

February 3, 2014

Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street NE.  
Washington, DC 20549-1090

**SUBJECT:** File Number S7-09-13 (Request to Allow Intermediaries to Take Equity Stakes in Issuers and Not Count the Value of Such Equity Towards Certain Amounts)\*

Dear Secretary Murphy,

Pursuant to § 227.300(b) of the Proposed Crowdfunding Rules:

[A]n intermediary . . . may not have a financial interest in an issuer that is offering or selling securities in reliance on Section 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)(6)) through the intermediary’s platform, or receive a financial interest in an issuer as compensation for the services provided to or for the benefit of the issuer in connection with the offer or sale of such securities. For purposes of this paragraph, a *financial interest in an issuer* means a direct or indirect ownership of, or economic interest in, any class of the issuer’s securities.<sup>1</sup>

However, as discussed below, § 227.300(b)’s prohibition should NOT apply to funding portals, or other intermediaries, for at least five reasons.

1. **The JOBS Act does NOT apply this prohibition to intermediaries.** While the JOBS Act prohibits an intermediary’s “directors, officers, or partners (or any person occupying a similar status or performing a similar function) from having any financial interest in an issuer using its services,” it does NOT prohibit an intermediary *itself* from having such an interest.<sup>2</sup>
2. **§ 227.300(b) contradicts the JOBS Act’s legislative history, which expressly supports intermediaries taking equity stakes.** For example, in the March 29, 2012 Congressional Record, Senator Scott Brown stated:

[I]ntermediaries should be allowed to take an equity stake in offerings. This, however, does not mean that intermediaries should be able to choose which offerings to participate in but rather it should be a standard process for any offering that the intermediary facilitates. This will incentivize an intermediary to focus on the issuer quality over quantity, providing more vetting for investors and greater alignment of interests.<sup>3</sup>

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\* The comments and opinions expressed herein are those of the author and should not be attributed to his employer.

<sup>1</sup> 78 FED. REG. 66428 (Nov. 5, 2013) [hereinafter “Proposed Crowdfunding Rules”], § 227.300(b), 66555-66556.

<sup>2</sup> Securities Act of 1933 § 4A(a)(11), JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306 at 317 (2012) (to be codified at 15 U.S.C.A. § 77d-1(a)(11)).

<sup>3</sup> 158 Cong. Rec. S2231 (daily ed. Mar. 29, 2012).

3. **If intermediaries are compensated (at least in part) with the equity stakes of issuers, intermediaries will have an economic incentive to screen out bad issuers which, in turn, will protect investors.** I concur with Senator Brown’s position that allowing intermediaries to take equity positions in issuers will incentivize the intermediaries to focus more on issuer quality and provide a form of vetting and protection for investors.<sup>4</sup> Moreover, given that crowdfunding will entail small investments being made by accredited and unaccredited investors, the investment amounts will not always justify investors incurring significant transaction costs (*e.g.*, by carefully researching issuers and the terms of particular offerings). In addition to being a repeat-player of sorts in the crowdfunding space (and thus perhaps well positioned to spot problematic issuers), intermediaries who are compensated with the equity stakes of issuers would seem likely to service only those issuers they see unique value in – *i.e.*, ventures they believe are underpriced. While the intermediaries would not want to “insure” investors against the risk of investing in issuers using their services, intermediaries with “skin in the game” would have more of an economic incentive to not service poor issuers in the first place. This vetting by intermediaries should be welcomed (not prohibited).
4. **Allowing intermediaries to take equity stakes will help issuers preserve cash – and cash is critical for issuers relying on the crowdfunding exemption.** Granting equity (in lieu of paying cash) to an intermediary would likely improve an issuer’s cash position (if, for example, an issuer grants its stock to an intermediary for its services and those shares are *in addition to* shares issuer would otherwise sell to investors).<sup>5</sup> Moreover, it is common knowledge that preserving cash is important for startups<sup>6</sup> and other issuers likely to rely on the crowdfunding exemption.
5. **Allowing intermediaries to take equity stakes may reduce the transaction costs of crowdfunding and thus make it more economically feasible.** According to SEC estimates, intermediaries will charge issuers a compensation fee that ranges from 5 to 15% of each offering.<sup>7</sup> The SEC also estimates that issuers must incur additional initial and ongoing costs (such as the costs associated with preparing and filing the Form C and Form C-AR).<sup>8</sup> The resulting transaction costs may jeopardize the use of the crowdfunding exemption. Allowing intermediaries to charge an equity interest would still result in an economic cost to issuers (*i.e.*, giving up a portion of their ownership interest). However, allowing issuers to take equity stakes may help reduce transaction

