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BAR ASSOCIATION

Business Law Section
Michael D. Ecker, Chair

February 3, 2014

VIA EMAIL (rule-comments@sec.gov)
Ms. Elizabeth Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-09-13 – Regulation Crowdfunding Proposed Rules

Dear Ms. Murphy:

This letter is submitted on behalf of the Business Law Section (the "Section") of the Philadelphia Bar Association (the "PBA") in response to the request for comments by the Securities and Exchange Commission (the "Commission") regarding rules proposed by the Commission in Release Nos. 33-9470, 34-70741, File No. S7-09-13 (the "Proposed Rules"). Under the Proposed Rules, the Commission proposes to adopt Regulation Crowdfunding under the Securities Act of 1933, as amended (the "Securities Act") to implement Title III of the Jumpstart Our Business Startups Act (the "JOBS Act").

The undersigned are the Chair and Vice Chair of the Securities Regulation Committee (the "Committee") of the Section. Please note that the comments expressed in this letter do not represent the official position of the Committee, the Section or the PBA.

Below are our comments to selected portions of the Proposed Rules.

1. Disclosure Requirements

A. Tiered Financial Statement Disclosure Requirements Based on Aggregate Target Offering Amounts.

Title III of the JOBS Act added Section 4A to the Securities Act, which sets forth certain intermediary and issuer requirements with respect to crowdfunding offerings. Securities Act Section 4A(b)(1)(D) establishes a framework of tiered financial disclosure requirements based on aggregate target offering amounts for offerings under Securities Act Section 4(a)(6) (the crowdfunding exemption) within the preceding 12-month period.

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According to Section 4A(b)(1)(D) of the Securities Act:

- an issuer offering $100,000 or less must disclose: (i) its most recently filed income tax returns for the most recently completed year (if any), and (ii) financial statements certified by the issuer's principal executive officer;
- an issuer offering more than $100,000, but not more than $500,000, must provide financial statements reviewed by a public accountant that is independent of the issuer; and
- an issuer offering more than $500,000 (or such other amount as the Commission may establish by rule) must provide audited financial statements.

The Proposed Rules set forth the same thresholds as those of the JOBS Act, as described above. The JOBS Act expressly authorizes the Commission to establish the threshold that triggers an obligation to provide audited financial statements. We recommend that the Commission exercise this discretion and raise the threshold to $1,000,000.

The crowdfunding provisions of the JOBS Act were intended to help startups and small businesses raise capital by making small offerings less costly. Applying the audited financial statement requirement to offerings targeting less than $1,000,000 is overly burdensome given the objectives of the JOBS Act. Such a requirement would stifle issuers and impede the development of crowdfunding as a useful way of raising capital and as an emerging industry. We therefore respectfully request that the Commission raise the minimum threshold of target offering amounts, at which audited financial statements are required, to $1,000,000.

At least three considerations warrant such an increase in the threshold. First, many startups and development stage companies do not maintain records necessary for audited financial statements to be prepared. Even where there are historical financial statements that can easily be audited, startup companies seeking to raise less than $1,000,000 are likely to be enterprises with little to no operating history or are likely to have relatively uncomplicated financial information. Audited financial statements from such companies would be unlikely to provide any more information or assurances than a review by a public accountant. Second, preparing audited financial statements is a costly, time-consuming effort. For many issuers, an audit would be prohibitively expensive. The cost of preparing audited financial statements will be a major obstacle to fundraising efforts under the crowdfunding exemption. The Commission has assumed that an audit of the financial statements of an issuer seeking to raise $500,000 to $1,000,000 within a 12-month period would cost approximately $28,700; such an audit expense would represent 2.87% of $1,000,000, and 5.74% of $500,000.[1] Third,

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[1] *See, e.g.*, *Crowdfunding*, Securities Act Release No. 33-9470, Section III.B.3.b n.948 and accompanying text (Oct. 23, 2013), estimating the cost of an annual audit of financial statements to be $28,700, an amount which may very well be low, especially for small issuers with an operating history.

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accounting firms providing audits for financial statements of issuers targeting less than $1,000,000 in a crowdfunding offering may be unable to obtain cost effective insurance coverage for such audits. The absence of appropriate or affordable insurance coverage may reduce the number of accounting firms willing to perform such audits. This reduction in the supply of appropriate audit services would increase the cost to issuers seeking such services, and may even result in issuers being unable to obtain such services at any reasonable price. Taken together, the low utility and high cost of obtaining audited financial statements for companies seeking to raise less than $1,000,000 weigh against imposing any requirement to produce such audited financial statements.

