February 3, 2014

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

Via email to rule-comments@sec.gov

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

Dear Ms. Murphy:

I am pleased to provide these comments on the proposed rule regarding Crowdfunding.[1]

Introduction

Title III of the JOBS Act[2] provides a crowdfunding exception to the registration requirements of the Securities Act of 1933. The crowdfunding exception will allow small issuers to raise, subject to substantial regulation, up to $1 million a year in small increments from ordinary investors through a registered funding portal via the internet. State Blue Sky laws regarding registration and qualification are preempted.

Crowdfunding has the potential to substantially improve small firms' access to capital provided that the regulatory framework adopted by the Commission does not impose prohibitive costs on either issuers or funding portals. It also will enable ordinary investors access to investments in start-up companies that ordinarily only accredited investors have access to. The primary advantages of crowdfunding is that it will enable small firms to access small investments from the broader public (i.e. from non-accredited investors) and resale of the stock will not be restricted after one year. If, however, the regulatory costs associated with crowdfunding are too high, then issuers will either use other means to raise capital or be unable to raise capital and ordinary investors will be denied the opportunity to make these investments.

Firms using crowdfunding will almost invariably be the smallest of small businesses. More established firms or those seeking more than $1 million will use Regulation D or, perhaps, Regulation A+. If the Commission overregulates crowdfunding, it will frustrate the bi-partisan intention of Congress and the President and impede both the ability of small firms to raise the capital they need to create jobs, innovate and contribute to the prosperity of the country and the ability of small investors to invest in the firms with the most potential growth. This is no idle possibility. The history of the small issues exemption and Regulation A demonstrates that

[1] Proposed Rules, "Crowdfunding," *Federal Register*, Vol. 78, No. 214, November 5, 2013, p. 66428. Release Nos. 33-9470 and 34-70741; File No. S7-09-13 [hereinafter "Proposed Rules"].
[2] Jumpstart Our Business Startups Act, Public Law 112–106, Apr. 5, 2012.

overregulation can destroy the usefulness of an exemption. Recall, Regulation A as currently constituted is seldom used.[3] It is simply too costly.

The Commission is underestimating the costs imposed by the proposed rule and by the statute. Obviously, the Commission can only directly affect its own rules. But it needs to be aware that the sum total of the costs that will be imposed by the proposed rule are likely to be near, or exceed, the point where issuers will find crowdfunding to be uneconomic. As one commentator put it, there is the need to be "light" and if problems appear in the future, then tailored changes to the crowdfunding rules can be crafted.[4] There is every reason to believe that the proposed rule, while not as "heavy" as it might be, is not sufficiently "light" to make crowdfunding the success that Congress and the President intended it to be.

The Commission is under an obligation to honor the intent of lawmakers and make crowdfunding work, for entrepreneurs and the investing public. When evaluating the many comments that it will receive urging "heavy" regulation from those who opposed the JOBS Act in general and crowdfunding in particular, it needs to be aware that those commentators' agenda is not to make crowdfunding work but to kill it. They are seeking to accomplish through the regulatory process what they could not accomplish in Congress. The Commission should not let itself be their means to achieve this goal.

Economic Analysis

Economic analysis of entrepreneurial capital formation is difficult because of the dearth of data. This lack of data hinders the ability of the Commission to make sound policy and is something the Commission should undertake to rectify.

Given the current data-deprived situation, the economic analysis contained in the proposed rule, is a serious attempt to examine the issues. It is clear to this commentator, however, that it almost certainly dramatically underestimates the costs being considered and gives a mistaken impression about the potential feasibility of crowdfunding as a means of raising capital for entrepreneurial ventures.

Consider the summary of the analysis of the cost to issuers in section III.B.3 (see next page):[5]

[3] "Factors That May Affect Trends in Regulation A Offerings," United States Government Accountability Office, July 2012 [GAO-12-839]

[4] Andrew A. Schwartz, "Keep It Light, Chairman White: SEC Rulemaking Under the Crowdfund Act," 66 Vanderbilt Law Review En Banc 431 (2013).

