



GOVERNANCE • PRODUCTIVITY • STRATEGY

Massachusetts Securities Division
Attn: Crowdfunding Regulation
1 Ashburton Place, Room 1701
Boston, MA 02108

Dear Secretary Gavin:

We are deeply appreciative of this opportunity to provide comments on Code of Massachusetts Regulations at 950 C.M.R. 14.402(B)(13)(o) (the “Crowdfunding Exemption” or the “Exemption”); it is the responsibility of the private sector to inform policy to whatever practical extent in order to promote greater overall societal benefit. We further believe that these new regulations are of paramount importance to the Commonwealth’s ability to maintain a strong culture of entrepreneurship while providing some minimum guidance to establishing consumer protections that safeguard capital and the rights of residents throughout the Commonwealth and beyond. It is obviously no secret that after California’s Silicon Valley, when it comes to innovation--especially in technology and biosciences--the world looks to Boston and Cambridge for inspiration. Thus, we believe it is both proper and worthy of acknowledgement that the Commonwealth of Massachusetts emerge as a leader in creating practical crowdfunding regulations without reactively waiting for Congressional action from Washington, DC that has heretofore stalled.

Our firm, Continewity LLC, was founded by individuals who possess an average of fifteen years of professional experience as public accountants, internal auditors, management consultants and executives in finance, audit and general management. Collectively, we have performed over a thousand projects that have helped hundreds of organizations of all sizes to improve their performance via innovative approaches to risk management and profitability assessment via evidence-based analysis and cross-functional knowledge sharing. As Continewity’s founder and managing director, I have personally delivered solutions to organizations throughout New England with Boston Consulting Group, Forrester Research, Harvard Bioscience, Spire Solar and Semi-Conductors, and Molecular Insight (since acquired by Progenics) representing a few of my past clients located in Massachusetts. Our firm plans to open a Boston office this before the end of 2015, undoubtedly in large part due to Greater Boston’s uniquely vibrant innovation-driven local economy.

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While we have provided detailed comments in the enclosed appendix, I would like to briefly draw your attention to the overall themes:

1. Although legislative treatment may be relatively recent, there is nothing “new” about crowdfunding in the sense that innovators—***ethical or unethical***—have always sought to unitize investment vehicles via some form of intermediary;
2. Persistent issues of ***informational asymmetry*** (alternatively, *asymmetrical information*) will always inflate transaction costs within any market-driven mechanism, and therefore the best way to sustainably achieve low cost, efficient structures is to reduce the information gap as much as possible;
3. Lack of information on behalf of the investing public is the dominant reason for market inefficiency, so enhanced investment-related ***financial literacy*** should be considered.

Should there be any questions or comments with regard to our attached detailed comments, please do not hesitate to contact us. I personally welcome any queries within which my firm can be of further assistance.

Very truly yours,

A handwritten signature in black ink, appearing to read 'Ahmad', with a stylized flourish extending from the end.

Ahmad Abdul-Qadir, CPA, MBA

Managing Director

Detailed Comments

Where the original request for comments contains multiple questions within a paragraph or numbered question, we refer to it sequentially as X.1, X.2, etc. Where there is only one pertaining question or request for comment, we refer to it with a X.0.

Q#	Question Text	Continuity Response / Comment
1.1	Relationship to the Federal Intrastate Offering Exemption. The Crowdfunding Exemption is tied to the federal intra-state offering exemption under section 3(a)(11) of the Securities Act of 1933 and SEC Rule 147. That exemption is available for a security which is part of an issue offered and sold only to persons resident within a single state where the issuer of such security has been formed and is doing business in that state. It is anticipated that most crowdfunding issuers will wish to offer securities via the Internet. Does the federal requirement that offers and sales be made only to persons resident within a single state limit the usefulness of the Exemption?	Yes, we believe that the single state limit does indeed limit the Exemption's usefulness. Our professional perspective is that the intrastate exemption clauses stemming from Reg D are outdated and incapable of reflecting how technological advances have permanently altered how business is conducted and how capital is raised in the 21st century.
1.2	Should the Securities Division consider adopting alternative or additional regulations that would work with other federal rules that permit offerings not strictly limited to a single state (for example, Rule 504 of SEC Regulation D or SEC Regulation A)?	We do not believe that the alternatives mentioned offer net incremental benefits worth considering at this time.
2.0	<u>Alternatives to Single-State Offering Exemption.</u> Should the Securities Division consider adopting rules to facilitate offerings made in more than one state? If so, would regulatory <i>cooperation</i> and <i>coordination</i> among the states be desirable with respect to such offerings?	We believe that inter-state regulatory cooperation and coordination would be ideal, however the historical track record highlights reasons why that proposal is both problematic and unstable due to political forces, for which an adequate elaboration would extend beyond the scope of this comment letter.
3.1	<u>Limitation on Forms of Security: Equity or Debt.</u> The Exemption is limited to equity or debt securities. Should the Securities Division consider making the Exemption available for other forms of securities?	Yes, see response 3.2 below.

