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NASAA

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Submitted electronically to rule-comments@sec.gov

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

RE: NASAA Comments in Response to Release Nos. 33-9470 and 34-70741 (File No. S7-09-13), "Crowdfunding"

Dear Ms. Murphy,

The North American Securities Administrators Association, Inc. (NASAA) submits the following comments in response to Release Nos. 33-9470 and 34-70741 regarding the adoption of proposed Regulation Crowdfunding and the amendment of related regulations.

The members of NASAA are the state-level securities regulators who partner with the Commission in policing the sale of securities. As the regulators closest to the small businesses that will utilize Regulation Crowdfunding and the investors who will participate in this new marketplace, we encourage you to take a balanced regulatory approach that minimizes unnecessary costs and burdens on small businesses while providing meaningful investor protection from fraud and abuse. Without adequate investor protections, investors will avoid this market, depriving small businesses of a potential source of capital, thereby frustrating the goal of Congress to spur investment in start-ups.

Title III of the Jumpstart Our Business Startups (JOBS) Act gave the Commission relatively little discretion in its rulemaking, so much of the Commission's task in the proposing release was to simply implement Congressional will. We are pleased to see the Commission use what little discretion it has for the benefit of investors in several areas, but we are confused by the Commission's attempt to exercise discretion that it does not have to the detriment of investors in other more critical areas. The Commission has no authority to ignore Congressional mandates, and the Commission's proposals to circumvent the issuer and investor investment thresholds, for example, are unauthorized anti-investor propositions that NASAA cannot support.

We also believe more can and should be done within the statutory scheme to protect businesses operating in this marketplace. The exemption was specifically created to give entrepreneurs and other small businesses the funding necessary to get a good start, but those businesses will also need regulatory guidance to truly succeed. Unlike larger, more sophisticated issuers who typically have seasoned securities counsel and experience clearing deals with the Commission and state securities regulators, entrepreneurs and newer, smaller businesses are facing these regulatory hurdles for the first time. They may not understand what constitutes material information they are required to disclose or how to avoid making misleading, actionable statements. Without regulatory review or clarification by the Commission, issuers and intermediaries may mistakenly believe that the scant amount of disclosure required to qualify for the registration exemption is all the law requires for anti-fraud purposes. The Commission could resolve some of the regulatory mystery for these businesses by taking extra steps to educate them on the larger compliance requirements and making fuller disclosure tools available for their use.

I. The Commission cannot by rule strip investors of core protections mandated by statute.

A. The Commission cannot remove and should not seek to distort the statutory caps on annual offering amounts. (Q. 2).

In Section 302 of the JOBS Act, which created the new exemption for crowdfunding in Section 4(a)(6) of the Securities Act of 1933, Congress listed the basic conditions of the new exemption. The very first limitation on the exemption is that "the aggregate amount sold to ***all*** investors by the issuer, ***including*** any amount sold in reliance on the [crowdfunding exemption] during the 12-month period preceding the date of such transaction," must not exceed $1 million (emphasis added). The plain meaning is clear – the crowdfunding exemption is meant to help a company raise a maximum of $1 million in any given year, and all securities sold by the issuer count against the $1 million limit.

Relying on another section of the JOBS Act, Section 4A(g), the proposing release attempts to create "statutory ambiguity" where none exists to improperly allow parallel Rule 506 offerings that would circumvent the $1 million limit. The language from Section 4A(g), which states "[n]othing in the [crowdfunding] exemption shall be construed as preventing an issuer from raising capital through means other than [the crowdfunding exemption]," does not conflict with the offering cap set forth in Section 4(a)(6)(A). An issuer can use whatever methods it wants to raise capital, but it cannot use crowdfunding to exceed an overall annual limit of $1 million.

Congress viewed $1 million as a sufficient boost for small businesses using crowdfunding to get their start. As Senator Jeff Merkley, the author of the Senate amendment containing the relevant language, explained: "[T]he amendment allows existing small businesses and startup companies to raise up to $1 million per year. That is a substantial amount for a small business." 158 CONG. REC. S1829 (daily ed. Mar. 20, 2013). By statute, issuers needing more than $1 million in a year's time must progress to other exemption and registration alternatives.

B. The Commission must implement statutory caps on annual investment amounts and should do so in a manner that limits, not expands, investor loss. (Qs. 6, 158-161).

