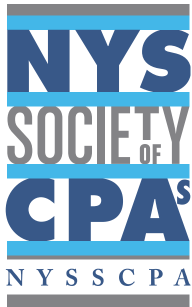


January 21, 2014

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

Submitted via email: rule-comments@sec.gov

Re: Comments on Regulation Crowdfunding under the Securities Act of 1933 and the Securities Exchange Act of 1934 to Implement the requirements of Title III of the Jumpstart Our Business Startups Act
File No.: S7-09-13

The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 29,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above captioned proposed rule.

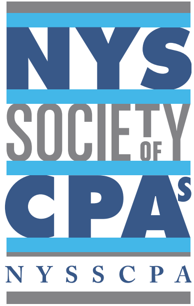
The NYSSCPA's Litigation Services Committee deliberated the proposed rule and prepared the attached comments. If you would like additional discussion with us, please contact Russell J. Kranzler, Chair of the Litigation Services Committee at (212) 533-2727, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

N Y S S C P A

J. Michael Kirkland
President

Attachment



NEW YORK STATE SOCIETY OF

CERTIFIED PUBLIC ACCOUNTANTS

Comments on Regulation Crowdfunding under the Securities Act of 1933 and the Securities Exchange Act of 1934 to implement the requirements of Title III of the Jumpstart Our Business Startups Act

File No.: S7-09-13

January 21, 2014

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New York State Society of Certified Public Accountants
Comments on
Regulation Crowdfunding under the Securities Act of 1933 and the Securities Exchange Act of 1934 to implement the requirements of Title III of the Jumpstart Our Business Startups Act

General Comments

Our focus as stakeholders in this process is as Certified Public Accountants, many of whom, by virtue of our training and experience, can speak knowledgeably about preventing, deterring and detecting fraud. As such, we are versed in fraud risk and are continually working on ways to mitigate the occurrence and magnitude of fraud perpetrated against the investing public including individuals, organizations and fiduciary entities. Given this focus, our response is limited to the sub-set of the proposed regulations identified below.

In general, we see that a reduction of regulatory oversight through relaxation of rules is at the expense of security and transparency in the investment vehicle known as "Crowdfunding." We note with concern that the Securities and Exchange Commission (SEC) is considering a tradeoff between transparency and functionality especially in connection with a new and, as of yet, untested method for offering securities to a broad cross-section of potential investors. We suggest that continued conservatism and caution be the hallmark of a regulator such as the SEC. We urge the SEC to consider the many recent financial events rooted in fraud and dereliction on the part of reporting company when it evaluates the level of oversight of the Crowdfunding investment vehicle. For example, on page 9 of the request for comments (RFC), the SEC states, "A person that operates such a web site only for the purchase of securities of startups and small businesses, however, may find it **impractical** in view of the limited nature of that person's activities and business to register as a broker-dealer and operate under the full set of regulatory obligations that apply to a broker-dealer." [Emphasis added.]

We question the issue of practicality of operation because it invokes the consideration of cost versus benefit as a condition for operation. As a portal or platform provider for the transaction of equity shares, practicality is part of a series of business decisions for the potential service provider, and should never be a consideration that impacts the quality of service or integrity of the securities being offered. To that end, if an operator finds it impractical to be regulated under prescribed rules, we challenge the SEC to identify a reason that such an operator would find it practical to self-regulate. Many of the RFC questions relate to the concept of "reasonable basis" for proposed standards and regulations. While this may be appropriate for assessing the relative risk of an investment, it is wholly inadequate for assessing the degree to which an intermediary in the investment process exercises the necessary investor protections provided by broker-dealers in the current brick-and-mortar environment. We are unconvinced of the rationale, and, accordingly, we do not support the regulatory proposal.

Elsewhere in the RFC, the SEC describes that the Crowdfunding investment vehicle is layered with intermediaries[1] . The presence of multi-layered agents increases the opaqueness of the investment vehicle and reduces the security of the investors and creditors in it. The narrative subsequently[2] indicates that the intermediaries' own reporting will benefit investors: "The proposed rules will require that this information be provided to investors at various points in time in connection with an offering and through various electronic means..."[3] We are unconvinced why an opaque, intermediate-driven environment would make the underlying investment and the associated risks more transparent to investors. Transparency is achieved by the dissemination of reliable, factual and meaningful information regarding the issuer, presented in an understandable manner, and made accessible to all potential investors who have indicated an interest in the investment.