[5] Proposed Rules. p. 66521.

Table I
Issuer Offering Costs

	Offerings of $100,000 or less	Offerings of more than $100,000, but not more than $500,000	Offerings of more than $500,000
Compensation to the intermediary	$2,500 - $7,500	$15,000 - $45,000	$37,500 - $112,500
Costs per issuer for obtaining EDGAR access codes on Form ID	$60	$60	$60
Costs per issuer for preparation and filing of Form C for each offering	$6,000	$6,000	$6,000
Costs per issuer for preparation and filing of the progress updates on Form C-U	$400	$400	$400
Costs per issuer for preparation and filing	$4,000	$4,000	$4,000
Total Costs	$12,960-$17,960	$25,460-$55,460	$47,960-$122,960

Source: SEC Economic Analysis, Proposed Crowdfunding Rules

The figures above generated by the Commission imply that the intermediary will charge approximately the following percentages:

Table II
Intermediary Fees as a Percentage of Offering Size

	Offerings of $100,000 or less	Offerings of more than $100,000, but not more than $500,000	Offerings of more than $500,000
Compensation to the intermediary as a percentage of the offering	$2,500/$25,000=10% $5,000/$50,000=10% $7,500/$100,000=7.5%	$15,000/$150,000=10% $30,000/$300,000=10% $45,000/$500,000=9%	$37,500/$500,000=7.5% $75,000/$750,000=10% $112,500/$1,000,000= 11.25%

Source: Derived from data in SEC Economic Analysis, Proposed Crowdfunding Rules

These estimates are almost certainly wrong. The costs incurred by the intermediary in dealing with an issuer, doing the required due diligence and background screening, establishing a web page describing the offering and so on do not vary linearly with the offering size. As a percentage of the offering amount, they will be disproportionately high for smaller offerings. It is

both common sense and a fundamental tenant of price theory that intermediaries will try to recover their costs and make a profit, and they will charge accordingly. Similarly, intermediaries will not be able to routinely charge larger issuers more than their costs plus a reasonable profit due to competitive pressures. Thus, the idea that intermediaries will charge comparable percentages to issuers making a $50,000 offering and issuers making a $1 million offering is simply mistaken. Intermediary fees will decline as a percentage of the offering size as the offering size increases.

The costs shown in the summary table do not explicitly include attorneys' fees and accounting fees. Apparently, however, the Commission's economists believe that all costs associated with the offering (other than the intermediary fee), including attorneys' fees, accounting fees, management and administrative time and all other costs will be less than approximately $10,500 (i.e. the $6,000, $4,000, $400 and $60 in the above table). Except in the cases of true start-ups with no operating history to report on, this is almost certainly a gross underestimate.

The SEC estimates that the total burden to prepare and file the Form C, including any amendment to disclose any material change, would be approximately 60 hours.[6] Thus, the SEC appears to believe that an ordinary small business with no familiarity with Regulation Crowdfunding can assign one person for one and one half weeks to the task of completing its offering documents and actually get the job done. Only in the case of true start-ups with no operating history is this an even mildy plausible estimate.

The SEC estimates that "75 percent of the burden of preparation would be carried by the issuer internally and that 25 percent would be carried by outside professionals retained by the issuer at an average cost of $400 per hour."[7] 25 percent of $10,000 is, obviously, $2,500 and $2,500 divided by $400 per hour implies that the total accounting and legal time devoted to the offering will not exceed 6 ¼ hours. Again, this is not even remotely plausible. A more plausible estimate for billable legal and accounting time in connection with a crowdfunding offering would be five or ten times that. Regulation D Rule 506 offerings are, if anything, substantially less complex than a crowdfunding offering, given the nature of the proposed rule. Very, very few Regulation D offerings get done with accounting and legal fees of $2,500 or less.