We recognize that, given that the crowdfunding exemption is restricted to issuers raising not more than $1,000,000 in a 12-month period, raising the audited financial statement requirement threshold to $1,000,000 will, in effect, eliminate the audited financial statement requirement. We believe that requiring reviewed financial statements, rather than audited financial statements, would provide a better balance between investor protection and the costs and burdens on startup enterprises raising funds in crowdfunding transactions. In light of the costs discussed above, raising the audited financial statement requirement threshold to $1,000,000 would remove a major obstacle to the achievement of the goals of the JOBS Act.

B. Other Financial Statement Disclosure Requirements.

Under the Proposed Rules, the Commission has not proposed to exempt issuers with no operating history (or issuers that have been in existence for less than 12 months) from the financial disclosure requirements of Securities Act Section 4A(b)(1)(D) (discussed above). We recommend that the Commission not require issuers with no operating history and/or newly formed issuers to provide financial statements given the costs and burden of preparing such financial statements. It should be sufficient for such issuers to include a statement in its other disclosures under Section 4A(b)(1) that the issuer does not have any operating history and has nominal assets. Such a statement should be sufficient to inform potential investors of the risks of investing in the issuer's crowdfunding offering.

We recognize that some issuers with little or no operating history may have significant assets or indebtedness. It might be appropriate to require that such issuers provide a balance sheet as of a date reasonably proximate to the commencement of the offering, certified by the issuer's principal executive officer (for offerings of $500,000 or less), or reviewed by an independent public accountant (for offerings above $500,000).

2. Reporting Requirements

A. Ongoing Reporting Requirements.

Securities Act Section 4A(b)(4) requires, "not less than annually, [an issuer to] file with the Commission and provide to investors reports of the results of operations and financial statements of the issuer, as the Commission shall, by rule, determine appropriate,

subject to such exceptions and termination dates as the Commission may establish, by rule." Proposed Rule 202 of Regulation Crowdfunding would implement the ongoing reporting requirement in Section 4A(b)(4) by requiring an issuer to file on EDGAR and post on the issuer's website annually a report of the issuer's results of operations and financial statements, no later than 120 days after the end of the fiscal year covered by the report. The report must also include the disclosures required to be provided in connection with the issuer's crowdfunding offering regarding, among other things, the issuer's business and business plan, management, risk factors and capital structure of the issuer, as set forth in Section 4A(b)(1) of the Securities Act (collectively referred to as "non-financial information").

With respect to the requirement to provide financial statements, proposed Rule 202(a) of Regulation Crowdfunding would utilize the tiered financial disclosure requirements specified by the JOBS Act (as discussed in the preceding section in connection with crowdfunding transactions). We recommend that the Commission adopt rules requiring that such financial statements be reviewed only when the issuer's total assets exceeded a specified amount as of the last day of the issuer's fiscal year. Specifically, if the Commission adopts a rule requiring review by an independent accountant, the Commission should consider requiring such a review only when the issuer's total assets as of the end of its fiscal year exceeded $500,000. Inasmuch as Section 4A(b)(4) does not require that the annual reports to be filed by issuers include audited financial statements, we recommend that the Commission eliminate from proposed Rule 202 any requirement that issuers that have completed a crowdfunding offering file audited financial statements as part of their annual reports. However the Commission adopts a rule requiring audited financial statements, the Commission should consider requiring such audited financial statements only when the issuer's total assets exceeded $1,000,000 as of the end of the issuer's fiscal year.

These recommended thresholds harmonize with the $500,000 and $1,000,000 financial disclosure requirement thresholds discussed and recommended in the preceding section of this comment letter with respect to financial information disclosure at the time of the offering. (We also note that our recommended approach is consistent with the public reporting requirements imposed under Section 12(g) of the Securities Exchange Act of 1934, as amended, which are based, in part, on an asset test). We recognize that disclosure provided at the time of a crowdfunding offering and ongoing disclosure serve somewhat different purposes. However, the primary purpose of mandatory financial disclosure is always the same – that is, enabling investors to assess the financial condition and performance of a business. Moreover, the crowdfunding legislation and the Proposed Rules will apply, in the vast majority of circumstances, to very small, early-stage issuers. As noted above, many of these issuers will have little or no operating history and fairly uncomplicated financial information. These issuers most likely will not have the resources to be able to obtain the accounting, auditing and legal services necessary to comply with the ongoing, detailed reporting requirements of proposed Rule 202. We believe it is therefore appropriate to use the same thresholds – both for financial disclosure requirements in connection with offerings as well as ongoing financial reporting requirements. In addition, basing the levels

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of required disclosure on the issuers' total assets has the rational effect of automatically adjusting such levels, in any given situation, according to the issuer's size.

