Jason W. Parsont[1]

February 18, 2014

Via E-mail: rule-comments@sec.gov

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Crowdfunding: File No. S7-09-13

Dear Ms. Murphy:

On November 4, 2013, I submitted a letter to highlight a number of recommendations from my recent article, *Crowdfunding, the Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. ___ (forthcoming Spring 2014), which focused primarily on Regulation D and its interaction with crowdfunding. That letter and my recent article are available at the following web addresses: http://www.sec.gov/comments/s7-06-13/s70613-463.pdf and http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2279711.

In this letter, I offer five recommendations that are specific to Regulation Crowdfunding.[2] They are as follows:

- Distinguish "insignificant" from "significant" deviations under proposed Rule 502;
- Use a different approach to motivate timely filing than the approach in Rule 100(b);
- Adopt an integration safe harbor to facilitate back-to-back exempt offerings;
- Tailor prior exempt offering disclosure to the needs of non-accredited investors; and
- Adopt a resale safe harbor for crowdfunding securities.

Each recommendation is described in further detail below.

I. Distinguish "insignificant" from "significant" deviations under proposed Rule 502

The Commission has proposed a safe harbor under Rule 502[3] for certain insignificant deviations from a term, condition, or requirement of Regulation Crowdfunding. Such a safe

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[1] The author of this comment letter was until recently a Lecturer-in-Law and Post-Doctoral Research Scholar at Columbia Law School, and is now an associate at Clifford Chance US LLP. The author is also a member of the New York City Bar Association's Securities Regulation Committee (the "NYCBA Committee"). This comment letter reflects the author's personal views and not those of Clifford Chance US LLP or the NYCBA Committee.

[2] Crowdfunding, SEC Rel. No. 33-9470 (the "Proposing Release"), 78 Fed. Reg. 66427 (Nov. 5, 2013).

[3] *See* the Proposing Release, proposed Rule 502, 17 CFR 227.502.

harbor is essential because the conditions to the Crowdfunding Exemption[4] contain an unprecedented number of potential pitfalls, any one of which could destroy an issuer's exemption. The pitfalls arise primarily from the open-ended condition that the issuer must strictly comply with all of the many detailed requirements in Section 4A(b) of the Securities Act and Regulation Crowdfunding.[5]

The Commission's safe harbor proposal, which largely reduces this strict compliance burden to a substantial compliance burden, would seem to generally solve this problem. But substantial compliance only applies if the "failure to comply was *insignificant* with respect to the offering as a whole [emphasis added]." Thus, the analysis will center on the meaning of the term "insignificant." *Ad hoc* interpretation could heighten uncertainty for issuers since some obligations may be deemed significant without warning. So, the Commission has rightly asked: "Should we define the term "insignificant" or use a different term?"[6]

Defining this term (or its opposite – "significant") would increase certainty and would mirror the approach taken under Regulation D[7] and Regulation A.[8] In other words, only the following types of violations, which are not easily subject to cure, should be deemed to be significant to the offering as a whole: illegal general solicitation and advertising, illegal gun-jumping, exceeding the offering cap, and exceeding relevant purchaser limitation rules. Deeming these significant would tell issuers and adjudicators that an issuer's most important obligations are complying with the rules governing the advertising notice,[9] the filing of Form C "prior to the commencement of offering securities,"[10] the $1 million cap,[11] and the investor self-certification rules.[12] By contrast, compliance failures that are more easily subject to cure, such as filing delinquencies, should be deemed insignificant to the offering as a whole unless the issuer fails to cure the compliance failure within a reasonable period of time after discovery or notice from the Commission. A "notice and cure" provision of this kind could be a useful way for the Commission to incentivize issuers to comply with the many detailed obligations of Regulation Crowdfunding without imposing the draconian consequences that arise from violations of Section 5 of the Securities Act.

Distinguishing insignificant and significant deviations in this manner would give issuers greater certainty regarding their ability to rely on the Crowdfunding Exemption and would strengthen the incentives of issuers to comply with their obligations.

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[4] See Section 4(a)(6) of the JOBS Act and the Proposing Release, proposed Rule 100, 17 CFR 227.502.

[5] For example, in the absence of such a safe harbor, plain language would dictate that a mere failure by an issuer to file its annual report within the allotted timeframe proposed by Rule 202 would prevent the issuer from relying on the Crowdfunding Exemption.

[6] *See id.* at 270.

[7] *See* Rule 508(a)(2) under the Securities Act, 17 CFR 230.508(a)(2).

[8] *See* Rule 260 under the Securities Act, 17 CFR 230.260.

[9] *See* the Proposing Release, proposed Rule 204, 17 CFR 227.204.

[10] *See id.* at proposed Rule 203(a)(1), 17 CFR 227.203(a)(1).

[11] *See id.* at proposed Rule 100(a)(1), 17 CFR 227.100(a)(1).

[12] See id. at proposed Rule 303(b), 17 CFR 227.303(b).

