in the last couple of years for working in a bipartisan way or actually being, I don't know, particularly efficient. But when you look at the SEC's unwillingness to address capital formation issues, not just the investor protection side, but the capital formation side of their responsibility, they make Congress look like we're fast, speedy, and bipartisan.

ALEX ZOZOS: What were your thoughts on the SEC comment process for equity crowdfunding?

CONGRESSMAN McHENRY: I think the comments were fantastic. You had a great group of folks across the spectrum who actually understand the technology side. The SEC was very willing to listen, and at the staff level I've been very impressed with their willingness to hear from a diversity of folks that are either on a gift based side of crowdfunding as it exists now or those like RocketHub, and listening to folks that want to get into this space, that understand the technology, and understand how you police fraud in an online marketplace. So in that respect, the Securities and Exchange Commission has listened very well. In terms of the regulations they have written, I think they missed the mark, and I think it will take Congress to address it legislatively to fix it.

ALEX ZOZOS: Can you speak to whether you intend to influence the SEC's crowdfunding proposal, and, if so, how you intend to do that?

CONGRESSMAN McHENRY: With the way that Congress has created these regulatory functions, like the SEC, I've submitted my comments in person to Chair White, and to various other commissioners to make sure that they understand my perspective as an author of the crowdfunding piece of the JOBS Act and for them to understand clearly what the Congressional intent was. However, it also requires folks that are engaged in the securities marketplace, and for them to make their voices heard too. So yes, I'm going to continue to raise my voice for the SEC, and the good news is, if they don't get the regulations right, that as a member of Congress and a legislator, I can try to legislate in order to fix their mistake. If they don't get the regulations right, then I will use whatever power I have to fix it.

ALEX ZOZOS: Final question Congressman: what are some other securities laws that you and other members of Congress intend to address this year?

CONGRESSMAN McHENRY: Well, part of this is seeing that the JOBS Act is fully implemented, and we're still a long way from that as we're having this discussion. We've also not nailed down a complete package for JOBS Act 2.0, and we're still working on that, so we'll have more news to come on that front.

ALEX ZOZOS: Thank you very much for your time, Congressman. I know you're hard at work in Washington.

CONGRESSMAN McHENRY: Thank you all, thanks for gathering today, and thanks for being involved in this important endeavor.

PANEL I: GENERAL SOLICITATION

EMILY CHASAN: I'm Emily Chasan, a senior editor at CFO Journal at The Wall Street Journal. We have a great panel here. We have Mitch Ackles from the Hedge Fund Association; Buddy Donohue, Deputy General Counsel for Goldman Sachs Asset Management; Bob Grohowski, Senior Counsel at the Investment Company Institute; and Jim Jalil, partner at Thompson Hine, LLP. So we'll get a lot of different perspectives on general solicitation today.

If you didn't follow the legislative history of general solicitation in the JOBS Act, it's section 201 of the JOBS Act, which was passed in 2012.[1] Even though the JOBS Act is turning two, this general solicitation section was really only lifted about six months ago in September 2013. However, the general solicitation ban has been in effect since the 1930s. It was the early securities law that was largely designed to protect average investors from getting exposed to risky investments. Those types of investments and private offerings are really only supposed to be sold to accredited qualified investors. So you weren't supposed to advertise to the general public to protect them from taking risky investments.

The people who were working on the JOBS Act in 2012 thought that the 1930s approach was a little bit outdated. It's much easier for companies now to look at who their investors are and make sure that they're selling to the right kind of people. Simultaneously, it had gotten more challenging for companies and funds with the Internet and social media to make sure they weren't doing anything that would be considered advertising. So, people were always doing deals under this veil of secrecy, constantly worried they were at risk of blowing up a deal by some offhand social media comment. So there's a lot of reason that they thought this was sort of outdated. But the private placement market, which is about a one trillion dollar market according to the SEC and is actually more than the entire global IPO market last year, is a huge tool for raising capital.[2]

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1. Jumpstart Our Business Startups Act, Pub. L. No. 112-106 [HR 3606], § 201, 126 Stat. 306 (2012).

2. SEC, Division of Economic and Risk Analysis, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009-2012, *available at* http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf.

Those who backed the ban said that it's going to be easier if we just lift general solicitation. They said it would be easier for companies to raise capital this way. It's really interesting who uses this. Lots of different companies can use it, but the biggest user is in the private placement market, primarily hedge funds. And they're just sort of dipping their toes in the water looking at this rule. Everybody is dipping their toes in the water to see what they'll do. It's still in the very early days, and we're going to talk a little bit about that.

Something else I would like to talk about is one of the biggest things to happen in general solicitation so far. The first day that the general solicitation provision was lifted in September, people on Twitter started writing hedge fund slogans, which was pretty funny. I picked out a few of them just to share: "There's no business like flow business," "we'll carry your interest," "just risk it," and "good to the last drop." So, there were a bunch of people saying, "let's see what's going to happen when hedge funds start advertising."

I think we're going to start off with Mitch, who will tell us whether hedge funds are responding to the lifting of the general solicitation provision. Are they using it? And what are they looking at?

MITCH ACKLES: First of all, thank you very much for having me on the panel, and I would say that "hedge funds are dipping their toes in the water" is a perfect description of what's happening. They're just starting to get their ability and get organized in the sense of being able to do this. This is entirely new. Eighty years of not being able to do this is not going to change overnight. One thing I would say is the way it will happen eventually. And up to now, I've counted a grand total, and maybe my panelists can confirm this, of three advertisements that have taken place so far. Three advertisements, and there are a lot more hedge funds than that which are qualified to do this.

I think they're dipping their toes in the water for a couple of reasons. I think they're doing it because it's brand new and because the SEC has indicated that funds that do this are going to get special attention. I also think that even if you're following all the right rules, special attention might be something that might interfere with the day-to-day operations of your business. And if you've been able to raise money and reach investors without doing it, it's not necessarily something you want to go down the path of doing.

Do I think it's a good idea? I think free speech, free business speech is a great idea. I ask you in the audience, raise your hands if you have ever walked by the windows at Tiffany's? You can look at the jewels, but that doesn't mean you can afford what's in that window. So, I don't see any reason why advertising these high caliber investment vehicles should not be allowed. I think it's a great thing for the industry, I think it's a great thing for all investors, and as Barbara Novick from BlackRock once said to me, "sunlight is the best disinfectant." So even though you're going to have the ability to advertise a fraud, someone out there also has the ability to bring that to the attention of the appropriate people.

EMILY CHASAN: Thanks, Mitch. That was very interesting. I like that—"sunlight is the best disinfectant." We say that all the time in journalism. So Jim, can you focus on the implementation so far and the requirement for the standardization of the rules?

JAMES JALIL: The SEC has proposed some rules dealing with advertising. Before we get to that, a lot of the implementation really will not be like the advertising you see at Yankee Stadium, on the Internet, or on the radio. General solicitation had two basic prohibitions. One was the kind of advertising we're accustomed to seeing on television, the radio, and, now of course, the Internet. The other thing that was a chilling effect for hedge funds when it came to general solicitation was the ability to cold call or reach out to people unknown to them.

The rule had been, before general solicitation, that you couldn't solicit, you couldn't approach, you couldn't engage or seek to get money from anybody who is not known to you. And there were rules about how long they had to be known to you and how it could be done through a broker-dealer, making customer broker-dealers very complicated and sometimes arbitrary. You could meet someone, but you couldn't talk to them about a fund for forty-five days, sometimes ninety, sometimes thirty. A lot of the implementation of general solicitation rules will not be in advertising or billboards at Yankee Stadium. It will be the ability for hedge funds to cold call and to send emails to pension fund advisors, high net worth individuals, and institutions, and let them know that the fund exists and would be willing to have their money.

The problem, whether it's a billboard at Yankee Stadium or an email privately sent on what we call a cold call, is that there's no standard for what can be said. Our friends in the registered mutual fund area have precise rules of what can be said and what can't be said. The SEC in dealing with its old rules on advertising criteria is very concerned about fraud, exaggerating performance, and misrepresenting its experience. Although, it seems the problem is, and this is a personal observation, that our friends in the registered mutual fund area have a baseline of what the public expects to see.

In the hedge fund world, and I'm not a proponent of regulation for regulation's sake, far from it, the Hedge Fund Association, which Mitch is the president of, another industry body, FINRA, or the SEC could come up with standards so that when a hedge fund says their performance has been eight percent over the last four years, well how are they calculating that? There's eight percent and then there's eight percent. It says that "we've beaten the S&P by two hundred-forty basis points." What does "beat the S&P" mean? And so, things can be said, which are not fraudulent, but are also not comparing apples to apples, oranges to oranges. So the investor is confused when hedge fund A says X, and hedge fund B says Y. Are they the same thing? Can they really be compared? I think that remains to be seen.

The SEC's focus is on fraud, properly so, but as the Congressman said, the SEC really has two mandates. One, to prevent fraud, and two, facilitate capital formation. I think that nobody is in favor of fraud, but in terms of facilitating capital formation, standardization of hedge fund performance figures, experience, and investment goals is very important. Describing a strategy as a long-short fund I think is not really enough today to give the investor the information he or she needs to make an investment.

EMILY CHASAN: That's very interesting. It will be interesting to see if anybody starts to take up those baseline developments. It's been in the press so long to protect investors. So Bob, can you talk a little bit about buyer beware. Is this something that people are doing?

ROBERT GROHOWSKI: Thank you for having us, and thank you Fordham for including us in this panel. It is an important topic. I am from the ICI, the Investment Company Institute. Many of you may not be familiar with us, but we represent the registered fund world. Our members manage mutual funds, closed end funds, and ETF's. Many of our members also manage hedge funds and other private vehicles, and so they have both perspectives. But ICI's perspective is purely from the registered side. Interestingly, I think you're going to hear a lot of vehement agreement among my friends on the private side of the industry here. Mitch said, free speech is a great idea. I completely agree. I also think that fraud is a really bad idea. And Jim said the proposed rules from the SEC are very focused and very concerned about fraud. I would disagree with that. I think the proposed rules in many respects did not go far enough to protect investors in the marketplace from potentially fraudulent statements.

Congressman McHenry said that what the SEC is doing here is of deep concern. I think it's really important that we all start from the same baseline in understanding what it is that the SEC in fact has done here. They adopted Rule 506(c).[3] That's the rule that allows the general solicitation, with, in my view, very few substantive restrictions on how to conduct a 506(c) offering. They have not adopted, but proposed amendments to Form D and Form D filing requirements. That's intended to give the SEC a better handle on the types of offerings that are happening and the types of advertisements that are being used. They proposed, they did not adopt, simple legends that may be seen as boilerplate, and in fact can be seen as just warning labels–ways to distinguish a private fund advertisement from a registered mutual fund advertisement. They also proposed an extension of Rule 156 under the Securities Act of 1933. Rule 156 is not a very specific rule.[4] It is, you can kind of look at it as the Jeff Foxworthy of the rules. I'm from Virginia for those of you familiar with Southern humor. Jeff Foxworthy is the guy who said, "you might be a redneck if . . ." and had a number of jokes. Rule 156 is sort of like that. You might be committing fraud if you have unwarranted comparisons to benchmarks or exaggerated claims of your investment prowess. There's nothing really there to violate. It's merely guidance. And they merely proposed to extend that. They didn't even propose content restrictions on the hedge fund advertisements, performance advertising restrictions, or any standardized performance calculation methodologies.