In formulating the recommendations set forth above, we have been influenced by the fact that issuers who complete securities offerings under Regulation D or Regulation A under the Securities Act are not required to file with the Commission annual reports or other information on an ongoing basis – notwithstanding that (i) no restrictions are imposed under either Regulation D or Regulation A with respect to the amount of money an individual investor may invest (in contrast to the stringent limitations on amounts individual investors are permitted to invest in crowdfunding offerings), and (ii) under each of Rule 505 of Regulation D and under Regulation A, issuers may sell securities having an aggregate offering price of $5,000,000 within a 12-month period (i.e., five times the amount that an issuer may sell within a 12-month period in crowdfunding transactions). We also note that issuers may publicly solicit investors in Regulation A offerings and in certain offerings under Rule 504. The regulatory schemes embodied in Regulation D and Regulation A reflect regulatory determinations that the burdens and costs of imposing on-going reporting requirements on small, development-stage issuers exceed the benefits to investors in such companies.

In light of these considerations, we request that the Commission (i) require reviewed or audited financial statements, if the Commission imposes any such requirement, only under circumstances where the issuer's total assets exceeded $500,000 or $1,000,000, respectively, as of the last day of the issuer's fiscal year, and (ii) limit the information to be filed in annual reports under Rule 202 to reports of the results of operations and financial statements, eliminating the "non-financial information" referred to above. In the alternative, the Commission should require issuers to include such non-financial information only if the issuer's total assets exceed $500,000 as of the last day of the issuer's fiscal year.

B. Termination of Ongoing Reporting Requirements.

Under proposed Rule 202(b), an issuer must continue to comply with the ongoing reporting requirements until (i) the issuer becomes a reporting company, (ii) the issuer or another party repurchases all of the securities issued in reliance on Section 4(a)(6), or (iii) the issuer liquidates or dissolves. We believe that the requirement that the issuer repurchase all of the securities issued by the issuer in reliance on Section 4(a)(6) is too stringent. An issuer that has effected a crowdfunding transaction may have hundreds (or thousands) of security holders and it would be virtually impossible for such an issuer to locate and obtain the agreement of each of its security holders to sell their securities to the issuer. Accordingly, we recommend that the Commission modify the repurchase alternative to lower the repurchase threshold from 100% to two-thirds (2/3), so long as the issuer has made a bona fide offer to repurchase all securities held by investors who purchased securities in a crowdfunding exempt offering.

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In addition, because of the burdens and costs imposed on issuers by the ongoing reporting requirements of proposed Rule 202, we believe that a "sunset" provision should be added to Rule 202 in the form of a fourth triggering event. We recommend that the on-going reporting requirements should terminate after the issuer has filed three consecutive annual reports.

3. Limitation on Capital Raised – "Control" Definition

As noted in the Proposed Rules, the JOBS Act requires that the $1,000,000 aggregate 12-month limitation on amounts raised in crowdfunding offerings are aggregated with entities "controlled by or under common control with the issuer." In the Proposed Rules, the definition of "control" has been borrowed from Securities Act Rule 405.[2] This definition of "control" is very broad and its application in the determination of the 12 – month offering amount limitation would have unintended consequences which are likely to unreasonably restrict the ability of issuers to rely on the exemption provided by Section 4(a)(6) of the Securities Act in this situation.

Currently, the Commission staff and securities laws practitioners commonly consider entities to be under common control if they share a significant stockholder, such as one owning 10% or more of the voting securities of that entity, and such stockholder also has representation on the board of directors (or a similar management body), even if the representation on the board of directors does not constitute a majority vote. As a result, for example, if a venture capital fund owns 10% or more, but less than a majority, of the voting securities of two issuers, and has board representation on each of those issuers constituting less than a majority of the vote of the board of directors, the Proposed Rules might nevertheless require those two issuers to aggregate any offerings under Section 4(a)(6) for purposes of determining the $1,000,000 limitation. This would be true even though the management and operations of the two issuers were entirely distinct from each other.

Accordingly, we suggest that the Commission consider an alternate definition of control that does not rely on the historical application of that definition in the context of determining persons or entities who are deemed to be "affiliates" under the Securities Act. We propose that the aggregation in Section 4(a)(6) be applied to companies that are "under common control" only if there is either a majority of the companies' voting stock owned by the same person or entity or the right to designate a majority representation on their board of directors (or similar management body) possessed by the same person or entity. In addition, we propose a further limitation that the management and operations of the issuers may not be interdependent. For example, majority-owned subsidiaries of a common parent corporation would be aggregated for purposes of the $1,000,000 limitation, but companies that do not

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[2] The term *control* (including the terms *controlling*, *controlled by* and *under common control with*) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. Securities Act Rule 405.

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have overlapping operations and otherwise have no common control other than a significant but minority stockholder and a minority representation on the board of directors would not be so aggregated.

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We appreciate the opportunity for the Commission to consider our comments to the Proposed Rules.

Sincerely,

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