<p>3.2 If so, what other types of securities should be specified in the Crowdfunding Regulation? Will permitting the offer and sale of other forms of securities require issuers to provide special disclosures to investors in order to accurately disclose the characteristics of the investment?</p>	<p>We believe that hybrid securities with convertible properties are the most appropriate instrument for capital raised via crowdfunding. Such securities would take on the lower risk properties of debt at the outset of an investment project when the informational asymmetry is highest, and then be convertible at the sole discretion of the investor over time. In order to balance the time continuum along which the informational asymmetry gap between investor and issuer would normally be expected to narrow, we believe that this convertible option held by the investor would be the most effective security type available.</p>
<p>4.1 <u>Offering Amount Limit.</u> The Crowdfunding Exemption permits an issuer to offer and sell up to \$1,000,000 of securities in a 12-month period. (See Sec. 4 of the Exemption.) This limit increases to \$2,000,000 if the issuer has audited GAAP financial statements. The Securities Division requests comments on these offering size limits. If the offering limits were raised, would the Exemption, which applies only limited requirements to crowdfunding offerings, provide adequate protections for investors and local markets?</p>	<p>As with the monetary ceilings associated with Reg D exemptions (in particular, in the scope of Rules 504 and 505), any absolute dollar threshold is arbitrary and bears no correlation with the risk/return attributes of the ventures undertaken by the issuer raising capital. We therefore believe that a more useful framework, based on adjusted exposure subject to capitalization rules, would be the appropriate way to set limits over a rolling period, whether 12-months or other.</p> <p>[NOTE: We have developed models to formulate the exposure levels in such scenarios, but are unable to describe them in detail here due to the public accessibility of this comment letter.]</p>

<p>4.2 The Securities Division also seeks comments on the requirement for issuers to obtain audited statements in order to raise between \$1,000,000 and \$2,000,000. The Division solicits information about the costs and/or potential benefits of requiring that audited financial statements be included in a securities offering document.</p>	<p>While we believe the term ‘democratization’ is used excessively by media and pundits these days, it actually applies here as we have seen a technology-enabled trend since the 1980s that have continued to put more issuer-specific information into the hands of the average investor. Whereas an individual investor was obligated to rely on his/her broker for information in the 1980s, for example, we now see that anybody can access real-time information on mobile devices which has led to a dramatic shift of informational power, such that the term <i>democratization</i> rings quite true. With the emphasis on real-time data, we question the value of audited financial statements, and especially question their utility to an unsophisticated individual investor. What value do annual audits or even quarterly unaudited reports contain for an individual whose subjective opinions of his/her investment's intrinsic value changes daily?</p>
<p>5.1 <u>Investment Limitations.</u> Under Sec. 5 of the Crowdfunding Exemption, most investors may invest up to the greater of \$2,000 or 5% of income or net worth. The percentage investment limit is higher for investors with higher incomes or net worths. The limitation included in the Exemption substantially resembles the limit included in the SEC’s proposed regulations for the federal crowdfunding exemption. Is this investment limit an effective way to control the risk of an investor over-investing in a crowdfunding offering? Should the limit be higher or lower?</p>	<p>We believe there should be a sliding scale that is based on an investor's total adjusted exposure, with factors to adjust such exposure being based largely on situational and individual attributes, including investment experience and knowledge, stated risk and return objectives, and specific understanding of the issue being funded.</p>
<p>5.2 The Exemption will be lost if the issuer sells securities to any investor in excess of the investment limitations. Should the issuer be permitted to meet this standard based on a good faith reasonable belief about the purchaser’s income and/or net worth?</p>	<p>No. "Good faith" efforts are troublesome, and will empower attorneys to build both suits for plaintiffs and elaborate defenses for defendant issuers.</p>

