January 16, 2014

VIA ELECTRONIC SUBMISSION

U.S. Securities and Exchange Commission
Attn: Elizabeth M. Murphy, Secretary
100 F Street, NE
Washington, DC 20549
Electronic Address: rule-comments@sec.gov

Re: Crowdfunding, File Number S7-09-13

Dear Ms. Murphy:

The Office of Advocacy (Advocacy) offers the following comment to the Securities and Exchange Commission (SEC) in response to the above-referenced proposed rule issued on October 23, 2013.[1] The SEC issued the proposed rule to implement Title III of the JOBS Act[2], which established the foundation for a regulatory structure for startups and small businesses to raise capital through securities offerings using the Internet through crowdfunding. On December 16, 2013 and January 15, 2014, Advocacy hosted small business roundtables to receive feedback from small business representatives about the proposed rule. Advocacy also hosted several conference calls to hear input from small business. Based upon this feedback from small business stakeholders, Advocacy is concerned that the Initial Regulatory Flexibility Analysis (IRFA) contained in the proposed rule lacks essential information required under the Regulatory Flexibility Act (RFA)[3]. Specifically, the IRFA does not adequately describe the costs of the proposed rule on small entities, and the IRFA does not set forth significant alternatives which accomplish the stated SEC objectives and which minimize the significant economic impact of the proposal on small entities. For this reason, Advocacy recommends that the SEC republish for public comment a Supplemental IRFA before proceeding with this rulemaking. Advocacy also believes that the SEC should take into consideration small business representatives' suggested alternatives to minimize the proposed rule's potential impact.

Office of Advocacy

Advocacy was established pursuant to Pub. L. 94-305 to represent the views of small entities before federal agencies and Congress. Advocacy is an independent office within SBA, so the views expressed by Advocacy do not necessarily reflect the views of the SBA or the Administration. The RFA, as amended by the Small Business Regulatory Enforcement Fairness Act (SBREFA),[4] gives small entities a voice in the rulemaking

[1] http://www.sec.gov/rules/proposed/2013/33-9470.pdf.
[2] Pub. L. No. 112-106, 126 Stat. 306 (2012).
[3] 5 U.S.C. § 601 et seq.
[4] Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. § 601 et seq.).

process. For all rules that are expected to have a significant economic impact on a substantial number of small entities, federal agencies are required by the RFA to assess the impact of the proposed rule on small business and to consider less burdensome alternatives.

The RFA requires agencies to give every appropriate consideration to comments provided by Advocacy. The agency must include, in any explanation or discussion accompanying the final rule's publication in the Federal Register, the agency's response to these written comments submitted by Advocacy on the proposed rule, unless the agency certifies that the public interest is not served by doing so.[5]

Background

On October 23, 2013, the SEC issued the proposed rule to prescribe requirements governing the offer and sale of securities through crowdfunding. The proposed rule would also provide a framework for the regulation of funding portals and brokers that issuers engaged in crowdfunding are required to use.

After the SEC issued the proposed rule, Advocacy hosted two small business roundtables and several telephone conference calls to receive feedback on the proposal. Based on these meetings and phone calls, small businesses focused on two areas of the proposed rule: (1) disclosure requirements and (2) intermediary requirements.

(1) Disclosure Requirements

The proposed rule would set financial disclosure requirements for companies ("issuers") that raise capital through crowdfunding. If an issuer's target offering is $100,000 or less, the disclosure must include the income tax returns filed by the business for the most recently completed year and financial statements of the issuer, which must be certified by the principal executive officer of the issuer business. If the target offering amount is between $100,000 and $500,000, the issuer must provide financial statements reviewed by an independent accountant.

If the target amount of the offering exceeds $500,000, the proposed rule would require the issuer to provide two years of audited financial statements when it files its initial offering materials with the intermediary and the SEC. Although the JOBS Act does state that issuers seeking to raise over $500,000 must provide audited financial statements, section 302(b)(1)(D)(iii) of the law also provides the SEC with authority to change the amount of the $500,000 threshold by rulemaking.

