

# Congress of the United States

## U.S. House of Representatives

### Committee on Small Business

2361 Rayburn House Office Building

Washington, DC 20515-6515

February 3, 2014

Submitted by Mail and Electronic Submission

Ms. Elizabeth M. Murphy

Secretary

Securities and Exchange Commission

100 F Street, NE

Washington, DC 20549

**Re: Crowdfunding, Proposed Rules, 78 Fed. Reg. 66,428 (Nov. 5, 2013)  
(Docket No. SEC-2013-1894-0001)**

Dear Secretary Murphy:

These comments are submitted in response to the Securities and Exchange Commission's ("SEC" or "Commission") notice of proposed rulemaking<sup>1</sup> in the above-referenced docket that would implement the crowdfunding exemption to the Securities Act of 1933<sup>2</sup> and the Securities and Exchange Act of 1934<sup>3</sup> as mandated by Title III of the Jumpstart Our Business Startups Act (hereinafter "JOBS Act" or "Act").<sup>4</sup> Although issued after the statutory deadline, I appreciate the Commission's efforts in crafting the Proposed Rules that will enable small businesses to utilize crowdfunding as a new avenue for obtaining needed equity capital. It is important that as the Commission promulgates final rules, it strives to create a crowdfunding model that appropriately balances utility for small businesses with adequate protections for investors. In doing so, the SEC should comply with the Regulatory Flexibility Act (RFA)<sup>5</sup> and fully consider alternatives (some of which are outlined in these comments) that will optimize small business access to crowdfunding.

### **I. Small Business Capital Needs and Crowdfunding**

Small businesses create two-thirds of net new jobs in the United States,<sup>6</sup> and experience more rapid growth than their larger counterparts. Despite this significant contribution to the American

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<sup>1</sup> Crowdfunding, Proposed Rules, 78 Fed. Reg. 66,428 (Nov. 5, 2013) ("Crowdfunding NPRM" or "Proposed Rules").

<sup>2</sup> 15 U.S.C. §§ 77a-77bbbb.

<sup>3</sup> *Id.* at §§ 78a-78pp. In these comments (unless the context requires otherwise), the Securities Act of 1933 and the Securities Exchange Act of 1934 collectively will be referred to as the "Securities Acts."

<sup>4</sup> Pub. L. No. 112-106, Tit. III, 126 Stat. 306, 315-23 (2012) (codified at scattered sections of Chapters 2A and 2B of Title 15, United States Code).

<sup>5</sup> 5 U.S.C. §§ 601-12.

<sup>6</sup> [http://www.sba.gov/sites/default/files/FAQ\\_Sept\\_2012.pdf](http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf).

economy, entrepreneurs often cannot obtain capital from traditional sources.<sup>7</sup> At a time when small businesses are counted on to provide economic growth yet struggle to find early-stage capital, the JOBS Act was crafted in an effort to lower regulatory barriers and increase the availability of capital to small businesses. One avenue to provide such capital is crowdfunding; crowdfunding entails obtaining small amounts of money from large numbers of individuals, generally through various types of Internet portals.<sup>8</sup> Title III of the JOBS Act expands the ability of entrepreneurs to use crowdfunding by creating a limited exception from the normal requirements of the Securities Acts to register a security with the SEC before it can be sold the public, especially non-accredited investors.<sup>9</sup>

Recent research on the United Kingdom's crowdfunding model, which has been in place for three years, shows it is flourishing in a "light-touch" regulatory environment.<sup>10</sup> The study showed the crowdfunding market almost doubled in size from an equivalent of \$797 million to \$1.3 billion in United States dollars.<sup>11</sup> Additionally, in 2013 alone, crowdfinance in the United Kingdom contributed an equivalent of \$541 million in early stage and working capital to over 5,000 start-ups.<sup>12</sup> Another report released on January 15, 2014 showed that nearly 90 percent of the small businesses in Europe and the United States that had access to debt, equity or rewards-based crowdfunding capital hired or expected to hire employees.<sup>13</sup> This research, as well as testimony from witnesses at hearings convened by various subcommittees of the Committee on Small Business, demonstrates that crowdfunding, if implemented in a manner usable for small businesses, has the potential to create jobs – which was a primary goal of the JOBS Act<sup>14</sup>

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<sup>7</sup> *Where Are We Now? Examining the Post-Recession Small Business Lending Environment: Hearing Before the Subcomm. on Economic Growth, Tax and Capital Access of the Comm. on Small Business*, 113<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2013) (statement of Mr. Jeff Stibel, CEO, Dun & Bradstreet Credibility Corp. at 2, 4), available at [http://smallbusiness.house.gov/uploadedfiles/12-5-2013\\_jeff\\_stibel\\_testimony\\_final.pdf](http://smallbusiness.house.gov/uploadedfiles/12-5-2013_jeff_stibel_testimony_final.pdf).

<sup>8</sup> Thomas Hazen, *Social Networks and the Law: Crowdfunding or Fraudfunding?*, 90 N.C. L. REV. 1735, 1736 (2012).

<sup>9</sup> The crowdfunding exception to the registration requirement is in § 302(a) of the JOBS Act which creates a new § 4(a)(6) in the Securities Act of 1933 and is codified at 15 U.S.C. § 77d(a)(6). The exception only applies if the crowdfunding occurs through a portal established pursuant to § 302(b) which created a new § 4A of the Securities Act of 1933 and is codified at 15 U.S.C. § 77d-1.