<p>5.3 If the issuer can meet the requirement based on good faith reasonable belief, should the issuer be required to take reasonable steps to verify the income and/or net worth of purchasers?</p>	<p>N/C</p>
<p>5.4 Unlike the SEC's proposed crowdfunding rule, the Crowdfunding Exemption does not attempt to limit the amount an investor may invest in crowdfunding offerings as a category. Should the Securities Division consider adding a limit that would apply to investors' investments in crowdfunding offerings as a category?</p>	<p>N/C</p>
<p>6.0 <u>Excluded Types of Issuers.</u> Under sec. 6, the Exemption is not available to: blank check/blind pool offerings; investment companies; hedge funds or similar investment vehicles; '34 Act reporting companies; companies engage in oil, mining, or other extractive industries. The Securities Division solicits comments on these limitations.</p>	<p>While the proposed categories mentioned are certainly target-rich areas for fraud and deceptive manipulation of facts and figures to induce investment, they are not the only such categories. We should remember the origin of the term "blue sky" which would illustrate how outlandish unscrupulous investment scheme promoters have been and will continue to be in the future. We do not believe that any fixed list of categories will effectively prevent fraudulent issues, so we question whether attempting to separate the proposed categories mentioned is worthwhile, much less judicious.</p>
<p>7.1 <u>Minimum Offering Amount requirement.</u> Sec. 8 of the Crowdfunding Exemption requires the issuer to establish a minimum offering amount that is needed to accomplish the business plan. The minimum offering amount shall be not less than 30% of the maximum offering amount. The Securities Division requests comments on all aspects of this requirement, including the 30% standard for a minimum offering amount.</p>	<p>N/C</p>

8.0 Escrow of Funds until Minimum Offering Amount is Reached. Pursuant to Sec. 9 of the Crowdfunding Exemption, funds raised in a crowdfunding offering must be placed in an escrow account at an insured bank until the minimum offering amount is reached. The Securities Division requests comments on the practicability of this escrow requirement. Should the Securities Division consider any alternatives to requiring that escrowed funds be held in an insured bank account?

Promoters and other actors behind scam/scam financial schemes have mastered all forms of creatively circumventing regulatory barriers. In the extreme, this could occur for an issuer that had a high willingness to raise funds and was less sensitive to the total cost associated with such fundraising efforts. It could also happen at any other point along the spectrum of \$0 raised up until \$1,000,000 as currently proposed. We will briefly illustrate how simple it would be to establish a deceptive scheme to clear the arbitrary 30% minimum capital hurdle:

1. Financial scammer approaches issuer (or issuer initiates contact) promising that she can deliver the minimum level of capital required to exceed the crowdfunding threshold in order to shorten the duration such funds would be held in escrow;
2. Subsequent to agreement with issuer, financial scammer offers straw investors a guaranteed return on an arbitrary average investment amount; for simplicity, let's say that a total of 40 such investors agree to lend \$7,500 each for a total of \$300,000 in proceeds;
3. \$300,000 goes into third party escrow; issuer has unencumbered access to the next marginal dollar raised;
4. Financial scammer returns principal plus agreed upon finance charge (most likely paid by issuer indirectly to scammer to avoid an audit trail) to each straw investor;

Such a scheme could be modified to be either Ponzi-type or plain vanilla as described above; effectively creating a swap intended to bypass regulation. In doing so, the issuer has effectively converted an all-or-nothing funding scheme into a keep-what-you-earn scheme.

9.0 Bad Actor Disqualification. The disqualification language in Sec. 10 of the Exemption is modeled on the bad actor disqualification under Rule 506 of SEC Regulation D. The Securities Division requests comments on this provision.

N/C

	<p><u>Required Disclosures.</u> Under Sec. 11 of the Crowdfunding Exemption, issuers are required to provide certain disclosures. The regulation also reminds issuers of their obligation to provide full and fair disclosure of all material facts relating to the offering.</p>	<p>In an environment characterized by high informational asymmetry and low financial literacy¹, disclosures can be easily gamed. Since disclosures present a real cost to the issuer, any required disclosure should have a positive net cost (i.e. benefit) which up until now has been a very controversial issue with most researchers concluding that the benefit does not exceed the cost hurdle.</p>
10.1	<p>Would it be appropriate for the Exemption to spell out more details about required disclosures?</p>	N/C
10.2	<p>Would such disclosure requirements provide useful guidance to issuers?</p>	N/C
10.3	<p>Should the Securities Division consider requiring the use of a disclosure form?</p>	N/C
10.4	<p>Are the specified items of disclosure sufficient to protect investors' interests in crowdfunding transactions?</p>	N/C
11.0	<p><u>Specific Required Risk Disclosures.</u> Section 12 of the Exemption requires that specific risks of crowd-funded securities be disclosed, particularly the risks that there will probably be no ready market for the securities and that the securities will be illiquid. The Securities Division requests comments regarding these disclosures.</p>	N/C
12.0	<p><u>Annual Reporting by the Issuer.</u> Sec. 14 of the Exemption requires that issuers provide a report to the Securities Division after 12 months, or when the offering has been completed or terminated. The Securities Division requests comments on this requirement.</p>	N/C