The second core limitation set forth in Section 4(a)(6) is the annual individual investor investment cap. Paragraph (B) of Section 4(a)(6) provides that the exemption is available only if the following condition is satisfied:

> [T]he aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the [crowdfunding exemption] during the 12-month period preceding the date of such transaction, does not exceed—
>
> (i) the greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and
>
> (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000.

As the proposing release points out, an ambiguity in the foregoing text has created a conflict in how to apply the individual investment limits. If an investor has income less than $100,000 but net worth greater than $100,000 (or vice versa), it is not clear which investment limit controls. In our prior comment letter, we encouraged the Commission to resolve this conflict by restricting investments to the lower limit given the obvious purpose of the individual investment limit – i.e., limiting losses. NASAA believes that remains the logical, proper course for the Commission to follow in the final rule.

The statute later provides that it is the intermediary's job "to ***ensure that no investor*** in a 12-month period has purchased securities offered pursuant to section 4(6) that, in the aggregate, from all issuers, ***exceed the investment limits*** set forth in section 4(6)(B)." Section 4A(a)(8) (emphasis added). NASAA discourages the Commission from taking only an investor self-certification approach to ensuring compliance with the investment limits. Unlike Regulation D, which looks to issuers to "verify" or have a "reasonable belief" that an investor is an accredited investor to qualify for the exemption, the crowdfunding exemption looks to intermediaries to "*ensure*" that no investor exceeds the limitation set forth in section 4(a)(6)(B). The exemption itself is only available "*provided*" that the investment limitations are satisfied. It is doubtful that the Commission's investor self-certification approach will be sufficient to meet the standard set forth in the statute.

First, it is not clear that retail investors will be keeping careful tabs on their individual investment amounts. Given the relatively small investment amounts commonly sought in crowdfunding deals, as low as a single $1 investment in many instances, it would be fairly easy for an active crowdfunding investor to lose track. Second, investors may miscalculate their net income or net worth – for example, an investor could easily assume that net worth includes the value of his or her principal place of business. Without some form of independent, third-party check, there is a significant likelihood that investors, by accident or design, will not report accurate amounts and ultimately exceed statutory limits.

NASAA would encourage the Commission to implement alternative methods suggested by other commenters to at least verify investor income and net worth and, where feasible, require use of centralized databases to verify aggregate investment amounts. Whether such measures are adopted or not by the Commission in its final rule, intermediaries transacting higher investment amounts from an individual investor pursuant to subsection 4(a)(6)(B)(ii) would be wise to implement these due diligence safeguards.

II. The Commission should adopt reasonable investor protections and intermediary and issuer guidance as proposed.

The Commission proposed rules and clarified a number of statutory provisions in the proposing release that should improve Regulation Crowdfunding from both the investor and industry participant perspective. NASAA urges the Commission to adopt the proposals as described below.

- Privacy (Q. 236). New Section 4A(a)(9) of the Securities Act of 1933 requires intermediaries to take such steps to protect investor privacy as the Commission deems appropriate, and the proposed rule would require funding portals to comply with the same privacy rules that are applicable to brokers. Given the recent breaches in consumer financial data, the proliferation of identity theft, and the possibility that the lack of data security may lead to losses far greater than the amount invested, the proposed privacy requirement is a critical safeguard for investor data. It will also enhance the overall integrity of intermediary platforms for the benefit of issuers.

- Cancellation (Q. 182). The proposed rules give investors an unconditional right to cancel an investment commitment for any reason until 48 hours prior to the close of an offering. This is an important investor protection due to crowdfunders' reliance upon the "wisdom of the crowd" for the vetting of deals. A broad cancellation power will enable investors to get out of a deal if further research reveals that an offering is fraudulent, suspicious, or unfair.

- Job tracking (Q. 38). We are pleased that the proposal includes our earlier suggestion to track the employment levels for issuers who use the crowdfunding exemption. A fundamental premise of Title III of the "JOBS Act" is that it will create jobs, and this particular part of the proposal will document the statute's relative success in achieving that goal over the long term.

- Single intermediary (Q. 12). Under the crowdfunding exemption, an intermediary is expected to enforce investment limits and perform other important duties. NASAA agrees it would be difficult for an intermediary to properly monitor an offering that is listed on multiple platforms, so we support the proposal to prohibit issuers from using multiple platforms.

