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Via e-mail to rule-comments@sec.gov

Elizabeth Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File No. S7-09-13 - Release Nos. 33-9470, 34-70741- SEC Rule Proposal on Regulation Crowdfunding

Dear Ms. Murphy:

This letter is submitted in response to the request for comments by the Securities and Exchange Commission ("Commission") in Release Nos. 33-9470, 34-70741, File No. S7-09-13 (the "Rule Proposal"). In the Rule Proposal, SEC has proposed to implement Title III of the Jumpstart our Business Startups Act ("JOBS ACT") through adoption of Regulation Crowdfunding.

The undersigned are members of the Securities Committee ("Committee") of the Business Law Section ("Section") of the State Bar of Texas. Mr. Fahy is the Committee Chair. Each advises securities issuers. Please note that the comments expressed in this letter represent the views of the undersigned only and do not represent the views of their colleagues, clients or law firms or the official position of the Committee, the Section or the State Bar of Texas. None of the undersigned are being compensated, directly or indirectly, for our work on this comment submission

Set forth below are our responses to selected requests.

Request for Comment No. 81 – noted that compliance with the exemption under Section 4(a)(6) of the Securities Act of 1933 ("Securities Act") would not be known at the completion of the transaction if the subsequent filing of annual reports is a condition to the exemption as proposed under Regulation Crowdfunding. The Rule Proposal asks if the requirement to provide ongoing annual reports be a condition to the exemption under Section 4(a)(6). It also asks that if providing annual reports are to be a condition to the exemption, for what time period should this *post facto* exemption condition be imposed.

Comment to Request No. 81.

Issuers, Funding Portals and service providers need to be able to determine compliance with the Section 4(a)(6) Crowdfunding Exemption from the securities registration requirements of Section 5 of the Securities Act at or near the time of the transaction, not months or years later.

Crowdfunding is intended to use the Internet to provide capital to startups and small businesses. The amounts invested by investors are limited. The offering amount is limited to $1 million in a 12 month period. Section 4(a)(6) of the Securities Act is intended to provide a means for startups and small businesses to efficiently raise small amounts of capital.

These startup and small business issuers will likely not be well-versed in securities compliance and will need service providers to help them. Certainly Funding Portals and FINRA members who facilitate crowdfunding offerings are required to provide certain services, but these issuers will also need services of qualified securities attorneys and accounting firms.

Service providers in the securities industry must assess the attendant risks to their businesses in deciding whether to participate in an industry segment or provide services to specific issuers – because they can (and have been found to have been) liable under state and federal securities laws. While cases such as Central Bank[1] and Janus[2] have limited the liability of service providers in private federal litigation, that does not mean that they cannot be named in a federal court or arbitration complaint, incur the costs of discovery and litigation and may be required to settle to avoid the 0nslaught of further legal costs. Moreover, FINRA members will be required to estimate reserves for such costs under the Net Capital Rule.

Further, service providers can be targeted for aiding or abetting securities law violations by issuers by the Commission (and by FINRA for its members and Funding Portals). Hoping or assuming that the Commission and FINRA would use reasonable regulatory discretion in not pursuing service providers to crowdfunding issuers at the time of the transaction should a registration violation arise later based solely on the failure to file a subsequent annual report is hardly the way to structure an exemption and expect participation by any service providers that directly or indirectly are subject to Commission or FINRA disciplinary action.

In addition to potential regulatory disciplinary risks, the private plaintiff's bar will have full access to the panoply of state securities acts and FINRA rules to pursue the issuer and the service providers. It is axiomatic that a good lawsuit requires a solvent or insured defendant. Attorneys for crowdfunding investors who lose money in highly

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1 *Central Bank of Denver v. First Interstate Bank of Denver,* 511 U.S. 164, 225 S.Ct. 1439, 128 L.Ed.2d 119 (1994)

2 *Janus Capital Group, Inc. v. First Derivatives Traders*, 131 S. Ct. 2296, 180 L.Ed.2d 166 (2011)

risky startup enterprises will cast their net wider to capture solvent and insured service providers.