Table III
Total Costs as a Percentage of Offering Size

	Offerings of $100,000 or less	Offerings of more than $100,000, but not more than $500,000	Offerings of more than $500,000
Total costs as a percentage of the offering	$12,960/$25,000=52% $15,460/$50,000=31% $17,960/$100,000=18%	$25,460/$150,000=17% $40,460/$300,000=13½% $55,460/$500,000=11%	$47,960/$500,000=9½% $85,460/$750,000=11½% $122,960/$1,000,000=12%

Source: Derived from data in SEC Economic Analysis, Proposed Crowdfunding Rules

[6] Proposed Rules, p. 66540 (col. 2).
[7] Ibid.

This table III is based on the Commission's estimates which are undoubtedly much too low. Even, however, assuming they are accurate, the estimates show that crowdfunding will be an expensive source of capital for offerings of less than $250,000. In reality, once accurate costs are considered, crowdfunding is unlikely to be an economically feasible source of capital for a great many companies seeking to raise less than $500,000 unless the Commission works to keep compliance costs lower.

Initial public offerings, by way of comparison, cost 7 percent or less of the typical offering according to the Commission.[8] Of course, as the Commission notes:

> … the average cost of achieving initial regulatory compliance for an initial public offering is $2.5 million, followed by an ongoing compliance cost, once public, of $1.5 million per year. Hence, for an issuer seeking to raise less than $1 million, a registered offering is not economically feasible …[9]

In reality, once accurate costs are considered, crowdfunding is unlikely to be an economically feasible source of capital for a great many companies seeking to raise less than $500,000 unless the Commission works to keep compliance costs lower and the smallest companies – the intended beneficiaries of Title III – will be little better off than they were before Title III was passed.

$1 million Limit

The Commission is to be commended for proposing a rule that does not consider the amounts raised in offerings made pursuant to other exemptions when determining the amount sold during the preceding 12-month period for purposes of the $1 million limit in Section 4(a)(6). This is a simplifying provision that improves the odds of crowdfunding being successfully. It also will allow firms that so choose to pursue both crowdfunding and other sources of capital without being forced to choose one method or the other. Finally, it will mean that a company that did an initial round using, for example, Regulation D will not be proscribed from using crowdfunding.

Joint Income or Net Worth

The proposed rules states that annual income and net worth may be calculated jointly with the annual income and net worth of the investor's spouse. This is the appropriate approach. To disaggregate income and net worth would be complex and introduce a host of interpretative and practical questions for investors, issuers and intermediaries alike that would hinder the ability of crowdfunding to work.

Issuer Reliance on Intermediaries Efforts to Determine Applicable Investor Limits

The proposed rules would permit an issuer to rely on the efforts that an intermediary takes in order to determine that the aggregate amount of securities purchased by an investor will not cause the investor to exceed the investor limits, provided that the issuer does not have knowledge

[8] Proposed Rules, p. 66529 (col. 2).
[9] Proposed Rules, p. 66509 (col. 2).

that the investor had exceeded, or would exceed, the investor limits as a result of purchasing securities in the issuer's offering. This is the appropriate approach. There is no need for the issuer and the intermediary to engage in duplicative compliance efforts.

Accredited Investors

Since accredited investors can make unlimited investments in Rule 506 offerings, they should be able to make unlimited investments in crowdfunding offerings. The disclosure requirements in crowdfunding offerings are robust and generally greater than in Regulation D offerings. Accredited investors are, either themselves or through their purchaser representatives, able to evaluate investments in a more sophisticated manner than the general public and are more able to bear the risk of loss due to their higher income and net worth.

Legends

The Commission is seeking comment on whether it should require the issuer to include certain specified legends about the risks of investing in a crowdfunding transaction and disclosure of the material factors that make an investment in the issuer speculative or risky and whether it should provide examples in its rules of the types of material risk factors an issuer should consider disclosing?