<sup>10</sup> *SEC's Crowdfunding Proposal: Will it Work for Small Businesses?: Hearing Before the Subcomm. on Investigations, Oversight and Regulations of the Comm. on Small Businesses*, 113<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (statement of Mr. Jason Best, Principal, Crowdfund Capital Advisors at 10) [hereinafter Best Testimony], available at [http://smallbusiness.house.gov/uploadedfiles/1-16-2014\\_jason\\_best\\_testimony.pdf](http://smallbusiness.house.gov/uploadedfiles/1-16-2014_jason_best_testimony.pdf). Subsequent references in this memorandum will refer to the entire hearing as the "Crowdfunding Hearing."

<sup>11</sup> LIAM COLLINS, RICHARD SWART & BRYAN ZHANG, *THE RISE OF FUTURE FINANCE: THE UK ALTERNATIVE FINANCE BENCHMARKING REPORT 4* (2013), available at [http://www.nesta.org.uk/sites/default/files/the\\_rise\\_of\\_future\\_finance.pdf](http://www.nesta.org.uk/sites/default/files/the_rise_of_future_finance.pdf).

<sup>12</sup> *Id.*

<sup>13</sup> CROWDFUND CAPITAL ADVISORS, *HOW DOES CROWDFUNDING IMPACT JOB CREATION, COMPANY REVENUE AND PROFESSIONAL INVESTOR INTEREST?* 4 (2014), available at <http://crowdfundcapitaladvisors.com/images/CF-Post%20Funding%20Research%20FINAL%20Jan%202014.pdf>.

<sup>14</sup> A bill, H.R. 2930, created the crowdfunding exception and overwhelmingly passed the House during the first session of the 112<sup>th</sup> Congress. It was incorporated into the JOBS Act as Title III. 158 CONG. REC. H1239-40 (daily ed. March 7, 2012) (statement of Mr. Frank). H.R. 2930 was drafted to increase the availability of capital to small businesses so they could hire workers. See H.R. REP. NO. 112-262, at 4 (2011).

## **II. Committee Examination of the Proposed Rules**

On January 16, 2014, the Committee's Subcommittee on Investigations, Oversight and Regulations convened a hearing<sup>15</sup> which examined the proposed rules. Witnesses focused on whether the proposed rules would create a regulatory structure that enabled entrepreneurs to access in an effective and efficient manner crowdfunding as means to raise needed capital.

The consensus of the witnesses at the crowdfunding hearing, as well as a close scrutiny of the Proposed Rules by Committee staff, was that modifications are necessary to enhance the utility of crowdfunding without creating undue risk to the investing public. These alternatives would have been uncovered had the Commission performed an adequate initial regulatory flexibility analysis (IRFA) as required by the RFA – a subject to which we now turn.

### **III. The SEC failed to Comply with the RFA By Not Examining Alternatives that Would Maximize the Benefits of Crowdfunding for Small Businesses**

The RFA requires federal agencies, including the SEC, to prepare an IRFA if an agency finds that the proposed rule will have a significant economic impact on a substantial number of small entities.<sup>16</sup> The SEC should be commended for recognizing that the proposed rules will have a significant economic impact on a substantial number of small businesses. However, the SEC's IRFA is inadequate because the Commission failed to comply with the critical requirement of the RFA which is to examine alternatives to the proposed rule that could accomplish the objectives of the rulemaking. As these comments will show, there are a number of alternatives that the SEC could have considered which would maximize the benefits of crowdfunding to small businesses without undermining protections to the investing public. Therefore, in its preparation of the final rule and FRFA, the Commission should take its responsibilities under the RFA seriously by examining viable alternatives rather than claiming alternatives it has considered could undermine the objectives of its regulatory goals.

### **IV. Alternatives that Maximize Benefits to Small Businesses**

The SEC proposes to create a regulatory structure that undermines the effectiveness of crowdfunding. There are a number of alternatives to the Commission's proposals that will reduce regulatory barriers to crowdfunding without undermining the SEC's goal of protecting investors.

#### **A. Audited Financial Statement Threshold**

The JOBS Act requires issuers to file with the SEC and make available to intermediaries and investors a description of their financial condition, on a tiered basis. Issuers seeking \$100,000

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<sup>15</sup> Crowdfunding Hearing, *supra* note 10.

<sup>16</sup> 5 U.S.C. § 603. The RFA does not limit the economic impacts only to adverse consequences. As a result, especially at the proposed rule stage, an IRFA must be prepared to determine whether the proposed rule maximizes beneficial economic consequences. *See* H.R. REP. NO. 113-288 (Pt. 2), at 37-38 (2013) (highlighting differences between IRFA and final regulatory flexibility analysis (FRFA)).

or less must provide income tax returns for the most recently completed year and financial statements certified as accurate by the principal executive officer (First Tier); those seeking over \$100,000 but less than \$500,000 must provide financial statements reviewed by a certified public accountant (Second Tier); and those seeking over \$500,000 (or such other amount as the Commission may establish by rule) must provide audited financial statements (Third Tier).<sup>17</sup>