For example, Texas (where we practice law) specifically authorizes private lawsuits and arbitrations against service providers for violations of the securities registration provisions of the Texas Securities Act and provides for joint and several liability. The Texas act states:

> A person who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids a seller, buyer, or issuer of a security is liable under Section 33A *(including securities registration violations)*, 33B, or 33C jointly and severally with the seller, buyer, or issuer, and to the same extent as if he were the seller, buyer, or issuer. Texas Securities Act Section 33.A(2).

Similarly, the Uniform Securities Acts of 1956,[3] 1988[4] and 2002[5] provide that broker-dealers, agents and other employees and agents of sellers who materially aid the violation of the Uniform Securities Act can be jointly and severally liable with the sellers. Thus, plaintiffs' attorneys have ample statutory fodder to state claims for violations of the securities registration provisions of state securities acts against ancillary defendants, whether or not the claim is deserved.

While Section 4(a)(6) expressly preempts state law if it is complied with, if the exception is lost at some future date for the failure to file, or timely file the required annual report, the exposure to the various state securities registration laws remedies is very real.

Service providers deal with the risks for securities registration violations through their business processes. Importantly, service providers routinely make efforts to ensure that the requirements for an exemption are met, and in the case of Section 4(a)(6) it would include measures such as ensuring that the Form C notice is filed with the SEC and documenting subscriber qualifications. At the closing of the crowdfunding transaction they would typically have sufficient information to assess compliance at that time with Regulation Crowdfunding. But no amount of information can give any assurance the satisfaction of a condition for the Section 4(a)(6) registration exemption that must occur months and even years later will continue to be met.

For the reasons mentioned above we think that qualified service providers will be reticent to provide services to issuers when compliance with securities registration provisions cannot be assessed at the time the offering closes. Crowdfunding offerings

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3 The Uniform Securities Act of 1956 is adopted in Massachusetts and North Carolina.
4 The Uniform Securities Act of 1988 is adopted in Nevada and Utah.
5 The Uniform Securities Act of 2002 is adopted in Georgia, Idaho, Indiana, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, New Mexico, Oklahoma, South Carolina, South Dakota, Vermont and Wisconsin.

will not generate large amounts of cash flow for service providers. The offering amounts and the issuers are likely to be small and unable to sustain high costs. In assessing business risks, it would be reasonable for qualified service providers to choose not to support crowdfunding solely because of the open-ended liability for potential future securities registration liabilities. Indeed, crowdfunding issuers may just be left with service providers who are unable, disinclined or too inexperienced to properly assess the business risks inherent in having securities registration exemptions contingent on events occurring months or years after the offering terminates.

We are not aware of any other securities registration exemption that is contingent on a condition that could be one year or more subsequent to the close of the offering. The Rule Proposal contains a table of other securities offering exemptions on pages 322 – 324 of the Rule Proposal. None of those other exemptions require filing subsequent financial statements with the SEC as a condition of the validity of the offering.

Moreover, we don't know how auditing firms will record the contingent liability to return the entire crowdfunding offering that will result from the inability to receive any assurance at the closing of the offering that all elements of the Section 4(a)(6) exemption have been met. The potential for this liability to move from "contingent" to "probable" will never be more than 12 months in the future.

The issue of potential liability resulting from not knowing from year to year if the Section 4(a)(6) exemption is valid will arise with the first audit following completion of the offering. The issuer's auditing firm will be required to assess whether there is a "loss contingency" as defined by FASB Accounting Standards Codification Subtopic 450-20, Contingencies – Loss Contingencies ("ASC 450-20"), which states:

> A "loss contingency" is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more events occur or fail to occur. Resolutions of the uncertainty may confirm the loss or impairment of an asset or the incurrence of a liability.

Based on that definition, it appears that the possibility of the loss of the Section 4(a)(6) exemption by the issuer may meet that definition. Once a "loss contingency" is identified whether an accrual on the balance sheet must be made, or whether any disclosure of the contingency must be included in the financial statements will depend on further factors set forth in ASC 450-20. Those factors will likely be attempted to be addressed in the annual "*dance of the audit inquiry letter*" that is prepared by the auditors, sent by the issuer to the attorney, and responded by the attorney directly back to the auditors, all using language intended to meet their professional requirements and incur no liability. We believe that without removing the annual report filing contingency from the exemption the auditors will at a minimum be required to disclose the contingency in the issuer's footnotes to financial statements.