The Commission should set forth what it views as the material risk factors an issuer should be disclosing. Moreover, the Commission should give issuers some sense of how remote a risk must be before it is not worthy of disclosure. In the absence of such guidance, well-advised issuers will construct a very long list of risk factors so that a plaintiff's attorney cannot later accuse them of failing to disclose a risk that in hindsight was relevant or even material or decisive. Of course, long lists of remote risks tend to obfuscate and deflect attention from more important risks.

Prior Exempt Offerings

The Commission is seeking comment on whether it is appropriate to require a description of any prior exempt offerings conducted within the past three years, as proposed? It would seem that a complete understanding of the issuer's capital structure, including voting rights and the risk of dilution is the key consideration not what prior offerings resulted in the capital structure. In some cases, there may have been a great many offerings. A detailed discussion of these offerings is unlikely to be material to whether the investment is a sound investment and is likely to confuse readers. The key material question is the ownership and voting rights of the various securities and the risk of dilution (i.e. the capital structure extant as of the time of the offering).

Generally Accepted Accounting Principles

Under the statute and the proposed rules, issuers are required to file with the Commission, provide to investors and the relevant intermediary and make available to potential investors, financial statements. The proposed rules would require all issuers to provide a complete set of financial statements (a balance sheet, income statement, statement of cash flows and statement of changes in owner's equity) prepared in accordance with U.S. GAAP. GAAP is well understood

and affords comparability of financial statement among issuers. Financial statements prepared in accordance with GAAP or explicitly noting any variance from GAAP and stating the reason for the variance should be required of all but the smallest issuers (e.g. those with assets of $100,000 or less).

Voluntary Higher Standard Financial Statements

Under the proposed rules, issuers would not be prohibited from *voluntarily* providing financial statements that meet the requirements for a higher aggregate target offering amount. Since reviewed or audited financial statements provide a higher degree of protection to investors, issuers that want to provide financial statements meeting higher standards should be permitted to do so.

American Institute of Certified Public Accountants (AICPA) and Public Company Accounting Oversight Board (PCAOB)

The proposed rule allows the issuer to select between the auditing standards issued by the AICPA or the PCAOB. Generally, AICPA standards are more appropriate for small firms than PCAOB standards. However, the SEC should not force firms to choose one standard or the other. Moreover, the Financial Accounting Foundation (FAF), the parent organization of the Financial Accounting Standards Board (FASB), has created a Private Company Council (PCC) that will establish so-called "little GAAP" meant for private companies.[10] These standards will undoubtedly be more appropriate for small companies that PCAOB or "big GAAP" standards. Certainly the SEC should not create a third (or fourth) standard.

The SEC should not require that all audits be conducted by PCAOB-registered firms. First, the JOBS Act does not require it. It requires only the use of certified public accountants. Second, crowdfunded firms are not public companies in the sense of being registered companies and should not be treated as such.

Adverse and Qualified Opinions

Inevitably, there will be crowdfunding issuers that receive a "going concern" opinion modification in that there is a clear risk that will not be able to survive unless they raise capital and their business situation improves. In fact, it is likely that a majority of crowdfunding companies objectively *should* receive such an opinion. A qualified or modified opinion for this reason should not be disqualifying.[11]

---

[10] See http://www.fasb.org/pcc.

[11] Auditing Standards, Public Company Accounting Oversight Board, AU Section 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern," available at http://pcaobus.org/Standards/Auditing/Pages/AU341.aspx. See also Presentation of Financial Statements (Topic 205), "Disclosure of Uncertainties about an Entity's Going Concern Presumption," Exposure Draft, FASB, June 26, 2013.

Material Events Continuing Disclosure

The Commission is seeking comment of whether issuers should be required to file reports to disclose the occurrence of material events on an ongoing basis. The answer to this is an unqualified no. This is the kind of requirement more appropriate for public companies. Such a requirement would substantially increase costs and regulatory risk and make crowdfunding much less attractive. It is the kind of requirement that leads to $1.5 million in annual compliance costs for small public companies.