So, ICI's perspective, we supported the legends as a common sense first step, and strongly supported legends that would distinguish hedge funds from mutual funds in advertisements. We supported the extension of Rule 156, again as common sense. We stated that we didn't think the SEC went far enough with respect to requiring the filing of advertising materials, either with the SEC or potentially FINRA, and the corresponding staff review of the filing. We certainly didn't think they went far enough with performance advertising and the need for some standardized methodologies there. And we didn't think they went far enough by not addressing the base definition of accredited investor in the thresholds that apply there, which were established in 1982 and really have not been updated with the exception of taking out the value of one's personal residence since that time. So, they are badly out of date.

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3. 17 C.F.R. § 230.506.
4. 17 C.F.R. § 230.156.

One last thing: why did I take these positions? It was because, in large respect, from a mutual fund industry, we do have the benefit of hindsight. As Jim mentioned, on the registered side, we live with these types of rules and we have for many years. The history there can be instructive here. In 1979, mutual funds were given the ability to advertise performance for the first time.[5] We didn't have any content restrictions or any specific methodologies or standardized performance calculations, so the early '80s to the mid '80s became something of a wild west in mutual fund advertisements. By 1986, it had gotten bad enough that the industry led an effort that was supported and then taken forward by the SEC to develop Rule 482, which is the detailed Mutual Fund Performance Rule that was adopted in 1988.

There are two things to note there. One, industry wanted this as much as the regulators at that time for comparability's sake, for competition's sake, and for the benefit of investor's to be able to make apples to apples comparisons and have faith in the types of numbers that were being thrown around. And two, it took us almost a decade to get there, so it's not that surprising to me that hedge funds now are just beginning to dip their toes in the water. This takes some time to play out, but we fear that our friends in the hedge fund community will relive that history, absent some of these types of rules.

EMILY CHASAN: That's really interesting. And Buddy, can you please talk a little bit about the impact of the rules?

ANDREW (BUDDY) DONOHUE: First, I'm really happy to hear that there isn't going to be warfare because I'm Switzerland here. I'm between the warring factions between the registered world and the hedge fund world. I'm an interesting perspective on all of this. I've been very, very active in the registered investment world, as well as having private funds in the firms that I've worked for, and I headed up the SEC's Division of Investment Management from 2006 to 2010. So, I lived through some of the discussions that were going on during the period of time leading up to the Act and have some, I think, pretty good insight into the different concerns that the SEC may have.

If I was in Jim's position in terms of giving advice to hedge fund clients, I don't know that I would tell them to dip their toes in the water. There's a lot out there that hasn't yet been decided. If you select to be a 506(c) filing, you can't go back and rely on 4(a)2. You made your election. You no longer can say that there was no offering and if you

5. 17 C.F.R. § 230.482.

wind up not having been in compliance with all the provisions, you now have made an offer in violation of the securities laws. There's also a whole host of regulations that actually apply to you and to the disclosures that you're making with not much of a template to tell you how to do that. You have the Advertising Rule under the Advisers Act.[6] You have the Anti-Fraud provision in the Advisers Act,[7] the rule that applies to pooled investment vehicles, which applies to the offer and the sale of securities and statements made in connection with an offering or just in connection really with a private fund or a public fund.[8] You have the bad actor provisions, which could wind up applying.[9] Once you kind of cross that line, you can't go back with respect to that particular vehicle. And for hedge funds, you don't want to necessarily cut off the opportunity to do future funding. And so I'd be very cautious in this area.

There's also issues related to the CFTC. If in fact there's some commodities or futures that are being purchased by the fund, they have not updated, to my knowledge, their regulations to permit the offer. And so you're going to run afoul of an exemption that I think many do claim that they need in order to operate their businesses. So there's a whole host of potential risks that you're running if, in fact, you're running an advertisement. And if in fact you're a 3(c)(7) fund,[10] you don't need advertising. You're not out there to reach the general public if you're a successful 3(c)(7) organization, which most large hedges fund are. You have access to the clients that you need. You know, you need somebody who's a qualified purchaser. That's somebody who has five million dollars in qualifying investments. And so, from my perspective, the considerations that people have been giving for the big funds in terms of whether or not they're going to actually participate in this particular area is more defensive than it is offensive.

The discussions that I've heard, and Jim or Mitch, you may have some different feedback than I do, is the ability really to make information available out there without necessarily having to use your protected website or doing things of that nature. It's not actually out there to go trolling for clients or to do anything of that nature. So, it doesn't surprise me that you haven't seen a lot of advertisements and

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6. 17 C.F.R. § 275.206(4)-1.
7. 15 U.S.C. § 80b-6.
8. 17 C.F.R. § 275.206(4)-8.
9. 15 U.S.C. § 80b-3(e).
10. Investment Company Act of 1940, Pub. L. No. 112-90, § 3(c)(7).

you haven't seen a lot of folks out there. And by the way, when the SEC actually was considering this, the instructions to the staff at the SEC are quite thin in trading and markets, investment management, enforcement, and DERA, which is the economic analysis. Pay particular attention to this area because we really want to know about it.

I agree, you don't want the SEC paying particular attention to you, particularly where much of the performance oriented advertising is problematic. As Bob has indicated, the investment company area went through this, and I'll point out, there is actually a case or two relating to registered investment companies where they followed Rule 4(a)(2), and the ads were still found to be fraudulent because of issues relating back to the IPO area, where their performance all came from IPOs. Everything was actually true, except the court didn't put a footnote in to basically put it in perspective for people so that their decision was not misleading.

I'll end by saying that under the Advisers Act and under 206-1 and 2, you don't need to intend to commit fraud. And so those are just some of my thoughts, and I think the panelists here probably have some more insight than I might into some of these areas.

EMILY CHASAN: I think that's a really interesting point. That's what we've heard from funds as well, but they don't necessarily want to do advertising because you don't want every mom and pop to contact you. You want to make sure the right people with the right amount of money are the ones contacting you. So I'm curious, and think we should talk a little bit about why it's been such a slow start for hedge funds dipping their toes in the water. So Jim?

JAMES JALIL: I think it has been a slow start. I think in most of the funds, the larger funds, the 3(c)(7)'s also have 3(c)(1) clones. They really believe that the JOBS Act Title II helped them, not so much as I said before, put advertisements in newspapers, on the internet, or a website, but it freed them in the ability to contact institutional investors without being thought of as job soliciting. And that's where you've seen a lot of the activity, behind the scenes with presentations to established pension funds, you know CalPERS or the like. Calling up an institutional investor and saying, "We'd like to come talk to you about our hedge fund to see if you might be interested," would not have been permitted before.

MITCH ACKLES: They really did that? I mean it didn't seem like they had any difficulty necessarily contacting CalPERS or getting in touch. I don't think the SEC has ever taken, necessarily, the position that that is an offer.

JAMES JALIL: Well, it'd be things like attending seminars or conventions, and handing out cards, we get calls like that all the time.

ROBERT GROHOWSKI: Doing public relations.

MITCH ACKLES: What are you standing on the street?

JAMES JALIL: No, no, standing in a meeting or something else such as this, where you come up to somebody and say "I see you're interested in hedge funds. Here's my card if you'd like to call me." This is how we had been advising clients. And Mitch, you and I have been very familiar with this for years, and that it's probably not permissible absent of a pre-existing relationship.

MITCH ACKLES: That's the thing. The thing is exactly what you said. It's less a matter of advertising, it's more a matter of that sigh of relief that everyone had that now I can identify myself as a hedge fund and not think that something bad is going to happen as a result.

JAMES JALIL: Correct. And that has been a real cloud on the hedge fund industry for years, as to what extent you can by-pass the pre-existing relationship. I'm not so sure that calling CalPERS out of the blue would previously have been problematic, but it was something the industry struggled with.

The one thing I'd like to respond to is that the hedge fund side is private and it follows on 3(c)(1).[11] Section 3(c)(7) says non-qualified purchasers in a public offering. If you go back to the theory, it was dealing with investors who could fend for themselves. So I think that, on the public side, you're dealing by definition to a large extent with the public and the non-accredited investor arena, and I think that you have to have a little bit more scrutiny in terms of advertising.

I'm not suggesting that the ICI would oppose that, but on the hedge fund side, we're supposed to be dealing with sophisticated investors. So, the obligations I detailed—boiler-plate, legends, comparisons, and the whole protocols that exist on the registered public side. You and I might disagree, but I think that's not necessarily as robust on the private side because you generally shouldn't be dealing with the unsophisticated investors. Those investors on the public side have every right to heightened scrutiny and ought to be able to invest on the public side. Especially considering they put their 401(k), IRA, and college funds in public vehicles.

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11. Investment Company Act of 1940, Pub. L. No. 112-90, § 3(c)(1).

MITCH ACKLES: Yeah, I agree and we haven't called for a wholesale extension of the rules applicable to mutual funds to the hedge fund arena. What we said is that the rule should be developed in a way that is tailored to reasonable hedge fund practices. I think with respect to warning labels, legends, or boiler plates in advertisements themselves, it makes sense to me that the advertisement should say this is an advertisement for a private fund, it is not available to the public, it is not subject to the same protections afforded by the Investment Company Act, and there may be special risks. That simple statement to distinguish the hedge fund advertisement from a mutual fund advertisement when, even if the ultimate purchasers of the securities are going to be different and are going to be accredited investors, everyone will be able to see those advertisements potentially side by side in the marketplace.

I just think it behooves both the hedge funds and the rest of the collective investment fund community to have something that says, "look, this fund is not available to everyone." If you're truly targeting only accredited investors with the advertisement, then it shouldn't be an undue burden to include that kind of language in the advertisement.

EMILY CHASAN: Well this part of the rule was very controversial at the SEC and with crowdfunding. All of these rules that sort of open up capital information that was previously prohibited or very controversial because of fraud risks. So the SEC proposed the additional measure that Congressman McHenry was talking about, that they could do more restrictions on what people are doing, and force people to file their advertising with the SEC, just to be able to track it a little better. So that was proposed around the same time they put out these rules on general solicitation. It's just a proposal, it hasn't gone anywhere yet, but I'm curious what you guys think of that and where that's going, especially in light of what Congressman McHenry said about Congress' intent. Why don't we start with Mitch and just go down the line.

MITCH ACKLES: I'm not adverse to funds having to do the same things that mutual funds do in general. Ultimately, I think that there is a lot that we can learn from the things that the mutual industry had to deal with. There are things that we can learn from when lawyers could not advertise that we can take advantage of as we go down this path.