The statute prescribes specific amounts defining the first and second tiers, but for the third tier, the statute gave the Commission the discretion to establish the threshold at any amount more than \$500,000. The Proposed Rules include a requirement that all issuers seeking over \$500,000 must submit audited financial statements to the SEC, i.e., the Commission did not exercise its discretion to raise the limit for the Third Tier.<sup>18</sup> In explaining its decision not to utilize the discretion given to it by statute and establish a higher threshold, the Commission notes “Congress specifically selected \$500,000 as the threshold at which to require audited financial statements. If we were to raise the threshold to \$1 million, as suggested by some commenters, it would eliminate the requirement for issuers ever to provide audited financial statements because the maximum offering amount under Section 4(a)(6) is \$1 million.”<sup>19</sup>

A close examination of the Commission’s rationale for failing to exercise its statutory discretion with respect to the Third Tier reveals numerous flaws. First, the SEC misreads the statute since the \$500,000 is not a threshold but rather a floor that the Commission may modify.<sup>20</sup> From this floor, the SEC then reasons that it would be inappropriate to exercise its discretion to raise the Third Tier to \$1 million as commenters requested.<sup>21</sup> What the Commission did not analyze is whether the statutory objective of creating a useful crowdfunding mechanism for small businesses would be met by raising the level triggering the submission of audited financial statements above \$500,000 but less than \$1 million. Nor did the SEC, when it rejected using the statutory discretion afforded it by Congress, consider that there might be other alternatives that provide adequate protections to investors.

The requirement of audited financials is frequently cited as too costly for small businesses. At a recent SEC forum on small business capital formation, a partner from a leading accounting firm predicted the cost to small businesses of providing audited financial statements could be upwards of \$18,000 to \$25,000.<sup>22</sup> One industry expert says that this provision will discourage businesses from raising the full amount of capital they need, predicting most will limit their crowdfunding

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<sup>17</sup> 15 U.S.C. § 77d-1(b)(1)(D).

<sup>18</sup> Proposed 17 C.F.R. § 227.201, Crowdfunding NPRM, 78 Fed. Reg. at 66,553.

<sup>19</sup> *Id.* at 66,446-47.

<sup>20</sup> 15 U.S.C. § 77d(b)(1)(D).

<sup>21</sup> Crowdfunding NPRM, 78 Fed. Reg. at 66,446-47.

<sup>22</sup> Kim Wales, *Is Financial Disclosure for Crowdfunding Companies Too Expensive?*, CROWDFUNDINSIDER, Dec. 18, 2013, available at <http://www.crowdfundinsider.com/2013/12/28428-is-financial-disclosure-for-crowdfunding-companies-too-expensive/>. The cost of audited financial statements for businesses seeking over \$500,000 is significantly higher than the cost of financial statements reviewed by a certified public accountant for those companies seeking between \$100,000 and \$500,000, which is estimated to be between \$6,000 and \$15,000 depending on the complexity of the review. <http://www.cpataxmag.net/feature-stories/65-feature-stories/834-cpas-are-ready-to-perform-reviews-for-crowdfunded-startups>.

raise to \$499,000 in order to avoid the requirement.<sup>23</sup> Another indicates that with this requirement, “it’s hard to imagine attractive companies will take advantage of crowdfunding,”<sup>24</sup> indicating the manner in which it is proposed would be a disappointing outcome for not only small companies, but investors.

These statements were echoed in the Crowdfunding Hearing. Jason Best, Principal of Crowdfund Capital Advisors, testified that this requirement places an unreasonable burden on entrepreneurs and small businesses and may establish a “soft cap” on raising more than \$500,000 through crowdfunding due to the cost of capital this regulatory burden imposes.<sup>25</sup> He also noted this “soft cap” effectively reduces the total amount of capital available by 50 percent.<sup>26</sup> Mr. Best noted that this was not the legislative intent for this act.<sup>27</sup> At the same hearing, DJ Paul, Co-Chair of the Crowdfund Intermediary Regulatory Advocates, testified that this requirement may create a ‘doughnut hole’ between \$500,000 and \$1 million where issuers do not utilize Title III at all.<sup>28</sup> Yet another witness, Daniel Gorfine, Director of Financial Markets at the Milken Institute, testified that the overall ongoing reporting, disclosure and compliance burden for issuers begins to look significant, especially in light of the relatively small sums of capital that can be raised under Title III.<sup>29</sup>

The general public are not sophisticated investors, and their ability to differentiate between financials reviewed by independent CPAs and those prepared under the audit standards of the accounting profession for publicly traded companies is minimal at best. On the other hand, the cost differential to small businesses is significant. The Second Tier, issuers seeking between \$100,000 and \$500,000, must provide financial statements reviewed by a certified public accountant (CPA) that is independent of the issuer.<sup>30</sup> The American Institute of Certified Public Accountants Accounting and Review Services Committee issues Statements on Standards for Accounting and Review Services. The standards for the review of financial statements prescribe the accountant to consider a multitude of factors, which include: “whether the financial statements have been prepared in conformity with the applicable financial reporting framework; unusual or complex situations that may have an effect on the financial statements; significant transactions occurring or recognized near the end of the reporting period; events subsequent to the date of the financial statements that could have a material effect on the financial statements;

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<sup>23</sup> Sherwood Neiss, *It might cost you \$39K to crowdfund \$100K under the SEC’s new rules*, VENTURE BEAT, Jan. 2, 2014, available at <http://venturebeat.com/2014/01/02/it-might-cost-you-39k-to-crowdfund-100k-under-the-secs-new-rules/>.