Reporting Obligations for Micro Offerings

The Commission is seeking comment of whether it should consider excepting certain issuers from ongoing reporting obligations (*e.g.*, those raising a certain amount, such as $100,000 or less). Such an exemption would make crowdfunding more feasible for the smallest companies and should be definitely considered. As noted above, the attractiveness of crowdfunding for these companies is likely to be very limited because of the regulatory compliance costs involved and the risks to the investing public is small due to the small size of the offering.

Terms of Offering

The proposed rules would define "terms of the offering" to include: (1) the amount of securities offered; (2) the nature of the securities; (3) the price of the securities; and (4) the closing date of the offering period. This definition is simple, clear and reasonable.

Valuation Methodology

The Commission is seeking comment of whether it should require or prohibit a specific valuation methodology. It should not. Valuations of start-ups and young companies are highly subjective because of differing assessments of the companies' prospects and the risks that they face. It is more art than science and no one methodology is demonstrably correct.

Intermediary Interests in Issuers

The Commission should permit an intermediary to receive a financial interest in an issuer as compensation for the services that it provides to the issuer. This will enable issuers with limited capital to gain access to the crowdfunding marketplace. The potential conflicts of interests that may arise from this practice are limited. Generally, the intermediary would have the same interests as other investors. Disclosure of the arrangement is sufficient.

Background Checks and Due Diligence

The Commission is seeking comment on whether it should require intermediaries to conduct specific checks or other steps (such as a review of credit reports, verification of necessary business or professional licenses, evidence of corporate good standing, Uniform Commercial Code checks or a CRD snapshot report) and whether it should specify a minimum or baseline level of due diligence to help establish a reasonable basis?

I would urge the Commission to indicate what behavior uncovered by a background check is disqualifying, which needs to be disclosed and which does not. For example, is a 15 year old DUI or marijuana possession felony conviction disqualifying? Does it need to be disclosed? Are the requirements limited to crimes of moral turpitude? Is the background check requirement limited to a *criminal* background check and, if not, what other types of background check will be required? For example, is it mandatory to disclose tax liens, judgments, bad debts or similar issues and if so, how is such a background check to be conducted? Liens and judgments, for example, are often not on a central database. Guidance on the parameters of this requirement is very important. The Commission should also take into account the fact that such checks are time consuming and expensive.

The Commission should also consider the recent EEOC revised "Enforcement Guidance on the Consideration of Arrest and Conviction Records in Employment Decisions under Title VII of the Civil Rights Act of 1964." It is clear that the EEOC and SEC are pursuing very different policy agendas in this area and we would ask that SEC and EEOC guidance be consistent since companies cannot comply with conflicting legal requirements issued by two different agencies.

Educational Materials

The Commission should decide what educational materials that intermediaries should use. In this way, regulatory risk will be eliminated, intermediaries will definitely know what materials should be provided and the Commission will be sure that appropriate materials are actually provided. Intermediaries should, however, be allowed to provide additional educational materials if they would like to do so.

Investor Representations

The proposed rule allows an intermediary to rely on the representations of a potential investor as to whether they have complied with the overall crowdfunding investment limitations. Given the fact that it is quite literally impossible for the intermediary to know what investments the investor has made elsewhere, this is entirely appropriate.

Fidelity Bonds

The Commission is seeking comment on whether it is appropriate to require a funding portal to have a fidelity bond and with respect to the fidelity bond requirement, whether the proposed coverage of $100,000 is appropriate for funding portals. A fidelity bond would protect the portal from employee theft or embezzlement. A surety bond would protect customers from having their funds stolen. Since, however, funding portals are prohibited from holding customer funds, this later issue is of limited concern. It is also not clear that the Commission should require a fidelity bond. The risk of employee theft or embezzlement from a firm that does not hold cash or customer funds does not appear particularly high. Obtaining the bond is simply one more expense that the portal must incur and it is necessary to control compliance related costs if crowdfunding is to be a success. For this reason, the SEC definitely should not impose "some other requirement" on funding portals, "like insurance or something similar to SIPC."