As far as being able to file, I do think that the SEC needs to take great care with the infrastructure they provide to be able to do that efficiently. You know this is something that we can borrow from other agencies where these types of things happen. If I need to upload my thirty-minute infomercial, it might take a long time. And I also think that there needs to be a different lens that we need to look at for hedge fund advertisements versus mutual fund advertisements. There's an expected sophistication of the people in the hedge fund audience by virtue of them needing to be qualified or accredited, and I think that we need to look at it through that lens. But I also think that three hedge funds, a grand total, have advertised so far. The sky has not fallen, and I don't think there's anyone in this room or in any room that can show me that there's some greater percentage of fraud in hedge funds than there is in anything else. I'm of a personal view that the more visibility we have, the more access to this information, the less likely the fraud will be because people are going to be able to check things and verify them a lot more easily through standard methods that we all use today like Google.

Also, separate from my job as the president of the Hedge Fund Association and a lobbyist, I run a PR firm. Several years ago, former chair of the SEC Harvey Pitt said to me, "Mitch, Hedge Fund PR, is that legal?" It is, and Emily can attest to this because I've worked with Emily on hedge funds before. I think the best side effect or one of the best side effects is that a hedge fund can now take a call from a reporter and talk to them. You know this has been a big issue for me for many, many years where a reporter has gotten a hold of a performance number or some information about a fund and I'm not able to confirm it because I can't confirm that the reporter is qualified or accredited or that the readers of whatever they're going to publish are qualified. So I've got issues with The Wall Street Journal or with CNBC, where they've called me with an incorrect number about a client in terms of performance. And attorneys, including one from Thompson Hine, have barred me from answering that question. So now maybe there will be a little more clarity and a little more openness, and this whole idea that hedge funds are mysterious or secretive might be addressed.

ANDREW (BUDDY) DONOHUE: I have some insight actually into much of the SEC's concern. The SEC is an independent agency. It is charged really with three different areas that it is concerned about. One is of course capital formation. One is investor protection. The other is maintenance of fair, orderly, and efficient markets. So those are the three prongs that the SEC has and of course there's tension between those.

What's happened with the JOBS Act is actually that it has highlighted the tension between two of those, which is investor protection versus capital formation. So what you're seeing out in daylight right now is a tension that does exist all the time within the SEC in terms of the philosophical differences between commissioners about which weighs more and which is more important in their view of the three. All three are important.

I would challenge that there's only been three advertisements. Actually, that's a very limited view I think of what an advertisement is. The very concerns that you had prior to the enactment of the JOBS Act and the availability of advertising still exists if, in fact, you haven't opted to take advantage of that. And advertisements generally are a very broad topic under the securities laws, which is what has caused the concern. So to say that there's only been three advertisements, I think is misleading. Maybe there's four. But in any event, handing out a brochure or doing things of that nature could constitute advertising. So that is I think how the bigger funds are thinking about it, in terms of having the ability really to have a conversation with folks within part of what Jim had mentioned.

ROBERT GROHOWSKI: I think Buddy, to that point exactly, it's advertising and general solicitation. So, broader than what we think of as traditional advertisements, the potential for emails or other things that are going out that could get picked up on the internet are included.

Let me tell you with respect to performance advertising, specifically what we expect to see and what we saw in the fund industry in the early '80s. I think there's no question that the general anti-fraud rules in the Securities Acts apply to this space as in the registered fund world. We had that same type of regime in the early '80s, and what we got were figures that were defensible as being factually true, but were for stub periods or odd periods based on non-standardized methodologies. There were things like up eight hundred percent in the last six and a half years. Well that might be true, but without any context around it, it doesn't tell you much of what happened. Maybe the fund was very small at the very beginning, had outsized returns initially, has not been able to replicate those kinds of returns, and more recently has been badly trailing the market. To simply say you're up over a period of time, it's not a standard period, and could itself be misleading. Those are the kinds of things that we expect to see as we start to see performance advertisements in the hedge fund space.

There are statements that the promoter really believes are true, and if it is true, isn't that an absolute defense. It's not in securities laws and it can be misleading. As Buddy mentioned, the "hot IPO" allocation cases—if the performance cannot be replicated, and if the performance is based on periods of really aberrational performance, those are the kinds of things you should be cautious about using when touting performance. Those are the kinds of things I think you will see. It's hard to say, Mitch as you said, whether there is more fraud or less fraud? There's fraud everywhere.

I am not up here to say there's no fraud with mutual funds or other registered products. Fraud is what it is. The North American Securities Administrators Association and state securities regulators list Rule 506 private placements as their single top area for fraudulent activity in the last two or three years. So the 506 offering space does have quite a bit of fraud that the securities regulators have seen, and I think we have to think about, rather than outright fraud, the fact that you're going to see those kinds of performance statements that are factually true, but still misleading.

JAMES JALIL: I agree with that. I think we talk about fraud sometimes and we think of some Wolf of Wall Street, some con artist, or some boiler room operation who's taking your money and then disappears. Of course, there have been criminals with us since the days of Pharaoh and always will be, but the things that the industry has to self-police, I believe, is going to be performance data. As Bob said, claiming an eight hundred percent return over five years can be a true statement. As a lawyer, we have to educate our clients that truth is not necessarily the defense. So, I absolutely agree.

I think that if we can have some industry standards of how performance data is done whether it be GAAP accounting or things that are really beyond my pay grade in terms of how it's presented, then when an investor gets performance data, he can compare apples to apples and understand what it really means. These people aren't bad people, but they're salesmen, and they want to present themselves in the best light possible, and they don't think it's fraud, they just think this makes me look good, so why don't I just say it this way. It's not wrong, it's true, and I think it's going to be a grey area. By the way, I am in favor, personally, of standardization. I think that's going to help the industry, and it will help the performers stand out if it's some standardized presentation.

EMILY CHASAN: We talk about hedge funds because they're sort of the principle users of this private offering market, but there was a study, not of funds, but of operating companies, like tech companies and real estate companies, that have been raising capital using general solicitation. I think they looked at about 800 companies that have raised capital since September on iCrowd, and they found that ten percent of operating companies are using general solicitation. So some people are using it and I wanted to ask what is the best practice, what are the ways that people are using this, and what do you think will be most popular going forward? Why don't we start with Jim?

JAMES JALIL: It's interesting. I believe that crowdfunding, which is the next topic, will be a large component of small capital formation. I don't want to steal the thunder, but 506(c) was a realization by a lot of people that investors made a lot of money in things like Facebook and other social media. And because of the way the law is structured, a lot of smaller investors weren't able to participate in those successes because they couldn't invest. I think that some people didn't see it to be very fair. It was venture capitalists and accredited investors who were able to invest at the early stages, simply because Facebook was not able to garner or ask for investors who were not sophisticated or accredited. So, I think that, operating companies looking for capital and small caps, everything from an auto body shop in the Bronx to the next Facebook to the next advancement in the digital age, to the extent that they can advertise for capital truthfully, honestly, and fairly, will use it more and more, and I think that's going to benefit capital formation. Always keeping, as Buddy says, an eye on the fraudster.

ANDREW (BUDDY) DONOHUE: Isn't that an argument for an amendment of our system? In Europe, they are less concerned about the offering process and the control is really at the sale. The way I see it, this particular Act effected it, but in a small way with a lot of conditions that wind up being problematic. People may want to use that particular provision, but the offer and sale both being covered has been somewhat of a challenge I think for everyone, including registered investment companies. Maybe there is an alternative approach, which is to say forget - obviously offering materials have to be correct—but maybe loosen that area and go more the European approach, which is control it at the sale.

JAMES JALIL: It's interesting Buddy, it's very insightful, because it all starts with section 5(c) of the 1933 Act, which said you can't offer.[12] Everything's followed from that. If it had been written in 1933, "you can't sell," we would have a totally different legal regime. So it's interesting. Maybe it has to be rethought.

EMILY CHASAN: Mitch, did you have anything to add on what you think the best practice would be?

MITCH ACKLES: Well, I like the crowdfunding idea. I hear that Veronica Mars got her movie made as a result of that. I think that the

12. Securities Act of 1933, Pub. L. 112-106, §5(c).

idea of the JOBS Act was to do exactly what it is called, create jobs. And I think that ultimately the ability for people to do this – and I may be president of the Hedge Fund Association, but we've got lots of attorneys that help me with all of the legalese and the specifics – is a great thing overall. I believe that ultimately the reason you're seeing these other companies do it is because there is some value in it. There's some value in finding new investors. This is a leveling of the playing field where investors that don't typically have access to these types of things can get access. I think that's important.

I also think it's completely separate from what we see in the hedge fund world. You know in the hedge fund world, you should have a level of sophistication, you should have a standard, and the standard of the suitability in the hedge fund world can be different than this. I think overall it's a very smart thing and I'm very curious to see what the specifics are. It's an exciting place for people to be.

EMILY CHASAN: Bob, I think you talked earlier about the accredited investor definition and I'd be interested to hear from all the panelists, but we'll start with Bob. That definition hasn't been updated for over twenty years. And now that it's out there and people can reach all sorts of accredited investors, does it have to be updated? Is it more dangerous that it hasn't been updated?

ROBERT GROHOWSKI: Well, I think dangerous is an interesting word there. I don't know that I would have chosen that word, but as Buddy said, the issues that are raised by Title II of the JOBS Act go to very core concepts around securities regulation. Why do you want to regulate the offer or just the sale? And who needs the protections of the securities laws that we have and the benefit of SEC oversight? The basic idea is that there's absolutely a place in our system for offers and sales of securities that don't have to have a heavy regulatory touch because they're being sold to investors who, as the Supreme Court said so many years ago, can fend for themselves. So the challenge, I think, with the definition of accredited investor is to come up with a way to define that universe of investors who can truly fend for themselves.

It's a rule or a standard that was adopted in 1982 and so now it's more than thirty years old. The basic rule is $200,000 in income or $300,000 with your spouse, and a reasonable expectation for having that same level of income in the coming year, or a million dollar net worth excluding the value of your home. The exclusion of the value of your home was the big change to that in recent times. It was established in Dodd-Frank.[13] Other than that, it really hasn't been updated.

Back in 1982, in terms of sheer numbers, the universe of people was something like, I can't remember if it was 1.3 or 1.7 million people in the United States. Now based on wage growth and inflation and the erosion of those standards, you've got something before the value of the home was taken out, it was up to nine million or so, in terms of the universe, I think it's down to somewhere with a seven handle. But the universe is quite a bit larger than it was back in 1982. I don't know whether the universe or the size of the universe of investors matters so much. Really the idea there is, can those people fend for themselves?

Personally, I don't think that wealth has ever been a terribly reliable indicator of financial sophistication. It is an indicator of the ability to withstand a loss and of the ability to potentially obtain advice that will help guide investment. But in terms of financial sophistication, wealth may not be the best test. An investment's own test may be better. There may be other ways to reach financial sophistication. The SEC recently issued a no action letter to the Managed Funds Association talking about knowledgeable employees of hedge funds.[14] That makes perfect sense to me. The end goal for all of us should be to define the universe of people who can truly fend for themselves.