<sup>24</sup> J.D. Harrison, *New Crowdfunding Rules: The Good and Bad News for Entrepreneurs and Investors*, WASHINGTON POST, Oct. 29, 2013, available at [http://www.washingtonpost.com/business/on-small-business/new-crowdfunding-rules-the-good-and-bad-news-for-entrepreneurs-and-investors/2013/10/28/c634045e-3fe7-11e3-9c8b-e8deeb3c755b\\_story.html](http://www.washingtonpost.com/business/on-small-business/new-crowdfunding-rules-the-good-and-bad-news-for-entrepreneurs-and-investors/2013/10/28/c634045e-3fe7-11e3-9c8b-e8deeb3c755b_story.html).

<sup>25</sup> Best Testimony, *supra* note 10, at 5.

<sup>26</sup> The statute permits businesses to raise \$1 million in capital through crowdfunding. If businesses, due to the audited financials requirement limit their efforts to less than \$500,000, that is a reduction of 50 percent.

<sup>27</sup> *Id.*

<sup>28</sup> Crowdfunding Hearing (statement of Mr. DJ Paul, Co-Chair, Crowdfund Intermediary Regulatory Advocates at 3) [hereinafter Paul Testimony], available at [http://smallbusiness.house.gov/uploadedfiles/1-16-2014\\_paul\\_testimony\\_-\\_djp\\_-\\_final.pdf](http://smallbusiness.house.gov/uploadedfiles/1-16-2014_paul_testimony_-_djp_-_final.pdf).

<sup>29</sup> *Id.* (statement of Mr. Daniel Gorfine, Director, Financial Markets Policy, Milken Institute at 4) [hereinafter Gorfine Testimony], available at [http://smallbusiness.house.gov/uploadedfiles/1-16-2014\\_gorfinetestimony\\_final.pdf](http://smallbusiness.house.gov/uploadedfiles/1-16-2014_gorfinetestimony_final.pdf).

<sup>30</sup> 15 U.S.C. § 77d-1(b)(1)(D).



and their knowledge of any fraud or suspected fraud affecting the entity involving management that could have a material effect on financial statements.”<sup>31</sup> As a result, a review by a CPA is quite thorough.

Given the thorough and intensive screening of an issuer’s financial statements that would take place with a CPA review, and the limited ability of investors to distinguish between those standards and that of audited financials, it is logical to expand the scope of businesses that fall under the purview of such a disclosure requirement by raising the threshold which triggers the audited financial statement requirement. In an effort to maintain protection for investors, while simultaneously capturing a larger number of businesses issuing equity in an amount greater than \$500,000, as are the goals of the JOBS Act, I recommend the Commission use the discretion afforded to it by statute to raise the offering threshold for requiring the submission of audited financial statements from \$500,000 to \$900,000.<sup>32</sup>

### B. Ongoing Requirement to Submit Financial Disclosures

The JOBS Act addresses ongoing financial reporting requirements by dictating that “not less than annually, [the issuer must] file with the Commission and provide to investors reports of the results of operations and financial statements” as the Commission determines appropriate.<sup>33</sup> In the Proposed Rules, the SEC exercises this discretion granted by requiring issuers to provide such statements for the remainder of the life of the company and not just in the year it raised capital.<sup>34</sup> The SEC states that an issuer will be required to disclose information “similar to the information required in the offering statement, including disclosure about its financial condition that meets the financial statement requirements that were applicable to its offering.”<sup>35</sup> The Commission goes on to say an issuer would be able to voluntarily provide financial statements that would meet the disclosure requirements for a higher offering amount. In explaining its rationale in requiring the aforementioned ongoing financial reporting requirements, the Commission stated “[i]nvestors should benefit from receiving annual updates to the information they received when making the decision to invest in the issuer’s securities, which should allow them to continue to be informed about issuer developments.”<sup>36</sup>

Requiring Tier 3 issuers to provide audited financials is an ongoing reporting requirement will be burdensome for small businesses, as the cost of undergoing expensive audits on an annual basis

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<sup>31</sup> AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING AND REVIEW SERVICES COMMITTEE (ARSC), REVIEW OF FINANCIAL STATEMENTS 2660 (2013), available at <http://www.aicpa.org/Research/Standards/CompilationReview/DownloadableDocuments/AR-00090.pdf>.

<sup>32</sup> The recommendation to raise the threshold to a specific dollar figure of \$900,000 for the trigger to require audited financials was made after consultation with leaders in the industry.

<sup>33</sup> 15 U.S.C. § 77d-1(b)(4).

<sup>34</sup> The SEC proposes that issuers file the annual report until one of the following events occurs: (1) The issuer becomes a reporting company required to file reports under §§ 13(a) of 15(d) of the Securities Act of 1934; (2) the issuer or another party purchases or repurchases all of the securities issued pursuant to the crowdfunding exemption, including any payment in full of debt securities or any complete redemption of redeemable securities; or (3) the issuer liquidates or dissolves its business in accordance with state law. Proposed 17 C.F.R. § 227.202, Crowdfunding NPRM, 78 Fed. Reg. at 66,554.

<sup>35</sup> *Id.* at 66,451.

<sup>36</sup> *Id.*

will eat up a significant portion of the capital raised,<sup>37</sup> and is capital that could be used in other areas of the business. Furthermore, management of these small businesses and startups will be diverted from expanding their operations to complying with these potentially exhaustive yearly requirements.