II. Use a different approach to motivate timely filing than the approach in Rule 100(b)

The JOBS Act[13] authorizes the Commission to add new types of ineligible issuers to the statutory list under the Crowdfunding Exemption. The Commission is proposing to add, among others, issuers that have not filed with the Commission and provided to investors, to the extent required, the ongoing annual reports required by proposed Regulation Crowdfunding during the two years immediately preceding the filing of the required offering statement.[14]

The Commission's concern regarding delinquent filers makes sense because stale disclosure prevents investors from making informed investment decisions. It is not clear, however, that the Commission's approach is the best way to incentivize timely annual reports. Compliance with the proposed annual reporting rule,[15] which is a condition to the Crowdfunding Exemption,[16] already provides issuers with a powerful incentive to stay current. Subject to the application of the proposed substantial compliance safe harbor discussed in the prior section, any filing delinquency (even one day late) could potentially have severe consequences under Section 5. Since filing delinquencies are easily curable, however, it may be more desirable to motivate timely filing than to make delinquent filers ineligible (except when there is a refusal to cure). Instead of a new ineligible issuer rule, the Commission should consider motivating timely disclosure through the combination of the existing condition to the Crowdfunding Exemption and a notice and cure provision in the substantial compliance safe harbor. As such, the same notice and cure provision recommended in the prior section could negate the need for the Commission's proposed ineligible issuer rule related to filing delinquencies.

III. Adopt an integration safe harbor to facilitate back-to-back exempt offerings

Perhaps the largest omission in the Proposing Release is the absence of an integration safe harbor to prevent an offering under the Crowdfunding Exemption from being integrated with other types of exempt offerings conducted in close proximity. The Commission expressed a preference in the Proposing Release for non-integration, "provided that each offering complies with the requirements of the applicable exemption that is being relied upon for the particular offering."[17] The notion of non-integration in this context is sensible, but the Commission's informal proviso does not offer issuers sufficient assurance that two back-to-back offerings will not be treated as one.

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[13] *See* the Jumpstart Our Business Start-Ups Act (the "JOBS Act"), P.L. 112-106, 126 Stat. 313 (April 5, 2012) at § 302(b), codified in Section 4A(f) of the Securities Act, 15 USC 77d-1(f).

[14] *See* the Proposing Release, proposed Rule 100(b), 17 CFR 227.100(b).

[15] *See id.* at proposed Rule 202, 17 CFR 227.202.

[16] *See id.* at proposed Rule 100(a)(iv), 17 CFR 227.100(a)(iv).

[17] *See id.* at 18.

Imagine, for example, that an issuer seeks to raise $2 million in an offering under Rule 506(c) of the Securities Act[18] from accredited investors followed by a similar offering one month later that seeks to raise $1 million under the Crowdfunding Exemption from non-accredited investors. In isolation, each offering appears to comply with the requirements of the applicable exemption of that particular offering. Without a special safe harbor, however, such a back-to-back offering would be prevented by the plain language of Rule 502(a) under Regulation D.[19] Since the two offerings are within 6 months of each other, a five factor common law test would have to be satisfied as a condition of Rule 506(c). On these facts, the five factor test would not be met since it asks whether the sales are part of a single plan of financing, involve issuance of the same class of securities, have been made at or about the same time, are made for the same general purposes, and whether the same type of consideration is being received. Assuming all would be answered in the affirmative, the two offerings would be treated as one. As a result, the presence of non-accredited investors in the Rule 506(c) offering would foil its accredited-only condition and the sale of $3 million in the crowdfunding offering would foil its $1 million offering cap condition. Only a clear integration safe harbor between crowdfunding offerings and other types of exempt offerings would prevent results like this.

There is good reason to adopt such a safe harbor to encourage non-accredited investors in crowdfunding offerings to piggyback off of the work of accredited investors in accredited-only offerings like Rule 506(c).[20] Accordingly, the Commission should consider adopting a clear safe harbor that allows the Crowdfunding Exemption to become a viable method of capital-raising following initial capital raises to accredited investors.

IV. <u>Tailor prior exempt offering disclosure to the needs of non-accredited investors</u>

To the extent an integration safe harbor is adopted, non-accredited investors may soon have an unprecedented opportunity to invest in private deals that had previously been available to only accredited investors. There is a danger, however, that accredited investors might use their superior negotiating position to benefit themselves at the expense of non-accredited investors. This would negate the notion of piggy-backing. Accordingly, non-accredited investors will need tools by which they can measure their level of alignment with accredited investors.

The Commission is currently proposing, as part of its disclosure mandates, to require information about other exempt offerings conducted in the past three years, including the date of the offering, exemption relied upon, the type of securities offered, the amount of securities sold, and the use of proceeds.[21] The Commission has stated that such "information would better

[18] *See* Rule 506(c) under the Securities Act, 17 CFR 230.506(c).

[19] *See id.* at Rule 502(a).

[20] *See* Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption*, 4 Harv. Bus. L. Rev ___ at 57, 61-68 (forthcoming Spring 2014) (explaining the virtues of having non-accredited investors piggyback off of the work of accredited investors based on the theory that the latter, to the extent they have sufficient bargaining incentives, are typically in a better position than the former with respect to pricing negotiations, weeding out fraud, bringing to light important disclosures, and obtaining important deal protections).