ANDREW (BUDDY) DONOHUE: I agree with that. With respect to hedge funds, if you're registered with the SEC, an accredited investor is a necessary standard, but it is not the highest standard that your client is going to have to meet. Your clients are actually going to have to be a qualified client for you to receive a performance fee. That requires a two million dollar net worth or a million dollars of assets with that particular advisor. So it's a higher standard. I will also point out, and this is of concern to the Commission, that the SEC regulates less and less of the smaller advisors, and the performance fee, the one that requires the higher standard that I just mentioned, only applies to advisors that are registered with the SEC. Therefore, if you register with the SEC, you have a higher standard for charging a performance fee. And if you're not registered with the SEC, you're a smaller fund advisor—of which there are more than there are registered with the SEC—and you are subject to

13. Dodd-Frank Act, Pub. L. 111-203, § 413(a).

14. Response of the Investment Adviser Regulation Office and Chief Counsel's Office, Division of Investment Management (Feb. 6, 2014), http://www.sec.gov/divisions/investment/noaction/2014/managed-funds-association-020614.htm.

the lower standard. I suspect that may be where some of the greater difficulties may wind up occurring.

Every now and then somebody says, would you please define the following terms for me: accredited investor, qualified client, qualified purchaser, and then if you go into CFTC world, you have qualified eligible person. I've had people in Europe sometimes ask me "can't you guys just make it easier please?" This is hard. Lawyers make a living off of these distinctions.

JAMES JALIL: I agree with Bob and Buddy. It's always troubled me. I don't know how Mitch feel about this. You start with the basic premise from *Ralston Purina*[15] that the investor should be financially sophisticated to understand the investment. The problem with that is for years, thirty, forty years, lawyers wanted the bright line. They have to be able to advise their client. Sometimes it's easy. On the other side, often times it's not, and I think the Securities Bar really asked for the bright line and it became a dollar test. On the individual side, it came to a dollar test. And I'm not so sure that even the SEC is comfortable with that because the knowledgeable employee was an exception to that which made all the sense in the world. I would struggle with that a little bit. I would agree that the test should be, should always have been, and should still be investor sophistication. But how do you define that and when do you make a bright line? I don't know if you increase it to five million dollars net worth or two-hundred fifty million dollars. Even the concept of a dollar amount is interesting and I think should be looked at.

EMILY CHASAN: It's interesting that the dollar amount hasn't even really been adjusted for inflation.

MITCH ACKLES: Thirty years.

EMILY CHASAN: Thirty years and we've had a little bit of inflation. Mitch, what do you think about it?

MITCH ACKLES: I know a lot of wealthy people that don't know what a private issuer is. So, I think that there is a requirement, first of all, to address it. It's been too long. The SEC needs to take a look. They also need to understand that there are people that don't meet the net worth requirements that have a sophisticated knowledge and can look at these things in a reasonable way and understand what they are and what they mean. Some of them might be professors here, and I think that it's very important that the SEC take that into account. I would not be adverse to the HFA looking into supporting some type of test to determine whether someone meets those levels of sophistication. You

15. SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

mentioned the word bright line. I do think that having a certain net worth to be able to qualify to invest is very similar to those reasonableness tests. Unless an attorney that advises a hedge fund client has a clear set of rules that if you do A, B, C, and D, then you can do this. They're not going to be comfortable with things that are opaque or unclear. I think that's why there was a specific dollar amount set, and I don't think we're going to get away from that. I do think they need to take a look at it, just based on the fact that it's been thirty years.

EMILY CHASAN: I have heard people suggest recently about taking a Series 7 exam or something similar to show that they're a qualified investor. I don't think it is used now, but I've heard people suggest it.

ANDREW (BUDDY) DONOHUE: I would be very concerned if the government somehow was starting to have a test for people to take to determine whether or not they are sophisticated. When I was at the Commission, actually after an adverse court case, there was an attempt to institute a new term, accredited natural person, which would have upped the standard, particularly and only for private funds. It was like carrying a lightning rod through a huge thunder and lightning storm. I can't tell you how many scars I still have from that proposal that never went anywhere. So you know, I agree, it needs to be updated and they've worked out ways to do it and potentially modernize it, but I'm not sure anybody has a great idea on how to do that.

MITCH ACKLES: That's right. If we're talking about the JOBS Act, we still need to harmonize with the CFTC, and we have a lot of other things to do just with that part of it. But Buddy, it's interesting you say you still bear the scars. I think that 2007 proposal actually had a lot of top line support, at least from the public comment file, it had support from ICI and MFA.

ANDREW (BUDDY) DONOHUE: I didn't necessarily say that the lightning that was hitting me was from outside the Commission.

I think it becomes very, very tricky when you actually get down to saying who is going to qualify and who isn't. What you want to get to are people who not only can make the investment, withstand the loss, and withstand the liquidity of this type of investment. But also those people who can analyze the documents that they get, understand what they are reading, and more importantly, understand what they are not seeing because those documents aren't subject to the disclosure rules in the securities laws and to see the gaps and have the wherewithal to be able to ask the right questions to fill in those gaps and have, in essence, the negotiating power or stature to be able to get answers to those questions. How do you get to that universe? I think it becomes very difficult. And there is at least one Congressional letter in the comment file on this rulemaking by the SEC that suggests all manner of people should qualify based upon their personal situations. For example, having an accounting degree, a finance degree, an economics degree, or working at the SEC was on that list. In which case, every SEC staffer would qualify. I think a lot of those obviously go much too far. There's nothing about having an undergraduate accounting degree that puts you in the position to withstand a total loss on a hedge fund investment, and as a twenty-two year old, you probably don't understand what you're looking at.

JAMES JALIL: It's great that you said that on the hedge fund side, in terms of marketing, the Private Placement Memorandum just begins the discussion. Sophisticated investors, particularly institutional investors, demand extensive due diligence from hedge funds. Believe me, you get one hundred page DBQ's, sit down meetings, analyst meetings, and multiple presentations. So the system, in that sense, on that side is working. Because those sophisticated investors know exactly what they're doing and know exactly the right questions to ask, and it's more and more difficult for a hedge fund to get a significant investment from an institution because of all the hoops it has to leap through to market themselves or explain exactly what's being done. So that's an interesting observation.

ROBERT GROHOWSKI: One thing we didn't cover today was that the JOBS Act also amended the Exchange Act, with respect to—if you were a private fund, you were limited to 499 investors before you become subject to the public reporting requirements. You can now have 1,999 investors.[16]

So, just one question for the folks here. We've been talking about the Securities Act. What about the benefit of ongoing disclosures that one does get from public deals where there is an ongoing requirement that you get information about the investment that you've made. And I haven't heard anyone discussing—and I don't just mean here—the fact that by expanding this the way that it has, there's nothing that's being done with respect to the continuous reporting that one would get if one was investing in a public company.

16. Jumpstart Our Business Startups Act (JOBS Act), Pub. L. 112-106 (H.R. 3606), § 501 (Apr. 5, 2012).

EMILY CHASAN: This is a really good point and I think a good question to wrap up on. What will this look like in five years in the general solicitation landscape, what questions will arise, and how will companies address those questions?

JAMES JALIL: You know, if you had asked me five years ago, where would we be today, I would have given a great answer that would have been totally wrong. So, I'm not sure what we will be five years from now. I think Buddy makes a very, very good point. The level of disclosure typically given in a hedge fund is significantly different than what they'd get from a public company on an ongoing basis. I think the trend is going to be, unless politics change, and it's very bipartisan, so I don't know how it's going to change, to open up investments to a greater range of people. And I think the balance right now for the next five years ethically, between fraud and capital formation, is going to be more in the way of capital formation and less fraud protection. I could be wrong. I was wrong five years ago, so I'm sure I will be now, but that's what I see.

ANDREW (BUDDY) DONOHUE: I unfortunately agree with that last sentiment, but here I will steal some of Mitch's thunder I think. Here's what I would guess. Based upon the mutual fund industry's history and what we saw and how it played out, I would guess that the hedge fund industry will adopt some sort of a voluntary code of conduct for the industry with respect to performance advertising that is being followed by some, but not all, players in the industry. And I would guess that the ones who are following it, then take a further step and are at least contemplating, if they haven't already, submitting a formal rule making petition to the SEC to formalize it. I think the industry will lead reform efforts, and in five years or so you will really see that the reform efforts are needed.

ROBERT GROHOWSKI: A couple things. I think the overlap between the registered funds and the private funds will grow larger. I think that the divide between registered advisers that handle only private funds and those that handle only registered funds will certainly narrow as we're seeing folks going into both worlds and managing money in both worlds. I think you're going to see a number of enforcement cases that will arise out of private funds' publicity efforts, because the SEC has been told to show greater scrutiny and so you're going to have a number of the divisions that are actually going to be out there trolling and it's going to be there for everyone to see. So, I do think that you're going to see those, and I am worried that, in fact, the bad apples may actually have an adverse impact on what might well be the right answer, which is to have some liberalization in that area.

MITCH ACKLES: The sky will not fall. I think that hedge funds will continue to come up with new creative ways to take advantage of this new liberalization. I believe that coming up with standards is a fantastic idea and I think it's something we've already discussed and started to work on.

One thing that I will say is fraud is going to happen. Regardless of what rules you give to any industry, to any segment of the economy, or to any financial instrument, at some point, somebody's going to commit fraud, someone will find a way. It will be different from the way that we've seen it, and that's just part of the course.

The other thing that I think that we need to understand is we need to look historically. The people that first required hedge funds to register were actually the institutions. If you wanted to manage pension money, you were registered well in advance of being required to do so, and I do believe that the investors are going to drive a lot of things and that the regulators are going to take a lot longer in developing. I think it's going to be up to the industry, in terms of the trade bodies and the groups that had influence over those regulations, to work with the lawmakers and work with the regulators to make sure that they do what is in the best interest of growth.

I also think we can look at history. The tendency of lawmakers and regulators tends to be off the mark. They overdo it, and then they have to pull it back. They have to take into account what occurs and what the real world implication is when it happens. And I think that this is no different. I think we're going to see those fraudulent cases being brought. We're going to have to learn from them, and we're going to have to address them. And that's why I believe that the HFA and others have always taken the stance that let's work with extra caution and extra care when it comes to these advertisements. I think I've had this conversation with a number of you before. I would rather not see performance information in hedge fund advertisements. I think you can easily do a great advertisement talking about your brand, the stature and caliber of your people, and your longevity in the financial marketplace. And once you know they're qualified and meet the criteria, then open the door to the dialogue and start to share the performance numbers and the details and explain what they mean. But I think in order for hedge funds to be able to do performance advertising, they absolutely need to come up with standards.