Similarly, it is unclear to us how the "Commission staff will monitor the market for offerings made ... focusing in particular on the types of issuers using the exemption".[4] It is unclear how the SEC would have visibility into the actions of exempt crowdfunding investment vehicles if such securities (as defined) are not reporting to the SEC. It is doubtful that the SEC staff would "troll" the internet to seek comments from the investor community. The practicality of this approach is ambiguous.

Specific Comments

In response to the RFC, we make the following comments:

128. What would be the potential benefits and costs associated with having a regulated transfer agent for small issuers? Are there other less costly means by which an issuer could rely on a qualified third party to assist with the recordkeeping related to the securities?

Response: The potential benefits associated with having a regulated transfer agent include more efficient operations and a more compliant environment with trained personnel; complete, well-tested and understood information systems; and a well-practiced set of internal controls. The costs associated with having a regulated transfer agent for small issuers cannot at this time be estimated; however it would be a foreseeable cost to be incurred for access to equity capital. We believe that there is a lower cost solution that could achieve similar objectives for regulators and stakeholders that would contain costs. The American Institute of Certified Public Accountants (AICPA) promulgates the Statements of Standards for Attestation Engagement (SSAE), and, in

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[1] Page 12.
[2] Ibid.
[3] Ibid.
[4] Pg. 13

particular, SSAE number 16, *Reporting on Controls at a Service Organization*, (SSAE-16). Under that standard, previously known as Statement of Auditing Standards number 70, management *or another* party, defines a set of objectives which is attested on by a qualified third party CPA[5]. The manner in which an SSAE-16 report could be applicable to small issuers is by having the SEC act as the above mentioned "other party." In other words, the control objectives would be regulated, and the CPA would have to opine on the achievement of a minimum, pre-specified set of objectives that the small issuer must achieve. For example, the SEC may require the SSAE-16 report by a qualified CPA to report whether the issuer has achieved compliance with certain vetting process criteria of investors to ensure that they are qualified under standards or regulations that the SEC will publish. We believe that such a "middle-of-the-road" response will balance the needs of investors in terms of knowing the strength of internal controls while the issuer can reduce its compliance costs and maintain focus on the core business issues relating to the crowdfunding investment vehicle.

129. Is a "reasonable basis" the appropriate standard for intermediaries making such determination? Why or why not? Is it appropriate for one determination but not the other? If so, please explain which one and why. What other standard would be more appropriate, and why? What circumstances in the crowdfunding context should not be considered to constitute a reasonable basis? Should we permit an intermediary to reasonably rely on the representation of the issuer with respect to both determinations?

Response: A reasonable basis is an insufficient standard because it 1.) Is undefined and is unlikely to be applied with any degree of consistency, 2.) Cannot be assessed or tested against objective standards, and 3.) Provides a false sense of security to all parties including the SEC and its stakeholders that the representations made are accurate. If a party (be it the issuer or an intermediary) is set on misleading the other, the reasonable basis would have been the last line of defense absent any regulation. Such regulation would be more robust, and the reasonable basis would be a second line of defense against intentional and accidental misrepresentation (known colloquially as fraud and errors, respectively). To effectively and realistically create a system in which issuers' representations are accepted, the intermediary should be required to conduct a certain amount of monitoring of its own. The monitoring could be similar in depth and manner to "The Sarbanes-Oxley Act" Section 404, as interpreted by PCAOB Audit Standard No. 5, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements*, in which a "top-down" risk analysis of the issuer has to be made by the intermediary[6], and the monitoring is to be linked to the risky issuers and crowdfunding investment vehicle. The standard should also not be "reasonable care"; rather it should be raised to "prudent care." Under that standard, the intermediaries are not only required to establish that a

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[5] AT Section 801, *Reporting on Controls at a Service Organization.* www.aicpa.org/REsearch/Standards/AuditAttest/DownloadableDocuments/AT-00801.pdf