Nor can the SEC convincingly argue that the rules are designed to protect unaccredited investors. The Commission's recently issued proposed rules to implement Title IV of the Act do not include these ongoing reporting requirements for issuers seeking up to \$5 million through its capital pipeline.<sup>38</sup> The Title IV NPRM amending Regulation A would permit non-accredited investors to invest in offerings totaling no more than \$5 million in a twelve-month period, which the SEC denominates [Regulation A] Tier-1.<sup>39</sup> The Commission, in the Title IV NPRM proposes that Tier-1 issuers are only required to file an exit report on Form 1-Z<sup>40</sup> no later than 30 calendar days after the termination or completion of the offering, and are not subject to ongoing reporting requirements.<sup>41</sup>

In explaining why issuers using [Regulation A] Tier-1 are not subject to ongoing reporting requirements as are issuers using [Regulation A] Tier-2,<sup>42</sup> the Commission states: “[w]e are concerned that uniform ongoing reporting requirements for all issuers of Regulation A securities could disproportionately affect issuers in smaller offerings.”<sup>43</sup> Yet in the Proposed Rules implementing Title III of the JOBS Act, the Commission places the burden of ongoing reporting requirements on small issuers. Given the lower \$1 million limit on capital raised through Title III, it would seem sensible that the burdens associated with using it as a source of capital would be less. As proposed, the ongoing requirements for issuers using Title III could be significantly more onerous than for those using Title IV. It is entirely plausible to ponder why smaller companies with less risk to the public should be required to provide more information than larger companies with more publicly raised money, when both are making offerings to non-accredited investors. In his testimony, Daniel Gorfine notes that “given potentially significant costs, issuers at the higher end of the Title III range may be incentivized to postpone an offering until a Reg A or Reg A+<sup>44</sup> offering makes economic sense given the larger caps on a raise and unrestricted

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<sup>37</sup> If audited financials cost \$25,000 per annum then in 10 years half of a \$500,001 investment would be consumed in the preparation of audited financial statements.

<sup>38</sup> Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, Proposed Rules, 79 Fed. Reg. 3925 (Jan. 23, 2014) (hereinafter “Title IV NPRM”).

<sup>39</sup> *Id.* at 3927. It is important to note that while the SEC limits investors in Regulation A Tier-2 offerings to investing no more than ten percent of the greater of their annual income and net worth, no such limit exists for investors investing in Regulation A Tier-1 offerings. Proposed 17 C.F.R. § 230.251, Title IV NPRM, 79 Fed. Reg. at 4000.

<sup>40</sup> Form 1-Z is a new form created by the Title IV NPRM that allows Regulation A issuers to file the information generally disclosed in Form 2-A with the Commission electronically on EDGAR. Information required to be reported with Form 1-Z include the date the offering was qualified and commenced, the number of securities qualified, the number of securities sold in the offering, the price of the securities, any fees associated with the offering, and the net proceeds to the issuer. *Id.* at 3964. The proposed rules rescind Form 2-A, a basic 2-page questionnaire regarding sales and use of proceeds. <http://www.sec.gov/about/forms/form2-a.pdf>.

<sup>41</sup> Proposed 17 C.F.R. § 230.257, Title IV NPRM, 79 Fed. Reg. at 4003.

<sup>42</sup> Tier-2 issuers may raise up to \$50 million in a twelve-month period and are subject to additional disclosure requirements, including the submission of audited financial statements, ongoing reporting obligations, and certain limitations on sales. *Id.* at 3927.

<sup>43</sup> *Id.* at 3959.

<sup>44</sup> Reg A+ refers to Regulation A Tier-2 offerings, where issuers can seek up to \$50 million.

nature of issued securities.”<sup>45</sup> Given the SEC’s Regulation A proposal, it is hard to understand why crowdfunding investors with less at risk<sup>46</sup> need greater protection. That certainly does not comport with congressional intent to make crowdfunding available to small businesses.

In order to achieve the appropriate balance of creating an effective crowdfunding model for small businesses while providing adequate protections for investors, the Commission should create ongoing reporting requirements as an alternative for small issuers that require the disclosure of reviewed financial statements by a certified public accountant, but do not require the continued disclosure of audited financial statements, even if previously required to disclose audited financial statements pursuant to Section 4A(b)(1)(D) when the issuer sold to the public through crowdfunding. These alternative requirements also should require an issuer to submit annually an updated statement of financial condition, similar in nature to an abbreviated management’s discussion and analysis of financial condition and results of operations.<sup>47</sup> This reasonable approach would allow for a review of issuers’ financial conditions by an independent, outside entity, while relieving issuers of the high cost associated with annual audited financial statements. Additionally, the submission of an updated statement of financial condition and operations would provide investors with information concerning any recent financial developments or changes within the company since its last disclosure. It is important to note that this requirement is more than required of issuers under the SEC’s proposals to implement Title IV of the JOBS Act even though investors under Title IV might have more risk.<sup>48</sup>

### C. Cash Versus Accrual-Based Accounting

While the JOBS Act never specifies which accounting method issuers must use in preparing financial documents for submission to the Commission, investors, and intermediaries, the SEC proposes requiring the use of United States Generally Accepted Accounting Principles (GAAP).<sup>49</sup> GAAP, or accrual-based accounting, differs from cash-based accounting in that income is recorded when a sale is made, even if the payment is not received immediately, and expenses are recorded when services or goods are received, not when they are paid.<sup>50</sup> Using

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<sup>45</sup> Gorfine Testimony, *supra* note 29, at 4.