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<sup>4</sup> *Id.*

<sup>5</sup> That is, an issuer would preserve cash if : (i) the issuer is not already raising the \$1 million maximum allowed under the JOBS Act; or (ii) the shares granted to the intermediary would not “count” towards the amount being raised (*e.g.*, if the SEC adopts final rules (a) allowing intermediaries to take and equity stakes and (b) stating that said equity does not count towards the offering amount).

<sup>6</sup> *See, e.g.*, Guy Kawasaki, *Reality Check: The Irreverent Guide to Outsmarting, Outmanaging, and Outmarketing Your Competition*, 107 (2008) (*citing* the great Silicon Valley corporate finance lawyer, Craig Johnson “The leading cause of failure of startups is death, and death happens when you run out of money.” *Id.*).

<sup>7</sup> Proposed Crowdfunding Rules, *supra* note 1, at 66521.

<sup>8</sup> *Id.*

costs. As stated above, intermediaries who are compensated with the equity stakes of issuers would seem likely to service those issuers they see unique value in – *i.e.*, ventures they believe are underpriced. This perceived discount by intermediaries could be shared with issuers in the form of a lower compensation fee (*e.g.*, intermediaries may actually prefer (a) 3% of the total shares of stock being issued to (b) a 10% cash fee and a prohibition on investing that fee (and/or other amounts) into the issuers).

In addition to modifying § 227.300(b) so that the prohibition does NOT apply to intermediaries, the SEC should allow issuances of securities to intermediaries (as compensation for the services provided to or for the benefit of the issuer in connection with the offer or sale of such securities) to:

- Rely on the crowdfunding exemption; and
- NOT count towards --
  - The \$1 million maximum on the aggregate amount of securities that may be sold to *all* investors by an issuer during a 12-month period;<sup>9</sup>
  - The maximum amounts that may be sold to *any* investor by an issuer during a 12-month period;<sup>10</sup> or
  - The “target offering amounts” that may trigger the need for an issuer’s financial statements to be (a) reviewed by an independent public accountant (*i.e.*, if such amount is more than \$100,000, but not more than \$500,000) or (b) audited (*i.e.*, if such amount is more than \$500,000).<sup>11</sup>

Thank you Secretary (and other members of the Securities and Exchange Commission) for your hard work on this matter. It is no doubt important and challenging to balance the goal of protecting investors with the goal of making it easier for companies to raise funds they desperately need to grow. I hope the suggestions in this letter support both of these important goals. Please feel free to contact me at [REDACTED] if I may be of assistance.

Sincerely,

Jeff Thomas

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<sup>9</sup> Securities Act of 1933 § 4(6)(a), JOBS Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 306 at 315 (2012) (to be codified at 15 U.S.C.A. § 77d(6)); Proposed Crowdfunding Rules, *supra* note 1, § 227.100(a)(1), 66551.

<sup>10</sup> Securities Act of 1933 § 4(6)(a), JOBS Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 306 at 315 (2012) (to be codified at 15 U.S.C.A. § 77d(6)); Proposed Crowdfunding Rules, *supra* note 1, § 227.100(a)(2), 66551.

<sup>11</sup> Securities Act of 1933 § 4A(b)(1)(D), JOBS Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306 at 317 (2012) (to be codified at 15 U.S.C.A. § 77d-1(b)(1)(D)); Proposed Crowdfunding Rules, *supra* note 1, § 227.201(t), 66553.