EMILY CHASAN: Great, well, super interesting panel, great discussion, thanks to everybody for participating. Thanks to Fordham Law for hosting.

PANEL II: CROWDFUNDING

CATHERINE CLIFFORD: Welcome. My name is Catherine Clifford. I'm a senior writer at Entrepreneur.com, where I cover social entrepreneurship and crowdfunding. I'm really excited to welcome you to this panel. We have some amazing experts here, so let's start with each of them introducing themselves very briefly.

KIM WALES: Good morning everyone. I'm Kim Wales. I'm the founder of Wales Capital and CrowdBureau. Wales Capital is a management consulting firm focused on the JOBS Act and how you implement all seven titles, and CrowdBureau is a ratings research business directory platform. Thank you for allowing me to be here today, and I look forward to engaging with you as we do this panel.

JOANNE RUTKOWSKI: I'm Joanne Rutkowski from the Securities and Exchange Commission. I work in the division of trading and markets, and we're part of the team that's working on the rule making to implement the crowdfunding provisions. Also, while I have you here. Let me give you the disclaimer. Nothing I say today necessarily reflects the views of the Commission, the Commissioners, or any of the Commission's staff. Thank you.

ALON HILLEL-TUCH: My name is Alon Hillel-Tuch. I'm one of the co-founders and the Chief Financial Officer of RocketHub. We're one of the largest and oldest crowdfunding platforms in the world. This is our fifth year, so in crowdfunding, we're about to get our canes. We've been working very closely with a variety of different people on the JOBS Act and equity crowdfunding. We've seen a lot of success within the perks based world, and we believe there is an opportunity to drive the democratization of access to capital within equity crowdfunding. I'm so happy to be here, and I am looking forward to questions.

DOUGLAS ELLENOFF: My name's Doug Ellenoff. I'm a partner of a New York-based law firm of Ellenoff, Gross & Schole. We're a general practice. We specialize in securities law. We are one of the top IPO law firms in the country. We represent nearly sixty public companies, and we've spent the last twenty years building out alternative means of financing, including lots of acronyms like SPACs, PIPEs, and RDs. And in the crowdfunding space, we've spent the last two years working with most of the people on the panel to fashion the proposed rules, and we have had over one hundred crowdfunding engagements in the last two years and represent over fifty international and domestic crowdfunding sites.

CATHERINE CLIFFORD: We were talking before the panel started and decided that we really want to make sure that this is a conversation that engages the audience. So, to get started, Kim can you just give us a brief overview of equity crowdfunding and how it's different from donation-based crowdfunding?

KIM WALES: Sure. I'm going to provide you with a good background in terms of crowdfunding in general, because the term is extremely broad. The last panel talked a lot about general solicitation and advertising, and thinking through some of that discussion, you would only think that applies to hedge funds. But really it applies to a lot of what's going on in the market today. Crowdfunding, through general solicitation and advertising, can occur and is occurring on funding platforms as we speak. If you look at sites like Wefund, SeedInvest, Offerboard, and others, you can actually do some crowdfunding today. So, we'll talk more about that as we go through this.

As I was saying, crowdfunding, the term really describes a method of how one can go on the Internet to raise money. Several years have passed since crowdfunding actually started here in the U.S. The Statue of Liberty was actually crowdfunded. But we kind of evolved that model so what was not allowed through crowdfunding would go into rewards and donation-based crowdfunding. What was not allowed was securities based crowdfunding. And so endeavors like film and music records typically allowing small amounts of money to be raised by larger amounts of people is really what crowdfunding is all about.

While crowdfunding can be used to raise funds for many things, it generally has not been used as a means to offer and sell securities. And that's because offering and sharing securities and selling shares of your company generally triggers an activity you have to report to the SEC. Generally, selling securities through crowdfunding was not allowable prior to the signing of the JOBS Act in 2012. Congress actually created an exemption that would permit securities based crowdfunding when it passed the JOBS Act in 2012, and among other things, it was intended to alleviate the funding gap and to create jobs for this unfortunate recession that we've been in.

Title III is what we're going to talk a lot about today. Title II is what was talked about during Panel One. Title III established a foundation for regulatory structure that would permit entities to use crowdfunding as directed by the SEC. The JOBS Act will allow funding portals, recall the registered funding portals and intermediaries, which do not have to register as broker deals, but they do have to register with FINRA to allow individuals to go online to raise money.

CATHERINE CLIFFORD: Alon, do you want to help us understand the role of portals in equity crowdfunding?

ALON HILLEL-TUCH: Yeah, that's actually a heavy, weighted question. So the interpretation of what a portal is, is inconsistent right now across the board. FINRA looks at it one way. I know the Commission looks at it another way, and then the industry looks at it a way completely different.

So, I want to speak within the context of what RocketHub does and how that's going to apply to what we do in the future. So what happens right now is an individual or a group can come to our site, register, set up a goal of what they're trying to accomplish, how much funds they need, and perks or rewards they are able to give in return.

What we do as a platform is ensure it's legal and in good taste with minimum liability. It's purely just a gut check. So what does that really mean? It means that we're actually the bulletin board and the pin, but the project is actually the notes, right? So when you look at it within that framework—what happens with an equity crowdfunding—it should transfer across quite nicely. The role of the portal again should be the bulletin board and the pin. We're not the note, we're not the person reading the note. We cannot be the person reading the note. Our platform moves over six hundred new projects per day. Imagine someone reading through every single project. That's not doable.

Looking at the JOBS Act, what is its implication? Well, they said: "Gee, perks based crowdfunding works. Obviously people are using it. We're raising millions of dollars, and as a market we've done billions. Let's allow this to actually happen within the equity world." But then if you take a step back and you look at it, and ask well why is this even happening? I think if you look at it from a realistic perspective, you can actually realize that people are already doing group based equity funding. It's happening. It's not regulated. You know, Joe's Coffee might get money from Uncle Jim, his mom, his dad, and so forth, and he actually does a round of funding. That happens right now and that's an isolated event. A lot of people are raising funds in a manner that's actually not legal.

So what we're looking at here is, we were talking about it earlier, a huge water main that's kind of broken. The flow of water is everywhere and we actually have no idea what is going on. The JOBS Act actually allows us to finally create a framework that gives it some structure.

Lawyers should actually be happy about this. Usually, they come in and say how dare you, the world is going to end, and it's a nightmare. But if you actually look at it from an implementation perspective, suddenly it becomes: "Hey, we might not be able to capture everything fully, but at least we're going to get a sense of things." And getting a sense of things is more important than anything else.

So the role then of a portal is very, very different from a broker-dealer. The portal helps direct that flow, provides the tools that the entrepreneur needs, and it's not going to always be the next Facebook. Do you know how many Facebooks there are? There's one. Do you know how many small businesses there are? There are thousands. If you actually look at job creation, I know everybody likes to say small businesses drive jobs. It's actually young businesses that drive jobs. New businesses that drive jobs. And if you look at them, they're the ones who actually need the tools and mechanisms to actually do this. So the world of portals is giving them the equipment, the tools to do it themselves. A low cost, secure, compliant, and protected way that they can interact with investors that they were never able to do before.

DOUGLAS ELLENOFF: Just to add a little clarification to what Alon was saying about Joe's Coffee. I don't think there was anything wrong about Uncle Jim putting money in. There's been a friends and family exemption in the federal securities laws and state securities laws from the beginning. But the broad observation he's making is that if, and I will use just general numbers, venture capital in this county, which is not typically what we're talking about in Title III, is about twenty five billion dollars in annual funding. Then, there are angel investor networks across this country that put out a similar amount of money. Friends and family put out more than both of those groups every year, and they do it pursuant to friends and family exemptions. Whether or not it's pursuant to a Reg D offering or a 4(a)(2) offering, friends and family support local domestic businesses across this country.

As Alon said, what we have in the JOBS Act—it's amusing to me as a securities lawyer that it's controversial—is we are going to centralize through a regulated entity, by both the SEC and FINRA, pursuant to standardized disclosure and rules, the way this money is going to be invested going forward. So it is actually auditable. The amount of money that individuals can invest is capped, scaled to the amount of money they make or their net worth. So the lowest amount of money people can invest is $2,000 regardless. If you make between $40,000 and $100,000, you can invest five percent, and above $100,000, you can invest ten percent. There's an overall cap as well. The maximum that you can raise in a Title III crowdfunding is one million dollars. Add in the reality that Alon's talking about since there is friends and family financing going on in this country every single day.

This fundraising is going on without the magnitude of fraud that is often referenced, in my judgment, and we have conversations with state regulators and the SEC. It's not to say that fraud doesn't exist. Everybody fully recognizes that it exists. But I do believe that when you take it from an offline coffee shop, cocktail party, or barbecue and put it through a centralized funding platform, that it's going to be better, because fraud is a term that's not just stealing money. It's whether or not people are getting the proper communications. It's going to be done better in this new world.

So I think that's why all of us are a fan of Title III. What I would go on to say, because it's often misunderstood, is that the role of the SEC here has been very productive. They have spent two years working extremely hard to create a viable new industry and a better way of doing things than have been done before. That's not to say that there aren't certain things that we'd like to see change, but overall my hat is off to Joanne and the rest of the folks at the SEC. They've done an outstanding job as far as I'm concerned.

JOANNE RUTKOWSKI: Thank you. You know, I was thinking about this, and someone on the earlier panel said that going forward in the next few years, there probably will be a tilt towards capital formation. But the JOBS Act and what we have to do with crowdfunding puts us squarely in the crosshairs of capital formation and investor protection. As Buddy said, there's a tension there, and it's just something that you have to work within. You're never going to resolve it. So, one of the challenges in the rulemaking has been that Congress had a pretty detailed framework, and trying to get those pieces to work and to move, so that this industry moves forward.

I could talk about specifics of the rules, but just generally, we got the rule proposal out last fall. The comment period closed last month. As of Thursday, we had 279 comments. We're working through them and really the Chairman does have a priority, the industry. This industry doesn't go forward until the Commission adopts rules. Even at a very high level, Congressman McHenry identified some of the key issues on the issuer side. There are rules for issuers and this whole question about audited financials, for offerings of $500,000 or more. I've gotten a lot of criticism just saying that's unworkable and simply too costly. The second issue is the overall limit, the one million dollar limit on offerings. And that one, I think, we probably have even less flexibility because Congress pretty much hemmed us in saying one million dollars, but you can adjust for inflation.

I'm in trading and markets and we're more worried about the intermediaries. The big issue, which the Congressman identified, is this question about funding portals. And, as Alon said, what is their proper role? Congress said that funding portals can't provide investment advice, but at the same time, they put into place a provision very similar to 12(a)(2) of the Securities Act—they imposed liability on issuers for material misstatements and omissions.[17] And if you read the definition of issuer, it seems to capture intermediaries including funding portals. So, they're sort of caught. Damned if you do, damned if you don't. We tried to help with the safe harbor that would define certain activities in which they could engage without tripping into this impermissible investment advice. I think we got pretty much there, but the Commissioners pointed out, there's some problems, there's some disconnects in what we put out.