Other the questions that arise from both the legal and accounting perspectives that require answers include:

1) Can the proceeds from crowdfunding securities purchases be included without reserve in the issuer's capital if compliance with the terms of the exemption depends on future acts by the issuer?

2) How will banks and banking regulators treat crowdfunding securities if there is an unfulfilled future condition for the offering exemption in connection with standard financial ratio covenants in credit facilities?

In summary, we support requiring issuers of crowdfunding securities to be required to file annual reports until: 1) the issuer becomes a reporting issuer under the Exchange Act, 2) the issuer or another party purchases or repurchases all of the issued crowdfunding securities or 3) the issuer liquidates or dissolves its business in accordance with state law. But, we are convinced that the requirement for filing annual reports in the future should not be a condition *ab initio* to qualify for the crowdfunding offering exemption for the following reasons:

1) the lack of certainty of compliance at the close of the offering;

2) the "loss contingency" that is created for the sale of unregistered securities without an exemption that will exist until such time as filing the annual report is not required;

3) the impediment that such "loss contingency" will have on the ability to conduct future offerings; and

4) the negative impact on the market value of the securities offered by crowdfunding that the "loss contingency" will have.

There are more rational and logical ways for the Commission to implement the information requirement of Title III Sec. 302 (b)(4) than adopting a provision that inherently gives no certainty of compliance. The potential adverse consequences that could result from the proposed annual report filing requirement, whether or not it is ever violated, are disadvantageous to both the purchasing investors and the issuer. For example a couple of possible alternatives might include:

1) providing the issuer the option to file its first annual report, or interim financial information as a condition to meeting Sec. 4(a)(6), and continue the annual report filing requirement thereafter as proposed, but with different consequences relating to restrictions on the ability to raise capital through exemptions in the future; and

2) providing the issuer and certain officers, directors and shareholders the option to escrow their shares during a period up to 24 months, with

certain penalties for failure to file the annual report during such period, in lieu of losing the exemption for the failure to file the annual report.

Other Comment Requests

Request for Comment No. 1 – Using a $1 million net threshold to the Section 4(a)(6) issuer is consistent with the intent of Title III of the JOBS Act. The net funds are the funds that would actually go into the issuer's capital and allow it to fund business operations. Further, due diligence and audit fees relating to the Section 4(a)(6) offering should also be netted out of the $1 million cap.

Request for Comment No. 2 - The Rule Proposal takes the appropriate approach by not integrating offerings made through other securities registration exemptions with the Section 4(a)(6) offering. If the Commission determines that there should be integration of such offerings, we suggest that no more than a 90 day time lapse between offerings be required. We anticipate that many Section 4(a)(6) issuers will have undergone a friends and family financing round using other exemptions. These should not be included in the $1 million 12 month cap in Section 4(a)(6) if such financing round closed at some designated time period before the Section 4(a)(6) offering. While the Commission has provided guidance on offering integration suggesting that at least six months' time lapse between offerings, we think that a shorter period would be appropriate for Section 4(a)(6) issuers given that these issuers are highly likely to be development-stage business entities in need of capital to commence operations. These development-stage issuers should not be required to lie fallow for six months after raising funds from friends and family before commencing a crowdfunding offering. The time lapse between offerings should be no longer than three months.

Request for Comment No. 3 – Section 4(a)(6) issuers should not undertake concurrent Section 4(a)(6) and Rule 506(c) offerings. This could lead to the result of investors being put in accredited and unaccredited investor buckets with malleable offering designations for each investor.