<sup>46</sup> As previously noted, the Title IV NPRM provides for no limitations on an investment of up to \$5 million in Regulation A Tier-1 offerings from either accredited or non-accredited investors, while the Crowdfunding NPRM limits investors to investing the greater of \$2,000 or 5% of annual income or net worth if both annual income and net worth are less than \$100,000, and the greater of 10% of annual income or net worth or a maximum of \$100,000, if the investor’s annual income or net worth is equal to or greater than \$100,000. Proposed 17 C.F.R. § 227.100, Crowdfunding NPRM, 78 Fed. Reg. at 66,551.

<sup>47</sup> The management’s discussion and analysis of financial condition and results of operations (MD&A) is a discussion of a registrant’s financial condition, changes in financial condition and results of operation, and is required by Item 303 of Regulation S–K. 17 C.F.R. § 229.303. The preparation of an updated statement of financial condition similar to a MD&A would presumably require time of the management team, but would be relatively inexpensive compared to the significant costs associated with hiring of an accounting firm to audit financial statements.

<sup>48</sup> One might argue that the SEC is comfortable with Regulation A and its statutory mandate to update it by the JOBS Act whereas the Commission is uncomfortable in the Internet-based world of crowdfunding and therefore imposing unnecessary burdens. Alas, the SEC is not permitted to make that policy choice. The Constitution leaves that decision in the first instance to Congress.

<sup>49</sup> Proposed 17 C.F.R. § 227.201, Crowdfunding NPRM, 78 Fed. Reg. at 66,553.

<sup>50</sup> <http://www.sba.gov/community/blogs/community-blogs/small-business-cents/cash-vs-accrual-accounting-taxable-income-and-e>.



the latter, more commonly used method of cash-based accounting, income and expenses are recorded only when funds are received or disbursed.<sup>51</sup>

In explaining the rationale for requiring GAAP accounting methods, the Commission admits “this proposed requirement may impose a cost on potential issuers, especially those smaller issuers that may have historically prepared their financial statements in accordance with other comprehensive bases of accounting, such as a cash basis of accounting or a tax basis of accounting, rather than U.S. GAAP.”<sup>52</sup> But the SEC goes on to say “investors, however, would benefit from the requirement that financial statements be prepared in accordance with U.S. GAAP, as U.S. GAAP is widely used and would allow for more comparability among issuers.”<sup>53</sup>

The Commission’s proposal is misdirected and in direct violation of the statute’s goal to make crowdfunding usable for small businesses, as the large majority of small businesses do not use accrual-based accounting methods. According to the National Federation of Independent Businesses, only nineteen percent of small businesses use the accrual-method of accounting, while forty-one percent use a cash-method, and remarkably, twenty-eight percent are unsure of the method they use.<sup>54</sup> Additionally, the cash accounting method is much easier for small business owners since it more closely matches the way that they maintain their books, and under current law, a taxpayer with less than \$5 million in gross receipts is able to use cash accounting rather than accrual accounting.<sup>55</sup>

It is worth noting that many small businesses use cash accounting because it is the manner in which they file their taxes with the Internal Revenue Service. This would mean, conceivably, the SEC could be requiring issuers to establish two sets of financial records when CPA-reviewed financial statements are perfectly capable of addressing the viability of a firm if it uses cash-based accounting.<sup>56</sup> With such a large percentage of small business owners using cash-accounting methods, or unaware of the accounting method they use, it is troubling the Commission would require the use of GAAP for all businesses seeking capital through crowdfunding.

In order to achieve the appropriate balance of creating an effective crowdfunding model for small businesses while providing adequate protections for investors, the Commission should create, as an alternative for small issuers, a revenue threshold of \$5 million which would mandate the use of GAAP in the disclosure of financial records. Businesses with total revenue under this amount should be permitted to use either cash-based or accrual-based methods of accounting in preparing documents to submit to the aforementioned recipients. This will ensure that businesses using cash accounting will not need to create two sets of accounting records in order to access crowdfunding.

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<sup>51</sup> *Id.*

<sup>52</sup> Crowdfunding NPRM, 78 Fed. Reg. at 66,523.

<sup>53</sup> *Id.*

<sup>54</sup> <http://www.411sbfacts.com/sbpoll.php?POLLID=0050>.

<sup>55</sup> *The Treatment of Closely-Held Businesses in the Context of Tax Reform: Hearing Before the Comm. on Ways and Means*, 112<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (statement of Dewey W. Martin, CPA, on behalf of the National Federation of Independent Business at 8) available at <http://waysandmeans.house.gov/uploadedfiles/martintest3.07.2012.pdf>.

<sup>56</sup> In the cases of Enron, WorldCom, HealthSouth, and Lehman Brothers, among others, the use of accrual accounting did not prove to add any layer of protection for investors.

#### D. Issuers Limited to Using One Intermediary

The JOBS Act mandates that crowdfunding transactions must be conducted through an intermediary as defined in the law.<sup>57</sup> In its rulemaking, the SEC chose to limit issuers to the use of only one intermediary, rather than multiple intermediaries, to conduct an offering or concurrent offering.<sup>58</sup> The Commission claimed that “allowing an issuer to conduct a single offering or simultaneous offerings in reliance on Section 4(a)(6) through more than one intermediary would diminish the ability of the members of the crowd to effectively share information, because essentially, there would be multiple “crowds.”<sup>59</sup> The Commission is effectively arguing that the limitation on the use of multiple web portals is needed to enhance the sharing of information among investors and issuers.