So, the first problem is that you can apply objective criteria to say who's on or who's off your platform. In the next breath though, we say, you can't knock someone out based on the advisability of investing in that issuer or offering. Then, we sort of come back around and say, "but if you think there's a potential for fraud or an investor protection concern, you must keep them off." So, one of the challenges as we go to adoption will be to try to resolve and provide some clarity here.

The liability provision, I know, is an occasion to a lot of concern. It is what it is. It's a private right of action.[18] We did try to provide some guidance in the release about having reasonable policies and procedures reasonably designed to ensure compliance. For instance, if you review the materials before they go on the website. And then, we independently require that you have to have a reasonable basis for believing that the issuer's in compliance.

The third issue is that the statute basically says that senior folks in an intermediary can't have a financial interest in the issuer or the offering. And a number of commenters have pointed out that this may create a practical problem to the extent these are small businesses, they are startups, they may be cash strapped. The only way an intermediary may get its payment for services may be to take an interest in the issuer

17. Securities Act of 1933, Pub. L. 112-106, § 4A(c) (2012).
18. *Id.*

or the offering. They used to say that disclosure can cure all conflicts and if the intermediary invests on the same terms and conditions as other investors, that should meet most of the concerns. So I can't tell you where we're going to end up. We're working very hard and we are very sensitive to the need to try to make this work. Thank you.

DOUGLAS ELLENOFF: I already said nice things and if I was a regulator, I would have come out the same way. I don't interpret the provisions of Title III to capture liability for the funding platform. The construct of the statute makes clear that it's the issuers responsibility. They happen to add a clever phrase for those in the offer and sale of securities, which is being interpreted to capture the funding platform. But had Congress intended for the platform to have that liability, in the section for portal responsibilities, it would have said expressly just that. So that's kind of the industry's point of view on page 280.[19] And, by the way, had the SEC really believed that their interpretation was correct, they wouldn't have added the sentence on page 280, which expressly gives the funding platform that liability. Whereas I don't think the statute had it.

ALON HILLEL-TUCH: I mean it requests for comments from page 129 through page 134. It's a big document, so you can look it up. I actually have their sentence. You ready? So, "it appears likely that intermediaries, including funding portals, would be considered issuers for the purposes of . . . liability" under Section 4A(c).[20] So, when you look at it like that, it's basically the same as holding the Securities Exchange liable for fraud committed by an issuer listed on the exchange. Does that make sense?

JOANNE RUTKOWSKI: As I said, there was some challenges in the legislation.

ALON HILLEL-TUCH: So one thing that's important to keep in mind here is that the SEC is taking the brunt of this, but they're actually mandated by the way the JOBS Act is written. If you are a group that is being told to do something a certain way, maybe we should also look at how the JOBS Act itself was written. And you may not agree. You probably, actually do. Not everybody in the industry agrees, because a lot of the newer portals are running out of money. We're okay, but some

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19. Crowdfunding Rules, Securities and Exchange Commission Release Nos. 33-9470; 34-70741 (Oct. 23, 2013), http://www.sec.gov/rules/proposed/2013/33-9470.pdf (referencing page 280 of the document).

20. *Id.*

of the other guys are saying, "can you please get this going because this is our business plan, this is our model."

Don't rush it. Really. Let's look at the JOBS Act itself. Let's look at doing it right the first time because what happens when you don't do it right the first time is it's going to take much, much, much longer to fix it. So, we should revisit the issues that they're having. They're saying we understand the issues, we get it, but we can't do anything about it. So, let's give them the ability to actually do something.

DOUGLAS ELLENOFF: But this also comes up, and then I will let Kim jump back in, in a broader context. It's not just a U.S. crowdfunding movement. The Ontario Securities Commission came out with their recent rules, and there's no funding liability for the platform, there's no audit requirement, and there's full curation for the funding platforms of the deals that are allowed on their site. There are international movements in Australia, England, France, recently in Italy, and traveling to Southeast Asia shortly. It's worldwide. Not to mention, there are state initiatives that are in conflict to the federal approach called intrastate crowdfunding. Kim, do you want to touch on that a bit?

KIM WALES: Sure, so there are currently ten or eleven different states that have actually implemented intrastate crowdfunding. Some of the regulations for those states are similar to what's going on at the federal level, but they are mandated by their state. So, what does that mean? You have to be a business that resides in that state. You have to be an investor that resides in that state, and you have to follow all the laws that are put forward by that state. What we are finding is that some of the rules are a lot more flexible than what's being put out by the rule making process in Washington for the federal level. We're hopeful that this will bridge the gap because we're still waiting for the final rule making process to be completed. Some of the states include Washington, Kansas, Georgia, Wisconsin, Missouri, and Texas is thinking about it. I know New Jersey went on the record to consider this, maybe New York is following behind soon—we can only hope. So, there is an opportunity to do crowdfunding at numerous levels, not just at the federal level, which is not live yet in terms of Title III.

JOANNE RUTKOWSKI: Could I ask a question of the practitioners? What do you think are the real challenges for funding portals as a business model? I mean can you exist on your own? Are you going to have to enter an alliance or even an affiliation with a registered broker-dealer?

ALON HILLEL-TUCH: Portals are going to be different about this. There is not going to be any specific clear-cut way of doing it. We really hope that we do not have to partner with a broker-dealer. Our business model is not around investment advice. We don't want to start giving investment advice. A lot of the functionality that broker-dealers have is great, but at this early stage in the market, I don't want to make things too complicated. It just doesn't make sense to me. What we've been doing in the industry so far has been very, very simple and focused on the projects now and the future of the issuers. So, we hope we don't have to partner with a broker-dealer. We might have to partner with a broker-dealer, because of the liabilities, if we can't get the actual Act changed. But that's going to make things a lot more expensive.

We charge four percent right now on funds raised for perks. So, if you raised $100,000, that's $4,000 after you have made the raise. But, what's happening here is you might potentially—let's say you're offering target is over $500,000– have to pay for an audit up front. You have to do Form C up front. You have to get an EDGAR Code up front. But I'm pretty sure you guys know that not all companies raise funds, right? It's not new information. So, we're actually really concerned about the upfront costs.

With a broker-dealer involved, there might be some mitigation on it, but the cost of the broker-dealer is pretty high. We really don't want to see this market go over ten percent in overhead costs. We also don't want to see this market go to upfront costs. If there is too much of an upfront cost, the small business cannot afford it. If you're a new small business and you have to sink ten, twenty, thirty, forty thousand dollars, that could be a problem. That could be a serious problem because your chance of raising the funds is not one hundred percent. It's not even fifty percent. It's not even twenty percent. So, you have to keep that in mind from a cost benefit perspective. It doesn't shake out yet, but I think we'll get there eventually.

KIM WALES: Well, just following on what you're saying, Alon, in terms of the funding portals. I believe that we really should think of the fee structure, because currently, like you just mentioned, it's an all or nothing raise. If the funding platform has to wait until the end of the raise to actually get the revenue, well, I don't know how many funding platforms are going to be able to sustain themselves for all the offerings. If you say you average about six hundred new listings per day, how many do you think would go on as an equity or debt-based crowdfunding opportunity and actually raise the fully fundable amount?

ALON HILLEL-TUCH: It's interesting. I just did a hearing in Congress at the Financial Services Committee a few weeks back, talking about international competitiveness. It was discussed in a previous panel, and one of the questions was will small businesses use this? The Wall Street Journal did a piece on us and some of our small businesses. We have a lot of them. For example, there was this guy out of El Paso, Texas. He has a shoe company, and he raised $42,000 the first time on our site. He raised $500,000 the second time, and he just closed a $10,000,000 venture route. They asked him, "will you do equity based crowdfunding?" He said, "as it is right now, no way." And I said, "why?" He said, "I cannot afford to risk all of the audit. I cannot afford the risks that are involved with this. It just doesn't make sense for me to bear that risk. Let them come to me." Now, what's important about that, is that's a high quality investment. So, some of these are going to get a return. Not all of them. Most of them are not actually in my opinion. We could talk about liquidity at some point. That's a very interesting conversation that never comes up really for some reason. But this is a high quality investment. It typically gets venture capital, or even seed funding. And they're saying no, we don't need to. And those are the exact type of offerings you actually want to have on the platform. So, you have to kind of figure that one out.

JOANNE RUTKOWSKI: That's where I would get concerned about the longevity of a funding platform being able to sustain itself. If they are not getting fees upfront from these issuers, unless they're fully capitalized going into creating a funding platform, the lifeline of the portal is going to be short-lived. I think the other part to a funding portal, and I actually wrote about this in one of the comment letters, is if you look at the parallel offerings, we were really about that. But when you start to read the fine print, it says that a funding platform has to do both. You have to be able to raise the 506(c) on the same funding platform as you were doing the Title III offering. That becomes an issue because most of the funding platforms may not be partnered with a broker-dealer, or may not be a broker-dealer at all. So, what is the likelihood of having a parallel offering if you have to use the same intermediary to do both transactions?

CATHERINE CLIFFORD: I think there's two different perceptions from the ten thousand foot view; both that equity crowdfunding is going to completely open up the finance market and provide access to capital for so many more businesses, or that this is going to be opening up so much fraud. I feel like there's either the fear or the feeling that this is going to be a complete panacea for the market. Could you guys talk about how this is actually going to impact small businesses when the rules are finally written? What do you think this is actually going to mean for small businesses?

KIM WALES: I will start. I think that this is a wonderful opportunity for small businesses. It's a phenomenon. It is a movement, and we could not have asked for a better gift to some degree. So, I will start there. The second thing I'd like to say is that, in terms of fraud, if we just go to Australia where the oldest platform exists – ASSOB, the Australian Small Scale Offering Board, which has been in business for eight years – they have actually registered zero complaints of fraud. If we go to places like England, who have also been raising capital, I think for almost three years now, they have zero instances of fraud. And why is that? Well, because we're turning over a lot of the due diligence to the crowd.

So, it's not that fraud is not starting. It's that if you place an offering on a platform, and because it's now an open network, if something doesn't look right or feel right, I'm actually on that funding platform asking questions to the crowd. I'm saying, I saw this thing someplace else, maybe someone stole someone else's idea. Before you know it, within a very short period of time, the offering is shut down. And so, that's how we're minimizing the issue of fraud. At least that is the case today, in the rewards and donation based crowdfunding. I believe the same thing will proliferate when we go to equity and debt based crowdfunding.

ALON HILLEL-TUCH: Yeah, I mean Mitch talked about this in the previous panel. Sunshine is the best disinfectant. It's a great quote. And you go eighty years back, how did offerings happen? What information did you have available as an investor? It's not the same now, eighty years later. There's a few things that arrived—the Internet is one of them. Color television is another, you know, radio's been around for a while, access to information is very, very different. The amount that you can see as an individual from your home and from your computer is unimaginable to somebody in the '30s. It's incredible.