- Internet-only offerings (Q. 13). We support the proposal to define a "platform" in a way that limits crowdfunding to transactions conducted on the internet through a

single intermediary. Presumably, this requirement will facilitate the "wisdom of the crowd" by providing greater transparency to potential investors.

- Disqualification for reporting violations (Q. 17). We support the proposal to disqualify an issuer from using the exemption for two years if the issuer has not properly filed the ongoing annual reports for a prior offering. Under the crowdfunding exemption, securities will be sold broadly to the general public, and it is important for those investors to have access to continuing information about an issuer. It would also be improper to allow an issuer to conduct future offerings under this exemption if the issuer has violated the disclosure requirements for prior offerings.

- Treatment of "idea-only" companies (Q. 19 & 20). Investors in "idea-only" companies face significant risks, including the possibility that the promoters have no practical experience or knowledge to execute their ideas, or that the ideas may be infeasible due to regulatory, technological, financial, or other reasons. Vague or imprecise disclosure is a common investor complaint in fraud actions that NASAA would like to see crowdfunding issuers avoid. The proposed rules would make sure these issuers have a specific business plan (beyond a merger or acquisition with an unidentified company) and strike the proper balance between the needs of small issuers and the information requirements of the crowd.

- Disclosure of ownership and capital structure (Q. 37). We support the proposal to require disclosure of the terms of the securities being offered, including limits on voting rights, restrictions on transfer, the risk of dilution, and other important matters. Without these disclosures, investors will be particularly vulnerable to abusive practices like being pushed out of a company just when it starts to become successful. Moreover, as noted at the outset, mandating the disclosures will serve as much needed regulatory guidance to unsophisticated issuers who otherwise may not realize the material nature of the information for anti-fraud purposes. Ideally, the disclosures would be included as necessary components of the Form C.

- Financial statements compliant with U.S. GAAP (Q. 50 & 51). In order to assure that issuers provide clear and precise financial information to investors, all issuers should provide the financial statements required by the statute, preferably in accordance with U.S. GAAP. While the Commission may sympathize with commenters' objections to the statute's rigorous financial reporting requirements, its job is to enforce the statute as written. On the plus side, financial statements prepared in accordance with U.S. GAAP are generally self-scaling based on the size and complexity of the issuer, which should alleviate some of the reporting burden for early stage issuers. Moreover, by maintaining GAAP as the singular standard, investors will be able to make apple-to-apple comparisons of offerings and young issuers will start their businesses off on solid accounting footing. Getting it right in the beginning may also help an issuer avoid some of the difficulties it would face adjusting non-GAAP statements down the road when it has grown to a larger, public company that must provide reports compliant with GAAP.

- Disclosure of portal compensation (Q. 150). The proposed rules require an intermediary, when establishing an account for an investor, to clearly disclose the manner in which it will be compensated for crowdfunded offerings. This disclosure is too valuable not to mandate as it is a great benefit to investors evaluating various portals and investment opportunities.

- Bad actor disqualification (Q. 279). Section 302(d)(2) of the JOBS Act requires the Commission to establish disqualification provisions for both issuers and funding portals that are "substantially similar" to Rule 262. For issuers, the proposal mirrors the new disqualification provisions of Rule 506 (which were also required to be "substantially similar" to Rule 262). For funding portals, however, the proposal uses the statutory disqualifications that apply to broker-dealers under Section 3(a)(39) of the Exchange Act. We believe the use of statutory disqualifications for funding portals is appropriate, although we reiterate our opposition to the "grandfathering" of prior bad acts as reflected in the recent changes to Rule 506 and the proposing release. A propensity to commit securities law violations should not be rewarded through a provision that is meant to disqualify bad actors.

Some commenters have noted concerns with the costs associated with some of the foregoing proposals, but in many cases the Commission's hands are tied by the plain language of the statute and, on the whole, the benefits outweigh the costs. Combined, the proposals will make a significant positive impact on investor protection, which will in turn make crowdfunded offerings more attractive for retail investors. Investor confidence in the integrity of this new capital raising method is vital to the success of issuers who take advantage of this new exemption.

III. The Commission should reconsider and adjust its approach in other areas prior to adoption in the final rule.

A. The Commission should clarify the calculation of beneficial ownership (Q. 27) and should require greater disclosure regarding officer and directors (Q. 24), related-party transactions, (Q. 38) and executive compensation (Q. 46).