Under closer scrutiny, the rationale proffered by the Commission is farcical. Since the Commission rules already require the listing of all websites on which an issuer is listed, the individuals who will be investing can always check these portals for information thereby protecting the investor. It is more than reasonable to assume those individuals investing capital through crowdfunding intermediary websites will be comfortable enough with technology to view offerings on multiple websites. Therefore, logic strongly suggests that the more web portals on which an investment is listed the greater the likelihood that it will be seen by potential investors and those investors will be able to gather information from diverse sources rather than the users of one web portal.

If the premise of the SEC’s proposal is to access the “wisdom of the crowds,” limiting the crowds directly contradicts that goal and the proposal proffered by the Commission is irrational since the goal sought to be achieved (greater input from the universe of investors) is undermined by the limitation of using only one website. In order for crowdfunding to alleviate the capital burden for small businesses, pursuant to statute, the SEC should not limit issuers to offer securities on only one intermediary.

#### E. Summary

There are at least four potential alternatives that the SEC could have proposed that reduce burdens on small businesses seeking capital through crowdfunding portals. Had the SEC complied with the RFA, the SEC would have uncovered those. In performing its obligations under the RFA when preparing its FRFA, the SEC should consider adopting the aforementioned

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<sup>57</sup> Intermediary means a broker registered under Section 15(b) of the Exchange Act (15 U.S.C. § 78o(b)) or a funding portal registered under Proposed 17 C.F.R. § 227.400, Crowdfunding NPRM, 78 Fed. Reg. at 66,559 and includes, where relevant, an associated person of the registered broker or registered funding portal. Web portal, or funding portal, means a broker acting as an intermediary in a crowdfunding transaction carried out pursuant to the statutory exemption in Title III of the JOBS Act. Proposed 17 C.F.R. § 227.300, Crowdfunding NPRM, 78 Fed. Reg. at 66,555-56. Such broker also is prohibited from: offering investment advice; soliciting purchasers of securities displayed on its websites; compensating employees (or any other person) to obtain purchasers of listed securities; or hold, manage, or handle investor funds or securities. *Id.* The term “broker” is generally defined in § 3(a)(4) of the Securities Exchange Act as any person that effects transactions in securities for the account of others. *Id.* at 66,458.

<sup>58</sup> Proposed 17 C.F.R. § 227.100, Crowdfunding NPRM, 78 Fed. Reg. at 66,551.

<sup>59</sup> *Id.* at 66,435.

alternatives in an effort to meet the intent of Congress to promote the use of crowdfunding and increase job growth by small businesses, without undermining protection to investors.

## V. Requirements for Intermediaries Beyond those Mandated by the JOBS Act

Even if the Commission promulgates final rules that reduce the burden on small businesses using crowdfunding, Proposed Rules that make it too difficult for web portals<sup>60</sup> to operate would create insurmountable barriers to the utility of crowdfunding. This will undermine the objectives sought by Congress in creating a crowdfunding exemption to the registration requirements of the Securities Acts. As further detailed in the comments below, the SEC must ensure significant regulatory alternatives are created for web portals that allow their full participation in crowdfunding without creating undue risks for investors.

### A. Web Portals' Inability to Limit or Curate Offerings

The JOBS Act prohibits funding portals from offering investment advice.<sup>61</sup> In the Proposed Rules, the Commission interprets this to mean funding portals cannot exercise discretion in limiting businesses that seek to solicit investment through their platform.<sup>62</sup> The SEC proposes a safe harbor that would permit funding portals to apply objective criteria to limit offerings based on either type of security offered, or geographic location, but these filters would have to be designed in a way that results in a broad selection of issuers and portals could not curate these offerings.<sup>63</sup> In order to use the aforementioned safe harbor, the Commission states that “a funding portal may not use criteria based on an assessment of the merits or the shortcomings of a particular issuer or offering.”<sup>64</sup>

Further, the Commission proposes not to include a safe harbor based on riskiness of the issuer. In explanation of this decision, the SEC says they “preliminarily believe that an assessment of risk necessarily involves the exercise of judgment indicative of the giving of investment advice.”<sup>65</sup> This interpretation by the Commission could create situations where portals have legitimate concerns about an offering, but could not exclude them from listing on their platform. It is reasonable to say this policy violates the intent of statute, as it acts as a detriment to investor protection. Daniel Gorfine testified that “to require a platform to list an offering that it has a strong conviction will fail is contrary to promoting investor protection.”<sup>66</sup>

In order to achieve the appropriate balance of creating a usable crowdfunding model for small businesses while providing adequate protections for investors, the Commission should provide as an alternative to funding portals the discretion to exclude offerings from their platforms they

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<sup>60</sup> Many web portals are small businesses. The IRFA included in the NPRM estimates 30 of the 50 portals expected to register under the NPRM will be classified as small businesses. Crowdfunding NPRM, 78 Fed. Reg. at 66,549.

<sup>61</sup> Sec. 3(a)(80) of the Securities Act of 1934, as added by § 304(a) of the JOBS Act (codified at 15 U.S.C. § 78c(a)(80)).