So, when you look at offerings, does fraud happen? Yes. It does. People try to commit fraud on our platform every single day. I'm not going to deny that. Do they succeed? No. No one has. Why? Because it's so social. Kim talked about that. It's such a social kind of mechanism. It doesn't work that way. What do you look at on Amazon when you browse for a product? You look at the reviews. The more reviews for a product, the more likely you are to spend on it, even if it's five dollars more than the product that has no reviews. That's because you're socially inclined to see that validation. When you look at topics in the news, you like to look at trending topics, hot topics. Why? Because that's what other people are interested in. There must be a reason for that.

The same thing is going to happen within crowdfunding. It already does. It's like the high school dance. You have girls on one side, boys on the other, and music is playing and nobody's dancing. But then somebody starts dancing. If it's the high school quarterback, everybody else shows up, obviously. But if it's someone else, maybe some people start joining in, maybe some of the cliques show up, and eventually you notice everyone is dancing. But someone had to start it, and that person had to have social capital. What do fraudsters lack? It's that. You know, fraudsters don't have friends and family that support them. By definition, they lack that. So what we've noticed is when a project goes live on RocketHub right now and starts getting a lot of funds from people with no social media activity, it raises a red flag within our fraud detection engine, and we actually are able to close projects purely based on social trends.

DOUGLAS ELLENOFF: In Title III, you have a fraud check responsibility as a portal.[21] It's statutorily required, unlike private placements generally speaking, unless it goes through a broker-dealer. The great thing to observe over the last couple of years is, in our firm, when we do a fraud check or litigation search on the FINRA site it has cost us a lot of money over the years. There are people who are coming up with simple technology based solutions for determining whether or not people have a bad actor background. The cost of a lot of the expenses in Title III will be driven down over time. There are entrepreneurs, across the country and across the globe who are coming up with new ways of doing things. That's number one.

Number two, if there's one area where I think the SEC just did a really terrific job in the proposed rules is the social media aspect. It is all centralized. If you want to conduct a campaign, all social media has to go through that site, and everybody gets to see everybody else's comments. And unlike with friends and family where the entrepreneur gets to segment who they're telling what to, here it's all in full and fair view for everybody. So, that's the other thing that I think is terrific.

21. 15 U.S.C. § 77d-1(a)(5).

JOANNE RUTKOWSKI: I think you are highlighting an important role of the gatekeeper. The intermediary—whether it's a registered broker-dealer or a funding portal—has a significant and substantive role here. As a regulator, I will tell you what worries me. I was at a conference last summer and they were talking about how, between general solicitation and crowdfunding, there is about trillions in untapped capital in self-directed IRAs. You don't sleep well at night. You just worry about this. As an area in which there are start-ups, there is going to be a high failure rate. It's not a mirage, just the reality.

DOUGLAS ELLENOFF: The counterpoint is it's not all going to be start-ups. It's going to be a lot of community-based businesses that have been around for ten, fifteen years that are looking to raise debt capital. We believe that debt like Prosper Lending Club, which are registered securities unlike what we're talking about here, are four times what the equity markets are. I think when you're not talking about venture profile deals, but about deals where you have to show some self-liquidation of the securities, it's going to be loans by and large for the smaller businesses. The start-ups are probably going to need more equity.

CATHERINE CLIFFORD: Unfortunately, I think we're out of time. So I think we should thank our panel. They were really informative.

KEYNOTE ADDRESS

SEAN GRIFFITH: We're truly honored to have former SEC Commissioner Troy Paredes with us today. He is a dynamic individual, who has uniquely served as a practitioner, regulator, and academic. Former Commissioner Paredes' rich background allows him to appreciate the complexity of securities regulation from the various stakeholders' perspectives.

Former Commissioner Paredes recently completed his term as Commissioner of the United States Securities and Exchange Commission. In this role, he was pivotal in restructuring the financial markets. His term began just as the world was enveloped by the 2008 financial crisis, and he oversaw the implementation of most of the JOBS Act, as well as advancing numerous Dodd-Frank rulings.

In addition to his government service, former Commissioner Paredes was a professor of law at Washington University in St. Louis, with a secondary appointment as a professor of business by courtesy, and has also been a visiting professor of law at UCLA and Georgetown. Former Commissioner Paredes has written the Securities Regulation Treatise, the seminal piece of scholarship on the subject, in addition to numerous academic articles.

Prior to working in academia, former Commissioner Paredes worked in private practice where his practice focused on finance, mergers and acquisitions, and corporate governance. Former Commissioner Paredes is a graduate of UC Berkeley with a Bachelor's Degree in economics and of Yale Law School. Currently, he serves as a consultant, expert, and speaker, and without further ado, it is my pleasure to welcome former Commissioner Troy Paredes.

TROY PAREDES: Thanks very much. Thanks for the invitation to be here. I've now had the chance to be at Fordham Law on four or five different occasions for conferences, as well as on two occasions, if not three occasions, judging competitions. It's always great to have a chance to be back for all the great events that the law school puts on.

Let me start with a little bit of a disclaimer. I no longer have to give my standard traditional disclaimer that I had the privilege and honor to give for five years when I was at the Commission, but I've recently joined PricewaterhouseCoopers as a consultant, so it's important for me, from time-to-time, to remind folks that the views I'm sharing with you today are my own personal views that are not necessarily those of PwC or any of PwC's clients.

The conversation was great. I had a chance to listen to a number of the panelists. Given all the detail that the panels got into, I figured what I would do is try to stay away from some of the details and instead speak a little more generally, particularly from the perspective of one who, as was noted by the very generous introduction, had the chance to be at the SEC when the Commission was trying to implement the JOBS Act, and many other things, including the Dodd-Frank Act. So I'm going to try to give you a sense as to my take, bigger picture, on the JOBS Act. I'm going to focus particularly, by way of illustration, on the decision to lift the ban on general solicitation or 506(c), but one could draw some parallels to what is going on in the crowdfunding space.

I also would like to just take a moment to recognize the hard work of Congressman McHenry who was certainly instrumental. I know he spoke earlier this morning. He was instrumental in pushing forward the JOBS Act, so his leadership was key. And I myself, just to note, am a supporter of the JOBS Act, so by way of full disclosure I will get that out in the open at the outset.

I had, as I mentioned, the true privilege and honor to be a Commissioner at the SEC for five years, having stepped down in August of this past year. And so, as I said, I'll give you that perspective. What I wanted to share is what I usually refer to these days as the practice of regulating, or what I call the art and science of regulating and policymaking, because it is not so easy to sit back and try to figure out what the rules of the road ought to be.

Buddy Donahue is sitting in the front row, and Buddy and I have gotten to be good friends over the years of working together at the Commission and staying in close contact. So he knows from his first hand experience the difficulties of trying to make the kinds of judgments, even when you have direction from Congress, as to what you're supposed to be striving for. There are so many particular decisions that policymakers, whether they're the Commissioners, the staff, or others, need to make and it's not an easy task.

At the end of the day though, for me, it's all about balance, which is a pretty simple way of thinking about it. But what do I mean by that? So, the way I usually try to express the point is by considering all of my votes while I was at the Commission, and there were an untold number of votes. I voted yes on a lot of things. It turns out I voted no from time to time as well on various rulemakings. But when I think about the virtue, if you will, of that balance and policymaking, I always remind myself that every time I voted yes, there were good arguments to have voted the other way. It's also the case that every time I voted no, in particular when that ended up meaning that I was in the minority on a 3-2 vote, or from time-to-time perhaps even on a 4-1 vote, there were frankly very good reasons to vote yes. My yeses weren't without arguments in favor of no and my no's weren't without arguments in favor of yes. And when I voted no, to put it a little more concretely, it meant that I had three colleagues, if not four colleagues, in effect by virtue of their yes votes saying Troy you're wrong. And I often had staff that was in effect saying we too think you're wrong. The point is to drive home the following: policymaking, as with, I suppose everything in life, is about choices. Any time you have choices, you have tradeoffs. And you are simply balancing the good and the bad, the pros against the cons, the cost against the benefits; and you're always doing it, whether you're a policymaker or quite frankly, whether you're in business or giving advice as a lawyer, accountant, or consultant. You're making those judgments, and realizing there are lots of different arguments all the way around an issue. You're making your decision, giving your advice, whatever it may be, with limited information and with time constraints, because at some point the question is called. You have to make a decision and you have limited information. And again, you can always identify the ways in which something can turn out well and the ways in which something can turn out poorly, but you don't get to make these judgments after the fact. You make these judgments before the fact. That's the hallmark characteristic of making a decision. And your effort, I think, in all of those respects, is to try to do the best you can and to spot the potential consequences while realizing what you know, what you don't know, how it could go well, and how it go poorly, and then try to trade off all the different consequences and make the call, whether it's to vote yes or no, make the acquisition or don't make the acquisition, or launch that new widget or don't launch it. All I just said is cost-benefit analysis matters.

For the academics in the room, some of you have probably been paying attention to the flurry of academic research over the last couple of months that is focusing on cost-benefit analysis, particularly on cost benefit analysis in the financial services space. It's an obvious enough point, but for those who follow the Commission and policymakers more generally, sometimes cost-benefit analysis isn't the thing that drives the decision-making. And yet it's so important to the process, and frankly, it needs to be.

Let me just note one other quick thing about cost-benefit analysis. When we think about cost-benefit analysis, most of the conversation is, as I just described it in brief: you're sitting here today trying to anticipate the potential consequences tomorrow, and then making your judgments as to what you ought to do. But there's another dimension to it, which is also getting some attention—the so-called retrospective review. The fact of the matter is, after you make a decision and you put into effect whatever the decision was, at some point you receive actual results and you have actual consequences. You flip from needing to anticipate consequences and make judgments with the imperfect information that you always have to actually having the benefit of actual experiences. And so you see a lot of calls these days for so-called retrospective reviews of regulation to try to figure out whether or not the benefits folks are trying to achieve materialize, and whether or not the costs are what folks thought they were going to be. Maybe the costs weren't as significant. Maybe they were more significant. Maybe they were just a different type.

If you look at the 506(c) rulemaking, which lifted a ban on general solicitation, it in effect has something that is sort of like a retrospective review. The plan is to continue to monitor what happens to the marketplace as the ban on general solicitation is lifted. That's incredibly empowering for policymakers because it allows them to have information inside the actual consequences, so that they can better refine the rule going forward. It also, of course, requires a major dose of humility because when you do a retrospective review, you have to be open to the idea that notwithstanding the best of intentions, you may have gotten it wrong. This is not about anybody operating in bad faith, it's just to say, as I said at the outset, you're making judgments with imperfect information. And sometimes with the benefit of hindsight, you wish you had done something different. That requires you being able and willing to recognize that perhaps we were the source of the unintended consequences and to step up to the plate and make changes to the regulatory regime when that's what's called for.