Additionally, the proposed rule would also mandate nonfinancial disclosures not required by the JOBS Act. Section 227.201 of the proposed rule sets forth 10 pages of different nonfinancial disclosures that would be required for issuers. The proposed rule would require issuers to disclose information such as: the name of each person who owns 20 percent or more of issuer's voting power; a description of issuer's business and issuer's anticipated business plan; the number of issuer's employees; the risk factors associated with the investment; the target offering amount and deadline to reach target; whether investments in excess of the targeted amount will be accepted, and if so, how oversubscriptions will be allocated; and the intended use of the proceeds.

[5] 5 U.S.C. § 601 et seq.

(2) Intermediary Requirements

The proposed rule would also set requirements related to the intermediaries – funding portals and broker dealers – that issuers raising money through crowdfunding would be required to use. The proposed rule suggests that both funding portals and broker dealers should be treated as "issuers" that could be held personally liable for failing to meet the "due diligence" standard of the JOBS Act. Specifically, section II.A.5 of the proposal's preamble provides that "it appears likely that intermediaries, including funding portals, would be considered issuers for purposes of this liability provision."[6] It is noteworthy that the JOBS Act does not require this imposition of liability and the resulting due diligence standard that the proposed rule appears to mandate.

The proposed rule would also subject funding portals to certain additional constraints not applied to broker dealers. The proposed rule provides that funding portals cannot engage in the practice of sorting or organizing crowdfunded offerings based on subjective criteria.[7] However, the proposed rule would allow broker dealers to engage in this practice of sorting known as "curation."

The Proposed Rule's IRFA is Deficient

Because it does not adequately describe the impacts on small entities and because it does not discuss alternatives that might reduce those impacts, Advocacy believes that the IRFA contained in the proposed rule is deficient, and for this reason, the SEC should republish a Supplemental IRFA for additional public comment before proceeding with this rulemaking. Under the RFA, an IRFA must contain: (1) a description of the reasons why the regulatory action is being taken; (2) the objectives and legal basis for the proposed regulation; (3) a description and estimated number of regulated small entities; (4) a description and estimate of compliance requirements, including any differential for different categories of small entities; (5) identification of duplication, overlap, and conflict with other rules and regulations; and (6) a description of significant alternatives to the rule.[8] Advocacy is concerned that because the proposed rule's IRFA is deficient, the public has not been adequately informed about the possible impact of the proposed rule on small entities and whether there are significant alternatives to the proposed rule that would meet the SEC's objectives in a less costly manner.

The IRFA contained in the proposed rule does not adequately describe and estimate the costs the proposal would impose on small entities. Additionally, the IRFA does not set forth significant alternatives which accomplish the stated SEC objectives and which minimize the significant economic impact of the proposal on small entities. The IRFA only lists alternatives related to exempting small business from the proposed requirements. However, the SEC states that these alternatives do not accomplish the underlying goals of the rulemaking. Therefore, these are not "alternatives" for purposes of the RFA. Moreover, the IRFA does not discuss alternatives that may reduce the disproportionate economic impact on small entities.

Because the IRFA does not contain an adequate description of alternatives, the IRFA does not comply with the RFA requirement that an IRFA provide significant alternatives that accomplish an agency's objectives.

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[6] http://www.sec.gov/rules/proposed/2013/33-9470.pdf at 280.
[7] Id. at 233.
[8] 5 USC § 603.

Recommendations

Advocacy recommends that the SEC revise its IRFA to provide a description of the costs of the proposed rule and to include alternatives which would accomplish its objectives for the rulemaking. Small business representatives at Advocacy's roundtables have described two areas of concern where a discussion of costs and alternatives would help provide the public with more adequate data to assess the impact of the proposed rule and potentially minimize the costs imposed by the proposed rule: (1) disclosure requirements and (2) intermediary requirements.

(1) Disclosure Requirements

Small business representatives and owners expressed concern to Advocacy that the proposed rule's disclosure requirements would impose high costs and burdens. In particular, small business stakeholders are concerned about the potential costs associated with the proposal's audited financial statements requirement for issuers seeking to raise over $500,000 through a crowdfunded offering. Small business owners in contact with Advocacy have observed that this requirement would be problematic and burdensome because many of the issuers looking to raise capital through crowdfunding will be startups with little or no revenue to afford audited financial statements. Because the JOBS Act provides the SEC authority to change the threshold for audited financial statements, small business representatives suggested that the SEC should consider alternatives, such as raising the threshold amount, so that the proposal's audited financial statement requirement is less burdensome for small business.