[6] http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard/5.aspx

reason was provided—rather they would *also* be required to demonstrate that their actions, including monitoring, would be the same action that a prudent person with knowledge of all the facts would undertake. A prudent-care standard elevates the level of responsibility from a trading-agent ("reasonable") to a fiduciary, yet the risk-based approach reduces the amount of work to be done by the intermediary to an acceptable effective level. We believe that by requiring intermediaries to adhere to the fiduciary-like "prudent care" standard which exceeds the "reasonable care" standard and that more effective, efficient risk-based monitoring could take place for the purpose of accepting the issuing parties' representations regarding compliance with the rules.

130. Is it appropriate to have these two different standards under the proposed rules? Why or why not? If one of these standards is not appropriate, please explain what would be more appropriate standard and why.

Response: It is appropriate to have the same standard for both intermediaries and issuers. It would be inappropriate for these two groups to have different standards. The appropriate standard, as discussed in item number 129, is not just the "reasonable care" standard but it should be a "prudent care" standard for both groups. This is because:

1. A prudent care standard enhances the transparency and the level of responsibility expected from the party that is subject to the standard.
2. If one party is not subject to the same standard as the other, the effect is that fraud could be introduced to the system as the 'weakest link' can be easily broken.
3. Some intermediaries are also issuers and the existence of two standards could cause implementation confusion and an expectations gap on the part of investors and the general public.

131. Is this approach [conduct a background and security enforcement security check**] appropriate? Why or why not? If not, why not? Would another approach be more appropriate?**

Response: This approach is appropriate but it is incomplete. We encourage the SEC to regulate background checks for stakeholders such as officers, directors and others charged with governance (collectively: "officers"). However, a broader approach would allow periodic, recurring confirmation of compliance of officers. This broader approach is recommended because a singular point in time is not indicative of future action or pattern of behavior.

132. Should we require intermediaries to make the results of the proposed background checks publicly available? Why or why not? Would doing so raise privacy concerns?

Response: Making the results of background checks publicly available is not advisable because it could contradict existing Federal and state laws, as well as raising privacy concerns. However, requiring the results of background checks to undergo a systemic and standard grading system, akin to a "Risk/Capitalization" matrix used by financial analysts, could be beneficial to the public, *without* having to disclose private information. A multi-dimensional or multi-value grading system would be a sufficient disclosure that intermediaries should be required to undergo, and be publicly available. Subject to certain thresholds, event-based reporting may be advisable (*e.g.*, if an officer commits a felony that calls his/her managerial decision-making or ability to lead or direct the issuer into question).

133. Should we specify the steps that an intermediary must take in obtaining background and securities enforcement regulatory history checks on the issuer and its officers, directors (or any person occupying a similar status or performing a similar function) and 20 Percent Beneficial Owners? Should we require, for example, an intermediary to check publicly-available databases, such as FINRA's BrokerCheck and the Commission's Investment Adviser Public Disclosure program? Why or why not? Are there third parties who would be in a position to provide these types of services? Please discuss.

Response: A prescribed set of steps in this context is synonymous with a set of sound risk management procedures. However, risk management steps that are not informed by a well-considered risk assessment protocol could be, at best, unresponsive to the real risks and, at worst, create a false sense of security. Accordingly, it is our recommendation that steps be taken to require following a mandatory planning process similar to the Administrative and Technical Safeguards required under the Health Information Portability and Accountability Act ("HIPAA"). Under HIPAA, a set of "required" steps is mandatory; a second set of steps are "addressable." The addressable steps are optional as follows: an addressable step can be waived or complied with depending upon the level of risk and the facts and circumstances that this step is meant to address. It is our recommendation that a minimal set of steps to obtain background checks on officers, directors, *etc*. should be required. Beyond that, the intermediary should perform a risk assessment analysis and explain why the "addressable" steps can be waived. Further, there should be no requirement for an intermediary to waive these steps. They can perform them even if these addressable steps are deemed unnecessary. For example, a basic credit report and verification of identity would be a "required" step. However, inquiries and confirmation from employers and other parties may be an "addressable" step depending upon the intermediary risk assessment of the issuer.