¹ Winchester, D. D. (2011). *Investor Prudence and the Role of Financial Advice*. Journal of Financial Service Professionals. (July), 43–52.

<p>13.1 <u>Ongoing Company Reporting.</u> The Crowdfunding Exemption does not mandate that issuers provide ongoing reports to investors about the business and financial condition of the company. Should the Exemption require such reports?</p>	<p>N/C</p>
<p>13.2 If the Exemption does not require such reports, will there be any way for investors to receive ongoing information about the issuer?</p>	<p>N/C</p>
<p>13.3 <u>Sellers of Crowdfunding Securities.</u> Unlike the proposed SEC rules for crowdfunding, the Crowdfunding Regulation does not require the use of a crowdfunding portal to offer and sell crowdfunded securities. Only broker-dealers may receive compensation for offering and selling securities. At this time, it is anticipated that issuers would sell their own crowdfunding offerings or that they would be sold through licensed broker-dealers.</p>	<p>Additionally, per Paragraph 7 of 950 CMR 14.402(B)(13)(o), we believe that an online portal will be effectively acting as a placement agent, for which commission fees would be generated. Up until now, the leaders non-equity in transaction volume, Kickstarter and IndieGogo, have not publicly established relationships with registered broker-dealers or registered advisers, but we would expect them to do so in order to not lose market share as the distinction between reward-based and equity-based crowdfunding inevitable loses visibility on behalf of the typical consumer.</p>
<p>14.1 The Securities Division seeks information about how it is anticipated that these offerings will be sold. Should the Crowdfunding Exemption require or permit the use of a crowdfunding portal to offer and sell the securities?</p>	<p>Certainly permit, but perhaps not require.</p>

<p>14.2 If so, what would be the characteristics of such a portal?</p>	<p>While it is not possible to provide a detailed blueprint of the empirically-tested model for an effectively governed electronic commerce portal suitable for this purpose within this public document, we can offer the following insights:</p> <p>The ultimate goal should be to ensure that transparency reflects the same mechanism consumers are used to when purchasing consumer goods or even groceries. If we read a package label indicating 15 grams of fat per serving, for example, then we might have a civil claim against the manufacturer if it is determined that it misrepresented facts. Similarly, but of more severe human consequence, in the absence of objective and accurate information, we are left to rely on self-disclosed claims about processes that could harm us. Imagine a bakery indicating “these muffins are prepared in an environment that is free from peanuts or peanut byproducts” in order induce consumers—even those with severe peanut allergies—to use or consume their products; in such cases, deception could be a matter of life or death. As an analogy to crowdfunding platforms, why should the platform creator bear no responsibility for the completeness and accuracy of the portal when it is clear from research² that consumers place excessive credibility on information received online?</p> <p>The solution here would be develop a standard informational presentation explicitly describing the risks and limitations of the platform, similar to what medical professionals require a patient to view prior to electing to undergo surgical procedures. It is simply not effective to expect check-the-box acknowledgements to serve as a proxy for constructive understanding of the risks presented.</p>
<p>14.3 What kinds of regulation and registration should apply to such a portal?</p>	<p>N/C</p>

² Flanagin, A., Metzger, M., Pure, R., Markov, A., & Hartsell, E. (2014). *Mitigating risk in ecommerce transactions: perceptions of information credibility and the role of user-generated ratings in product quality and purchase intention*. *Electronic Commerce Research*, 14(1), 1–23. Retrieved from 10.1007/s10660-014-9139-2; Metzger, M. J., & Flanagin, A. J. (2000). *Perceptions of Internet Information Credibility*. *Journalism and Mass Communication Quarterly*, 77(3), 515–540.

15.0 15) Investor Feedback – The “Wisdom of the Crowd.” N/C

The Crowdfunding Exemption currently does not require that there be an Internet-based forum for potential investors to comment on and discuss these offerings. Should such a forum be required under the Exemption?