Broker-Dealer Registration Exemption

The Commission is seeking comment on whether the proposed exemption for funding portals from broker registration appropriate. It is appropriate. In my view, it is mandated. The structure of the JOBS Act shows that Congress clearly intended to create a category of regulated intermediary – a funding portal – that was more lightly regulated than a broker-dealer.

Anti-Money Laundering Rules

The proposed rules would require funding portals to comply with Anti-Money Laundering (AML) and the associated "Know Your Customer" requirements, to file suspicious activity reports (SARs) and comply with other aspects of the Bank Secrecy Act. This is a mistake of the first order. These rules are so complex and expensive to comply with that many European banks are now unwilling to accept U.S. customers and are terminating their relationship with existing U.S. customers.

Funding portals do not handle customer funds. The JOBS Act prohibits them from doing so. The banks and broker-dealers that do handle customer funds must comply with these rules. It is inappropriate to require funding portals to comply with these rules because the ability to engage in, or facilitate, money laundering does not exist to any meaningful degree and the costs of complying with these rules are likely to be so high as to make funding portals uneconomic. It will result in a situation where the only intermediaries are broker-dealers. It will frustrate the intention of Congress to establish a more lightly regulated intermediary class.

The Commission is not likely to hear much about this at this juncture since most of the people who are considering establishing a funding portal are entirely unaware of the burden these rules impose. But make no mistake, this provision will suffocate funding portals as a separate intermediary class.

Insignificant Deviations

The Commission is seeking comment on whether a safe harbor for certain insignificant deviations from a term, condition or requirement of Regulation Crowdfunding is appropriate and whether it should define the term "insignificant" or use a different term. The proposed safe harbor is highly constructive. It will prevent minor, insignificant or immaterial violations from having wholly disproportionate effects. However, it may be advisable to use the term "material" rather insignificant since the term material has a body of interpretations and case law which gives it a better defined meaning.

Section 12(g) Trigger

The Commission is seeking comment of whether it should permanently exempt securities issued pursuant to an offering under section 4(a)(6) from the record holder count under section 12(g) of the Securities Exchange Act and whether the Commission should exempt securities issued under section 4(a)(6) only when held of record by the original purchaser in the section 4(a)(6)

transaction, an affiliate of the original purchaser, a member of the original purchaser's family or a trust for the benefit of the original purchaser or the original purchaser's family.

The commission should permanently exempt securities issued pursuant to a crowdfunding offering from the record holder count under section 12(g) of the Securities Exchange Act. To not do so would be fatal to the usefulness of the exemption. An issuer raising $1 million from investors investing $1,000 each would have 1,000 investors, twice the limit under section 12(g) for non-accredited investors. The entire idea underlying the crowdfunding exemption is to allow ordinary, non-accredited investors to make small investments (often a few hundred dollars) in small companies. Many, probably most, crowdfunding offerings will have at least 500 investors and therefore exceed the section 12(g) cap.

Crowdfunding shares can be sold after one year to other non-accredited investors. Registered companies have typical ongoing compliance costs of $1.5 million annually.[12] If the sale of crowdfunding shares over time by the original purchasers can trigger the requirement to register (i.e. to become a public reporting company), then no well-advised company will use the section 4(a)(6) exemption because the annual cost of being a public company exceeds the maximum amount of capital that can be raised under the crowdfunding exemption. Once this risk is understood, no issuer would use the crowdfunding exemption and the Congressional purpose in creating the exemption will have been utterly thwarted. Thus, it is imperative that not only original investors not count against the section 12(g) limits but also that subsequent investors who buy shares originally issued pursuant to the crowdfunding exemption not count against the section 12(g) limits as well.

Sincerely,

David R. Burton
Senior Fellow in Economic Policy
The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
202-608-6229 (direct dial)
David.Burton@heritage.org

[12] Proposed Rules, p. 66509 (col. 2).