Further, small business stakeholders expressed concerns about the potential costs and burdens associated with the proposal's nonfinancial disclosures. However, the IRFA contained in the proposed rule provides no estimates of the costs that disclosure requirements would impose.

Small business representatives at Advocacy's roundtables proposed alternatives to the nonfinancial disclosure requirements that may minimize costs. One alternative to the proposed rule's nonfinancial disclosures suggested by a small business owner is that the SEC could adopt a simple "question and answer" format for nonfinancial disclosures similar to the format used in disclosures for Regulation A offerings. The question and answer format would be less burdensome for small business issuers while still providing the SEC with the information it is seeking under the proposed rule.

Another potential alternative suggested by a small business representative is that the SEC could develop standard, boilerplate disclosures for some of the more complicated nonfinancial disclosures, such as risk factors. Permitting small business issuers to use standard disclosures would serve as a less burdensome alternative that still accomplishes the purposes of this rulemaking. Because the proposed rule's nonfinancial disclosures are not required by the JOBS Act, Advocacy encourages the SEC to develop alternatives that would be less burdensome for small business.

(2) Intermediary Requirements

As described above, the proposed rule appears to impose statutory issuer liability on intermediaries. This is potentially a large expense for intermediaries that the IRFA does not estimate. For example, in order for an intermediary to avoid liability to a purchaser on the basis of an issuer's false or misleading offering materials, the intermediary would likely need to conduct an expensive and time-consuming due diligence on the issuer's

offering materials. This liability standard would be especially burdensome for funding portals because broker dealers will already have these procedures in place under requirements set by the Financial Industry Regulatory Authority (FINRA). Small business owners and representatives have suggested to Advocacy that the SEC should clarify that broker dealers and funding portals would not be subject to personal liability as an issuer.

In addition to personal liability being particularly costly for funding portals, the proposed rule would impose another cost on funding portals that the IRFA does not describe: the prohibition of funding portals to curate on the basis of subjective factors. The prohibition on curation is burdensome because it would place funding portals at a competitive disadvantage to broker dealers (who may curate offerings under the proposal). Moreover, if funding portals are not permitted to screen issuers on the basis of subjective factors, the funding portals could potentially be exposed to greater risk of personal liability for the offers on the portal.

Small business owners and representatives recommended to Advocacy an alternative to the proposed rule's restriction on funding portals' ability to curate. These small businesses suggested that the SEC create a safe harbor for funding portals to curate on the basis of subjective factors that do not engage in activities that could be treated as "solicitations." Another suggested alternative would be for the SEC to permit funding portals to curate on the basis of subjective factors so long as the portals disclosed to the public that its curation does not constitute a recommendation regarding the advisability of any investment on the funding portals. Both of these suggestions serve as alternatives that may reduce the costs and burdens of the proposed rule that the SEC should consider.

Conclusion

Advocacy is concerned that the SEC's proposed rule and IRFA lack essential information needed to properly inform the agency's decision making. Specifically, the IRFA does not adequately describe the costs of the proposed rule on small entities, and the IRFA does not set forth significant alternatives which accomplish the stated SEC objectives and which minimize the significant economic impact of the proposal on small entities. For this reason, Advocacy recommends that the SEC republish for public comment a Supplemental IRFA before proceeding with this rulemaking.

By republishing a Supplemental IRFA, small businesses will have more adequate data to assess the potential impact of the proposed rule. Further, the SEC will gain valuable insight into the effects of the proposed rule on small business. Advocacy also believes that the SEC should take into consideration small business representatives' suggested alternatives that may minimize the proposed rule's potential impact.

Advocacy is committed to helping the SEC comply with the RFA in the development of the proposed rule. Therefore, Advocacy stands ready to assist the SEC in the completion of a Supplemental IRFA.

Advocacy looks forward to working with the SEC. If you have any questions or require additional information please contact me or Assistant Chief Counsel Dillon Taylor at (202) 401-9787 or by email at Dillon.Taylor@sba.gov.

Sincerely,

Winslow Sargeant

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Copy to: The Honorable Howard Shelanski, Administrator
Office of Information and Regulatory Affairs
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