<sup>62</sup> Proposed 17 C.F.R. § 227.300, Crowdfunding NPRM, 78 Fed. Reg. at 66,556.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 66,486.

<sup>65</sup> *Id.* at 66,486-87.

<sup>66</sup> Gorfine Testimony, *supra* note 29, at 5. And as an added matter, the SEC's proposal on web portals directly contradicts the SEC's stated objectives in other parts of the Proposed Rules to protect investors.

deem to either have: a) tangible shortcomings that could be detrimental to investors; or b) are overly risky. The SEC could require the portals to file their reasons with the agency. Given such a filing, it is unlikely that web portals would indiscriminately exercise this “curatorial” discretion. Such a rule balances access to portals with protections for investors by those parties with greater expertise than the average non-accredited investor.

## B. Intermediary Liability

Congress, in the JOBS Act, creates liability for an issuer to a purchaser of its securities if the issuer makes an untrue statement, or omits pertinent facts needed to make a statement not misleading.<sup>67</sup> The Proposed Rules interpret the JOBS Act’s definition of an issuer as “any person who offers or sells the security in such offering” to mean that funding portals would be considered issuers for the purpose of this liability provision and therefore subject to its requirements.<sup>68</sup> In its explanation, the Commission says Section 4A(c)(3) defines, for purposes of the liability provisions of Section 4A, an issuer as including any person who offers or sells the security in such offering. On the basis of this definition, it appears likely that intermediaries, including funding portals, would be considered issuers for purposes of this liability provision.”<sup>69</sup>

In proposing that intermediaries can be held liable in the same way as an issuer if the issuer makes an untrue statement or omits pertinent facts needed to make a statement not misleading, while concurrently proposing to limit their discretion in listing or promoting any issuer’s offering over another on their site based on the perceived merits of an issuer, the Commission creates an untenable catch-22 for web portals. If the portal exercises discretion and removes an issuer that it knows has made untrue statements, the portal violates the SEC’s regulations thereby permitting the Commission to take enforcement action against the portal.<sup>70</sup> Alternatively, if it allows an issuer making false statements, it opens itself up to liability under title III of the JOBS Act, at least according to the Commission’s interpretation of that statute in the Crowdfunding NPRM.

These concerns were expressed at the Crowdfunding Hearing. Daniel Gorfine noted “it is difficult to reconcile permitting an intermediary to be found liable for an issuer misstatement or omission, and not permitting an intermediary to exclude an offering based on an assessment of the merits or the shortcomings of the offering or its issuer.”<sup>71</sup> He went on to say that “if intermediaries can be on the hook for the missteps of an issuer, then the intermediary should have greater discretion to decide on whether to do business with that issuer.”<sup>72</sup> DJ Paul testified this added layer of liability may have a chilling effect on the number of portals created to participate in Title III offerings.<sup>73</sup>

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<sup>67</sup> 15 U.S.C. § 77d-1(c)(2)(A).

<sup>68</sup> Crowdfunding NPRM, 78 Fed. Reg. at 66,498-99 (internal quotations omitted).

<sup>69</sup> *Id.*

<sup>70</sup> 15 U.S.C. §§ 78u-78u-7 (specifying Commission enforcement authority under the Exchange Act of 1934).

<sup>71</sup> Gorfine Testimony, *supra* note 29, at 6 (internal quotations omitted).

<sup>72</sup> *Id.*

<sup>73</sup> Paul Testimony, *supra* note 28, at 6.



The Commission should recognize the difference in ability of funding portals and registered broker-dealers to use discretion to select or curate offerings,<sup>74</sup> and apply liability to each as appropriate. In this case, given their differences in ability to use discretion, it is reasonable to assume the same level of liability as is reserved for issuers should not be placed on funding portals as it is on broker-dealers, as was proposed in the Crowdfunding NPRM.

In order to achieve the appropriate balance of creating a usable crowdfunding model for small businesses while providing adequate protections for investors, the Commission should remove the liability placed on funding portals in the Proposed Rules or permit them to curate offerings. Otherwise it is highly improbable that any rational business would establish a web portal in the a heads-you-win, tails-I-lose environment. And without web portals, there is no crowdfunding, which directly contravenes the statutory mandate from Congress in Title III of the JOBS Act.<sup>75</sup>

## VI. Conclusion

When promulgating final rules, the SEC needs to comply with RFA and examine appropriate alternatives that maximize benefits to small businesses and reduce burdens on web portals so that congressional intent for utilization of crowdfunding can be achieved. The analysis in these comments show that there are alternatives that reduce burdens without placing the general public who buy securities through crowdfunding at undue risk of financial loss. Should the Commission staff have any questions about these comments, please do not hesitate to contact Andrew Huff of the Committee staff at 202-225-5821.

Sincerely,



SAM GRAVES  
Chairman

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<sup>74</sup> A broker registered under Section 15(b) of the Exchange Act (15 U.S.C. § 78o(b)) acting as an intermediary for crowdfunding offerings is not subject to the NPRM's limitations on selecting and promoting offerings that apply to funding portals.

<sup>75</sup> And while the SEC may not support crowdfunding, it has no power to overrule a determination of the policy selected by Congress. See *Chevron, USA, Inc. v. NRDC*, 467 U.S. 837,842 (1984) (agencies must effectuate clear direction of Congress).