As a general matter, the disclosures required by the statute and supplemented by the proposed rules as described above should address the basic informational needs of most investors in most offerings. The Commission could provide material benefits to investors by tightening disclosure in a few additional areas. One such area that could be improved is the proposed requirement that beneficial ownership be calculated as of the most recent "practicable date." The open nature of the limitation provides little certainty for the investor and no guidance for issuers, diminishing its informational value as a result. The provision would better serve all parties if it was amended and based on a date not more than 90 days (or some other reasonable date certain) from the reporting date. The calculation should also be updated when there are significant changes in beneficial ownership.

The disclosure of officer and director business experience should also be improved by increasing the relevant period to five years instead of the proposed three years. The longer

disclosure window is not overly burdensome because the due diligence investigation for disqualification already requires at least a five-year look-back. The longer period also will make it more difficult to avoid disclosure of experience that includes unprofitable or failed business ventures.

The proposing release would only require disclosure about related-party transactions since the beginning of the issuer's last full fiscal year that exceed five percent of the aggregate amount of capital to be raised by the issuer. The disclosure of related-party transactions is important to investors because it tends to deter self-dealing by issuers, which is why the Form 1-A currently requires disclosure for the past two fiscal years. NASAA would recommend the disclosures be broadened to reflect the prior two fiscal years and the percentage threshold for disclosure be lowered.

Executive and promoter compensation disclosure is also important information for investors. The Commission could more aptly deter excessive compensation arrangements by having issuers disclose compensation of at least the five highest paid employees.

B. Form C should be revised to require disclosure of the jurisdictions in which the offering will be made (Q. 250).

According to Section 4A(d), the Commission must make information about the offering available to all the states or cause the intermediary to make it available. In the proposing release, the Commission would require information about an offering to be publicly available on the intermediary's website for a minimum of 21 days before any securities are sold, and the filings made with the Commission would be made available to the public on EDGAR. To give states the ability to monitor these offerings more effectively, the Commission should modify the Form C to require an issuer to check boxes indicating the jurisdictions in which the securities will be sold (which may include a box for "all" jurisdictions).

C. The Commission should eliminate the safe harbor for "insignificant deviations" (Q. 243).

The proposing release includes a safe harbor in proposed Rule 502 for insignificant deviations from a requirement of Regulation Crowdfunding. This allows an issuer to have the benefit of the exemption even though the issuer does not comply with all of its conditions, provided the failure to comply is "insignificant with respect to the offering as a whole" and the issuer made a "good faith and reasonable attempt to comply."

Issuers who violate a statute or rule often assert the safe harbor, whether or not they were in fact operating in good faith, increasing the burden on regulators and investors seeking to enforce the rules. The Commission obviously understands this dilemma, as evidenced by the fact that it created an exception *for itself* in Rule 502(b), which states that an insignificant deviation is no defense to an enforcement action by the Commission. The problem is that it will likely be the states, not the Commission, that act as the primary enforcers of the crowdfunding

rules.[1] While we welcome and encourage the Commission's enforcement efforts, our experience makes it difficult to imagine the federal government taking aggressive enforcement actions in cases that inherently involve losses under $1 million. As is fairly well documented, the Commission has not shown that type of initiative in policing the Regulation D marketplace, even in cases involving significantly higher amounts. While the best course may be for the Commission to eliminate Rule 502 entirely, it should, at a minimum, give the states a parallel exception in Rule 502(c) for their enforcement actions and more clearly delineate the violations that will be considered "significant" to avoid confusion and litigation of this issue.

Conclusion

NASAA supports the Commission's efforts to establish a rational regulatory framework for crowdfunding – one that represents a reasonable balance between the needs of small business issuers and the protection of the investors who will fund those businesses. The Commission must neutrally adhere to the mandates in the JOBS Act in seeking that balance, however, and reject the temptation to tip the balance pro or con investor, pro or con business, beyond the statutory lines Congress carefully laid out.

If you would like further information or clarification, please contact me or NASAA's General Counsel, Joseph Brady, at (202) 737-0900.

Sincerely,

Andrea Seidt
NASAA President
Ohio Securities Commissioner

[1] Under Section 18 of the Securities Act of 1933, state antifraud authority is never preempted and the remainder of blue sky law is not preempted unless the offering actually qualifies for the exemption under Regulation Crowdfunding. Therefore, if an offering fails to meet the conditions of Regulation Crowdfunding, a state will have grounds to pursue an enforcement action if the offering is not registered at the state level and does not otherwise satisfy an exemption under state law.