[21] *See* the Proposing Release, proposed Rule 201(q), 17 CFR 227.201(q).

inform investors about the capital structure of the issuer and would provide information about how prior offerings were valued."[22]

While this disclosure is a useful start, some additional disclosure about prior exempt offerings could further assist non-accredited investors in understanding how well aligned they are with earlier accredited investors. In particular, the Commission should consider requiring disclosure on whether earlier offerings had an active lead investor with relevant start-up experience and special financial incentives (e.g., a large stake and / or carried interest),[23] whether passive co-investors in such deals were accredited-only, whether the new crowdfunding offering would provide non-accredited investors with the same terms as passive accredited investors (i.e., most-favored nations protection), and whether any prior offerings were abandoned before completion.[24] This would help inform non-accredited investors as to whether accredited investors had passed on earlier opportunities to invest or made investments, and whether non-accredited investors will be able to participate on the same terms as passive accredited investors (but not any applicable lead investor).[25] Furthermore, since there are limits on the extent to which non-accredited investors are likely to read disclosure, such information should be disclosed in a prominent manner.[26] Information like this would better tailor such disclosure to the needs of non-accredited investors.

V. Adopt a resale safe harbor for crowdfunding securities

The JOBS Act prohibits resales of crowdfunding securities during the 1-year period beginning on the date of purchase, "unless such securities are transferred – (A) to the issuer of the securities; (B) to an accredited investor; (C) as part of an offering registered with the Commission; or (D) to a member of the family of the purchaser or the equivalent, or (E) in connection with the death or divorce of the purchaser or other similar circumstance, in the discretion of the Commission."[27]

A plain language reading, in isolation, would suggest that unrestricted resales by crowdfunding investors are allowed during the first year to other investors in the enumerated categories. The Commission appears to have adopted this reading, at least in the case of sales to accredited investors, by suggesting that immediate resales would be allowed, without further restriction, as long as "the seller shall reasonably believe that the person receiving such securities is an accredited investor."

But this reading seems to ignore the general rule that all sales of securities must be registered under Section 5 of the Securities Act unless there is an applicable exemption. Since the JOBS Act provides no self-executing exemption from Section 5, the only applicable

[22] *See id.* at 62.

[23] *See* Parsont, *supra* note 19 at 50-52 (endorsing the "Angel-Advised Deals" model).

[24] *See id.* at 66.

[25] *See id.*

[26] *See id.*

[27] *See* the JOBS Act, § 302(b), codified in §4A(e) of the Securities Act, 15 USC 77d-1(e).

exemption is Section 4(a)(1) of the Securities Act which applies to "transactions by any person other than an issuer, underwriter, or dealer."[28] Historically, the resale compliance analysis has focused on whether the reseller will be deemed a statutory underwriter for purposes of the exemption.[29] For a reseller to avoid this characterization, it must comply with a murky line of judicial interpretations and SEC positions often called the Section 4(1½) exemption.[30] The need to comply with this guidance will heighten uncertainty around resales unless the Commission adopts a safe harbor to guide resellers through the analysis.

There is precedent for such a safe harbor: Rule 144.[31] This rule gives resellers certainty that they will not be deemed statutory underwriters after a 1-year holding period for many types of private resales. Notably, crowdfunding securities were not added to the list, meaning that the Section 4(1½) analysis may apply both before and after the expiration of one year from the initial sale.

The omission by Congress to override the Section 4(1½) exemption in this context provides the Commission with an opportunity to clarify, by rule, what steps need to be taken to resell unregistered securities under Section 4(a)(1) within one year. The Commission could adopt an analog safe harbor to Rule 144 that applies during this period to crowdfunding securities. Presumably, the applicable requirements would be a synthesis of the common law built up around the Section 4(1½) exemption. This would not only create certainty for immediate resales of crowdfunding securities to accredited investors, but could also provide a precedent for other private resales that currently must comply with this murky exemption.

I hope this letter and my article help you with your difficult task of implementing this rulemaking. If you have any questions, or if I can otherwise be of assistance, please do not hesitate to contact me.

Very Truly Yours,

Jason W. Parsont

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[28] §4(a)(1) of the Securities Act, 15 USC 77d(a)(1).

[29] *See e.g.*, *SEC v. Chinese Consol. Benev. Ass'n, Inc*., 120 F.2d 738, 741 (2d Cir. 1941); *Gilligan, Will, & Co. v. SEC*, 267 F.2d 461 (2nd Cir. 1959); *United States SEC v. Universal Express, Inc.*, 475 F. Supp. 2d 412, 422 (S.D.N.Y. 2007).

[30] *See The Section 4(1½) Phenomenon: Private Resales of Restricted Securities*, A Report to I on Federal Regulation of Securities from the Study Group on Section "4(1½)," 34 Bus. Law. 1961 (1979), *available at* https://www.secondmarket.com/discover/wp-content/uploads/2012/01/The-Business-Lawyer-The-Section-4-1-1-2-Phenomenon-Private-Resales-of-Restricted-Securities.pdf

[31] *See* Rule 144 under the Securities Act, 17 CFR 230.144.