The request for comment also asks if the Commission should prohibit an issuer from using Rule 506(c) advertising and solicitations to condition the market for a Section 4(a)(6) offering or from converting a Section 4(a)(6) offering into a Rule 506(c) offering. Such offerings should not be done concurrently, but the Commission should allow issuers to change approaches based on market conditions without penalties. In our comment letter relating to the Regulation D rule proposal,[6] we said that requiring the advance Form D was an inappropriate for Rule 506(c) offerings due to multiple factors. Likewise, allowing a Section 4(a)(6) offering to convert into a Rule 506(c) offering would not be feasible if the Commission requires an advance Form D before advertising and general solicitations. Under that rule proposal soliciting or advertising

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6 Comment Letter from John R. Fahy and Wayne M. Whitaker dated September 30, 2013 relating to File No. S7-06-13 - Release Nos. 33-9416, 34-69960, IC-305985 - SEC Rule Proposal on Regulation D found at http://www.sec.gov/comments/s7-06-13/s70613-435.pdf.

pursuant to Section 4(a)(6) would bar issuers from using Rule 506(c) because of the inability to comply with the Advance Form D requirement, even though Title II of the JOBS Act explicitly provides for the advertising and general solicitation of such offerings. This is just another example showing that the advance Form D and a 15 day waiting period rule proposal for Rule 506(c) offerings is unwieldy and problematic.

Request for Comment No. 4 – Borrowing the "control" standard from SEC Rule 506(d) is appropriate.

Request for Comment No. 8 – The issuer knowledge standard for investor limits is appropriate when the issuer has relied upon an intermediary for investor qualification.

Request for Comment No. 9 – Given the availability of other securities offering exemptions for institutional and accredited investors, a special Section 4(a)(6) provision for such investors is not necessary. If an issuer finds institutional or accredited investors to fund the entire capital needs, it can terminate the Section 4(a)(6) offering and convert or start a Rule 506(c) offering.

Request for Comment No. 18 – The failure to file annual reports should not be a disqualification to use the Section 4(a)(6) exemption for the Section 4(a)(6) issuer's minority voting interest shareholders, who may be designated as control persons for passing the 20% voting interest threshold. These shareholders do not have the authority to compel the issuer to file an annual report. Likewise, the disqualification should not apply to persons who serve in positions similar to independent directors. These persons are also neither employees nor officers of the Section 4(a)(6) issuer and, if they are truly valued for their business expertise, may be concurrently serving in a similar position for other unrelated issuers.

Request for Comment No. 20 – We agree with the Rule Proposal that crowdfunding issuers should have specific business plans.

Request for Comment No. 22 – Section 4(a)(6) issuers should file their SEC filings in English so that we can be assured that the Commission staff and general public can understand them. While this may be an additional cost, it is a cost that offshore issuers should consider in attempting to access U.S. capital through crowdfunding.

Request for Comment No. 32 – Section 4(a)(6) issuers should be required to update the use of proceeds disclosure for material changes in the use of proceeds.

Request for Comment No. 48 – Section 4(a)(6) issuers with no operating history should specifically disclose that they have no operating history.

Request for Comment No. 49 – Section 4(a)(6) issuers should be required to disclose previous capital raising transactions within a reasonably relevant time period, including Section 4(a)(6) offerings. But, we do not think this should include the target offering amount of any of these offerings and whether these offering amounts were reached. An issuer's capital needs are not static. These can change based on the success in generating cash flow from operations or from other factors such as a cancelled proposed acquisition. Moreover, capital raising difficulties may relate to the choice and quality of the intermediary. Thus, the possible reasons for not selling a maximum offering amount are too myriad to require a catchall disclosure just based on the amount of the offering and the amount raised. In any event, for those that do research, this informati0n may be available through the Form C and annual report filings.

Request for Comment No. 50 – Section 4(a)(6) issuers raising more than $500,000 should use U.S. GAAP until such time as the Commission accepts IFRS for U.S. domestic issuers. Please note our related comment in response to Request for Comment No. 54 below.

Request for Comment Nos. 51-52 – Requiring recently-formed Section 4(a)(6) issuers to provide no asset/no income financial statements would be a waste of time and effort. Instead, disclosures that the Section 4(a)(6) issuer was recently formed and does not have substantial assets or operating cash flow should be sufficient to warn investors. To the extent that any additional disclosure should be required, this should be determined by the Funding Portal or FINRA member on a case by case basis as part of due diligence.