You're probably wondering what that has to do exactly with the purpose of this conference. Let me particularize what I just said to capital formation, to investor protection, and to the role of the SEC as the investor's advocate. Anybody who follows the SEC knows that there's a lot of conversation about capital formation, a lot of conversation about investor protection, and a lot of conversation about the SEC as the investor's advocate, particularly in a context of the JOBS Act.

So something has struck me in thinking about the JOBS Act and in having to make some of the judgments around what the regulatory regime ought to look like. Broadly speaking, there is often this tension that gets posed between capital formation on the one hand and investor protection on the other. And it's often framed as you can have one or you can have the other, but you can't have both. So you need to choose. Are you going to advance the goal of investor protection or are you going to advance the goal of capital formation? And I don't subscribe to that either/or framing, whether it's done explicitly or it's done implicitly.

So what do I mean by that? I think about investor protection in broader terms than the way investor protection is often conceived. The way investor protection is often conceived is narrow insofar as there's a particular focus on protecting investors against fraud, manipulation, and other abuses. Without question, that is core to what the SEC does. The SEC as you all know, has a very substantial, committed enforcement division, as well as an Office of Compliance, Inspections, and Exams. So protecting investors against fraud, manipulation, and other abuses is central to the SEC's mission and key to the operation of our markets. But, what investors care about, it seems to me, is more than just being protected against things like fraud, manipulation, and other abuses. What investors, I think, fundamentally care about is the opportunity to earn a return and the opportunity to accumulate wealth. They want to have a chance to invest. And investment is necessarily going to correspond with some major risk.

Now, why do I think it's important to think about investor protection in these broader terms? Because all of a sudden you realize that, at least to some degree, facilitating capital formation itself actually furthers core investor goals as well. It's not about issuers versus investors, or capital formation versus investor protection. The core fundamental investor objectives are advanced when legitimate capital formation is furthered as well.

Why is that? Well, if you have more companies who are able to raise capital, then that has the occasion of expanding the array of investment opportunities that investors have for putting their money to work. It's not to say, as the panelists were remarking, that every decision in terms of how to invest is necessarily going to yield terrific returns and accumulations of wealth. Sometimes that's the case and sometimes that's not the case. But so long as investors have the information they need or an appreciation of the information they don't have, they comprise the risk of asymmetric information. Allowing investors to be able to make informed judgments across an array of investment opportunities is really the name of the game when it comes to the federal securities laws. And facilitating capital formation has the effect, the definition if you will, of expanding the array or pool of available investment opportunities, which then should allow for even more opportunities to accumulate wealth, earn returns, and back something that folks believe in.

So, enter the JOBS Act. And what we've seen with so many of the policy discussions, whether it's around lifting the ban on general solicitation or around allowing crowdfunding, is that they have the flavor of pulling back some of the regulatory demands in the name of capital formation, but at the expense of investor protection. And again, given my broader conception of investor protection, I don't think it's an either/or. I think actually allowing for crowdfunding and lifting the ban on general solicitation has the prospect of not only serving important objectives of issuers, enterprises, entrepreneurs, and innovators, but can also, for reasons I said before, advance investor pools by expanding the array of investment opportunities investors have for putting their money to work.

So given that perspective, I happened to be at the Commission when the Commission was putting into effect rulemaking to lift the ban on general solicitation. I supported it and voted yes, one of my yes votes, in favor of lifting the ban on general solicitation. But that same day, I had a no vote at the meeting. I voted no when it came to the numerous additional regulatory burdens that the Commission proposed when it came to 506(c) offerings. That rulemaking, a second rulemaking where I voted no, continues to be ongoing, and we'll see where the Commission ultimately lands.

So how did I put all this together when I was thinking about how I was going to vote on these rulemakings? This is where I think something very challenging for the SEC comes up. So, I'm going to focus on the ban on general solicitation by way of illustration. Let's assume that we have a pool of investors and for purposes of my stylized example here, we can just treat them all as retail investors of one type or another. Imagine the following: If you lift the ban on general solicitation, a lot of folks express concerns that allowing for the ready advertisement of these offerings will increase the rate of fraud. There will be more fraud. That's an empirical claim as to whether or not there will in fact be more fraud. Let's just go with that as a risk if you lift the ban on general solicitation. What that means is there's a greater risk of at least some investors being defrauded, who otherwise wouldn't be, if the ban on general solicitation were in place. I would also note, the point that's made by those who supported lifting the ban, that lifting the ban on general solicitation facilitates capital formation, it's good for issuers, employees, local communities, and all the stakeholders of any sort of commercial enterprise. But it could also have the effect, as I suggested, of expanding the array of investment opportunities for investors to put their money to work, which again, as I've said, advances core investor pools.

So what we could have here is a scenario where there could be a group of investors, let's call them investors in group A, who will benefit from those regulatory burdens or prohibitions in place on general solicitation. Why will they benefit? Well, they'll benefit because they're the ones who would be defrauded if the ban were lifted. On the other hand, there's a group of investors who, because the ban is in place or other regulatory requirements that make it harder to generally solicit, will be hurt. Why will they be hurt? Well, because they're the ones who had invested in these legitimate enterprises that would have had a more efficient opportunity for raising capital. We'll call those group B investors.

So group A investors benefit from the ban because it reduces the chance that they're going to be defrauded. Group B investors are getting a lot of restrictions on general solicitation and are hurt by the ban because they won't have the investment opportunities they would have otherwise been able to take advantage of with the ban lifted.

We could kind of do the math differently and think about it in terms of who benefits and who hurts if you lift the ban. There's symmetry there. Why do I think this is so important to point out? Well, I think this is important because in my example, we have, regardless of what the Commission does, a set of investors in group A, which is benefited, and a set of investors in group B, which is disadvantaged. Or, we can flip it and say, if you lift the ban, the investors in group A are hurt, and the investors in group B benefit.

What's the investor advocate supposed to do? That's the question. Because what you don't have, in that scenario, is an instance where investors benefit if the Commission does something and non-investors are harmed. For the investor advocate, you could see how that balance may play itself out focusing on the investor. But once you realize that regardless of what the Commission does, and this comes up time and time again, this is not specific to the JOBS Act, when you actually try to evaluate it, when the dust settles and all is said and done, who is better off and who is worse off? What you will see in many instances is some investors are better off and some investors are worse off. What's the investor advocate to do? That's a very fundamental question because if you say, "well we need to focus on investors in group A." My question back would be, "well why? What's the theory, what's the value set, what's the thinking, analytic or otherwise, that says when given a choice between benefitting investors in group A versus group B or vice versa, what breaks the tie?" You now are passing judgment on your view of group A versus group B, and yet, they may be very hard to distinguish.

What you will sometimes see at the Commission in various rulemakings or speeches is that they'll talk in terms of institutional investors versus retail investors. You can think about the SEC needing to particularly look out for retail investors because they might not be able to, in the *Ralston Purina* 4(a)(2) language, "fend for themselves."[22] But in my example, it's not that. It's retail versus retail. I think you see that in many instances. I think the JOBS Act is an exact illustration of that.

So what's the Commission supposed to do? I'm not going to answer that question, because I don't have the answer ready and I think you could have different answers, each of which would have integrity and legitimacy to it. But, the importance of pointing it out is to make sure that policymakers recognize what the consequences are and make an "eyes wide-open" judgment. If you make that recognition, it makes it a much more difficult question when it comes to figuring out what the right policy response is. This is not specific to securities regulations, and certainly not specific to the JOBS Act.

All I really wanted to show with my very simple illustration is classic questions of efficiency versus equity. Do we think about the size of the pie or the allocation of the pie? What's the role of distributional consequences when it comes to who has what piece of the pie? There are economists and philosophers and others who have spent a long time thinking about this very question. What is important is to not lose sight of the fact that these very questions lurk when it comes to federal securities laws. They are at play when it comes to the JOBS Act, capital formation, investor protection, and the tension that is there.

You could imagine the view being that we, as a matter of policy or a particular policymaker, could legitimately say, "look, I think my role is to maximize the size of the pie and not be concerned with trying to

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22. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (stating that "[a]n offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering'").

pick winners and losers in terms of who has what size of the pie." That's what a lot of folks who focus on efficiency say—size of the pie versus allocation of the pie. There are others who may take a quite different view, which is to say "I hear you, and I understand that view, but we shouldn't view a loss that somebody may incur as the same as a foregone gain. We as a policy matter should focus on protecting folks against loss, even if it comes at the expense of somebody else being able to earn a gain." There's legitimacy to that view too.

The challenge is, what's the investor advocate supposed to do when it comes to wrestling with these questions? Now, a couple of quick responses on that. One response is what I was saying earlier about retrospective review. I will just tease out the example that I think is not too far from what you would see happen in the JOBS Act space. But it'd be a lot better, I think, for all of us if we place some numbers in my example. So how many folks are actually in group A? How many folks are actually in group B? What really is not only the size of the pool, but also the magnitude of the loss? I think with the benefit of retrospective review and data, you're in a better position to make some of those judgments.

There's another quick point here: the federal securities laws at their core, particularly when it comes to raising capital, including the '33 Act, '34 Act, and other parts of federal securities laws, have a somewhat different flavor on this point. It's about empowering investors to make informed decisions. Disclosure yields higher quality, more informed investor judgments, and lets investors decide how to allocate their capital.

So we can talk about what ought to be disclosed and about other ways in which we can protect investors in the crowdfunding legislation. It just kind of makes you rethink how you're going to protect investors, which is not just about making sure they have information. And maybe some would argue, they don't have all the information they would need. That relates to some of the questions that have been kicked around crowdfunding. To basically cap how much investors can lose is a way to protect them. To say, you just can't lose more than X amount. You see that with crowdfunding. But there's another piece of all this—financial literacy and investor education. However, we sometimes get so focused on all of the other things. It's important for the Commission and others not to lose sight of the importance of financial literacy and investor education.

The best protection, it seems to me, for investors is not the after the fact cause of action that somebody may have, whether it's a private right of action or SEC enforcement, but when investors are empowered to not invest their money in the first instance and find themselves subject to the risk of fraud or manipulation. And yet, if you look at the releases that continue to come out of the SEC, you continually see investors being defrauded. One response to that, not the only response, is to make sure all of us are doing what we can to ensure that investors are empowered with the right tools. Some of that is knowing what to ask. But it's not just knowing what to ask in terms of the first question. It's knowing what to ask in terms of the second and third questions. It's having the confidence to press and to press harder, and to talk when it seems like it just can't be the case that it's this good.

And so, as we think about capital formation, investor protection, and about whether there is a tradeoff between the two, and as we think about the circumstances under which those goals are actually very consonant with one another, I think one thing that will help resolve whatever tension there is between the goals of capital formation and the goals of investor protection, particularly when it comes to the prospect of scaling back the regulatory requirements, is if we commit to making sure investors have the tools that they need to ask the right questions, to press, and to protect themselves at the outset through their own diligence, their own pressing, and their own judgments as they evaluate what the investment options are that they face.

So let me end there. I appreciate the invitation to be here. Thanks.