Request for Comment No. 54 – The Commission should permit the use of cash accounting for crowdfunding issuers who raise less than $500,000 in a Section 4(a)(6) offering and have below a yet-to-be-determined asset or income level. Very small business entities use cash accounting because it is simple and consistent with the bookkeeping software likely to be used by such issuers.

Request for Comment No. 56 – The Commission should not require interim reporting because the crowdfunding issuers will almost certainly be very small business entities and the costs of these interim reports would be burdensome on such small businesses.

Request for Comment No. 59 – The Commission should require issuers to redact personally information from tax returns, particularly if the issuer was a disregarded entity for tax purposes before the Section 4(a)(6) offering. The fact that issuers are required to be business entities makes no difference if the issuer was a disregarded entity for tax purposes before the crowdfunding offering.

Request for Comment No. 62 – The Commission should not require audit partner rotation. Changing auditor partner results in additional audit fees in the first year as the new audit partner learns about the issuer's accounting treatments, procedures and personnel. Section 4(a)(6) issuers are likely to be very small business entities that need streamlined overhead.

Request for Comment No. 70 –As proposed an issuer that receives an adverse audit opinion or disclaimer of opinion are the only conditions under which an audit report will not satisfy the Commission's audit report requirement. We do not believe expanding the scope of opinions that do not satisfy the Commission's requirements to include qualified opinions is appropriate. Startup and small businesses often face uncertainties that require auditors to qualify their opinion. Adding qualifications to the audit report as a disqualifier would be significantly counterproductive to the startup and small businesses the crowdfunding exemption is trying to assist.

Request for Comment No. 71 - The auditors of Section 4(a)(6) issuers are subject to a comprehensive regulatory regime administered by the PCAOB and state accounting regulatory agencies. Given the professional credentialing process required, there is no discernible benefit to the Section 4(a)(6) issuers or their investors to provide for five years of good standing as a pre-requisite above the PCAOB and state license already required. However, such a requirement would have the benefit (to the auditors) of limiting the supply of auditors and thus driving up audit fees.

Request for Comment No. 128 –This request addresses whether the costs associated with requiring issuers to engage a transfer agent would result in a benefit justifying such cost. The comment also asked if there were less costly means to maintaining accurate records of the issuers' securities than engaging a transfer agent. We concur with the very real and practical considerations and concerns expressed in The Securities Transfer Association, Inc. comment letter dated December 18, 2013 from Charles Rossi, Chairman, STA Board Advisory Committee ("STA Letter") that addresses this issue.

While the STA Letter does focus on the record keeping and transfer agent needs; if any meaningful trading in the Section 4(6)(a) securities develops the transaction fees charged by brokers to handle a trade involving paper certificates are often disproportionately high when compared to the value or small number of securities held by the individual investors. The only currently effective way to reduce the cost of such trades is to have the securities held by Depository Trust Company. However, the current requirements imposed by DTC make this approach problematic. The use of the efficiencies provided by the internet and other electronic media are lost when the realities of how investors will be required to sell their shares is examined. The Commission is encouraged to address this issue by requiring and/or providing an incentive for DTC or another electronic depository company to serve this market.

<u>Request for Comment No. 129</u>–This request asks whether a "reasonable basis" is the appropriate standard for intermediaries' determination whether the issuer has established means to keep accurate records of the holders of the securities it would offer and sell through its platform. Again, we concur with the considerations and concerns in the STA Letter.

<u>Request for Comment No. 153</u> – Intermediaries should not be required to display issuer materials for closed offerings to the public, provided that such materials are subject to the intermediaries record-keeping requirements and production to the Commission and FINRA under Rule 227.404 or Rules 17(a)(3) and (4). The Form Cs and annual reports would be available as a public record of the Section 4(a)(6) offering. Further, removing the closed offering from the intermediary's website would prevent the investing public from relying on stale information. Publicly-available stale information about the Section 4(a)(6) issuer should be a regulatory concern given the active secondary market in restricted securities manifested by Second Market and SharesPost.

We appreciate the opportunity for the Commission to consider our comments to the Rule Proposal.

Very truly yours,

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