

**Securities Law Committee
Of the Business Law Section
Washington State Bar Association**

September 23, 2014

Faith Anderson, Chief of Registration
Department of Financial Institutions, Securities Division
P.O. Box 9033
Olympia, WA 98507-9033

Re: Proposed Crowdfunding Rules

Dear Ms. Anderson:

This letter represents the views of the Securities Law Committee ("**Committee**") of the Business Law Section of the Washington State Bar Association ("**WSBA**"). The Committee's members, approximately 35 lawyers who practice in the field of corporate law and securities regulation, represent small, medium and large businesses throughout the state of Washington. This letter was approved by more than 75% of the Committee. Neither the Board of Governors of the WSBA nor the Business Law Section of the WSBA has taken a position on the proposed rules, nor does this letter necessarily represent the views of individual members of the WSBA or their associated firms or companies.

The Committee has reviewed the proposed rules of the Securities Division ("**Division**") of the Washington State Department of Financial Institutions ("**DFI**") to implement the Washington JOBS Act of 2014 (the "**Act**"), contained in Chapter 460-99C WAC (the "**Proposed Rules**"). This letter provides specific comments and suggestions with respect to certain of the Proposed Rules.

Introduction

Many members of our Committee remain wary of crowdfunding offerings, both from a concern with the high risk of failure for these businesses and potential losses to unsophisticated investors, and the opportunities for fraud. Given the Legislature's passage of the Act, other members want to be sure the Division's regulatory approach is not so onerous as to discourage prospective companies from using the exemption. The suggestions in this letter are designed to increase the odds that the exemption succeeds in raising capital as intended by the Legislature, consistent with investor protection.

Specific Comments

Definition of Portal - WAC 460-99C-020(4)

The Proposed Rules track the Act's definition of portal (i.e., port districts and local associate development organizations), and adds a broker-dealer registered with the Division.

WAC 460-99C-210 describes activities of portals. As drafted, the Proposed Rules imply, but do not clearly state, that only portals may provide the activities identified in *WAC 460-99C-210(2)*. If that is the Division's intent, we think the Proposed Rules are too narrow and will prevent a number of qualified persons from providing the services needed by crowdfunding issuers. For example, we believe accountants, consultants and even attorneys should be able to provide the services listed in *WAC 460-99C-210(2)* without being deemed a portal, so long as they do not also engage in soliciting prospective purchasers or otherwise engage in activities that would bring them within the definition of a broker-dealer. Further, various websites and web "portals" may want to reference the offering (without soliciting investors) and should be able to do so without being a registered broker-dealer. There are no public policy reasons for limiting the persons who can assist the crowdfunding issuers on those types of issues, especially since we are concerned that few broker-dealers are likely to become portals due to the perceived higher risk and low returns from these activities.

Availability - WAC 460-99C-030(1(a), (e) and (j))

These sections prohibit "holding companies," companies with "complex capital structures" and "real estate programs" from using the crowdfunding exemption. We believe the inclusion of these categories of companies unnecessarily limits the availability of the exemption. There are many valid business reasons for being a holding company (e.g., to limit the liability of a parent company if it has multiple locations in which it does business). Wholly-owned, operating subsidiaries should not disqualify an issuer. Similarly, we object to the Division's exclusion of companies with "complex capital structures," a phrase that is particularly vague. For example, is a corporation with an outstanding class of preferred stock a "complex capital structure"? If it has two classes of common stock? If it has outstanding options or warrants? If it has outstanding convertible debt? We do not think a corporation having one or more of these instruments should be disqualified from qualifying for the exemption. Finally, the inclusion of "real estate programs" is also vague – does that apply to any company that attempts to develop real estate? We think that would be far too limiting.

We note that these disqualifications are identical to those in the SCOR offering rules. Given how few offerings have been conducted under that procedure, we think the Division should

loosen the restrictions for crowdfunding issuers in an effort to promote capital formation. The Division has other means of assuring the protection of investors.

Availability - WAC 460-99C-030(2)

We note this subsection limits the exemption to a corporation or LLC “that is resident and doing business within Washington.” While this language appears to be the same as in SEC Rule 147, as drafted, we find that terminology to be confusing. It would clarify the meaning if the Division included the other provisions of SEC Rule 147(c) which explain its meaning.

Availability - WAC 460-99C-030(5)

The Proposed Rules provide that the crowdfunding exemption is available for offerings of preferred stock so long as the preferred stock has the characteristics specified in *WAC 460-99C-030(5)*. Essentially, the Proposed Rules require every preferred stock offering to include the specified terms listed in (a) – (f), such as limits on dividends to common shareholders, liquidation preferences, conversion features (including participating preferred), antidilution protection (including price protection), voting rights generally and 12 specific items that must be approved by the preferred stockholders.

We do not believe the Division should be so restrictive. If common stock offerings are acceptable under the exemption, why should the Division dictate the terms of preferred stock offerings? Not only is the Division substituting its judgment of what should be “market” terms, but the required preferred stock terms may have the unintended effect of promoting common stock offerings where the investors have even less protection than a basic preferred stock offering. We are also concerned that the required terms are sufficiently complex (e.g., the anti-dilution provisions for shares subsequently sold at a lower price) that many crowdfunding issuers or investors may not understand the terms of the shares being offered. We believe *WAC 460-99C-030(5)* should be modified to clarify that preferred stock offerings are permitted, and to delete the requirements that the terms include those specified in (a) – (f).

Information requirements - WAC 460-99C-050

This section requires that investors receive the most recent Washington Crowdfunding Form, as declared exempt by the director.

We recommend expanding this section to indicate what other materials may be provided to investors, such as sales literature and summary descriptions. We also believe that crowdfunding issuers should be able to circulate sales literature and summary descriptions prior to delivery of

the Washington Crowdfunding Form, simply as a means of identifying investors who may actually be interested in the offering and thereby reducing the offering costs.

Escrow agreement provisions - WAC 460-99C-130

Subparagraph (3) prohibits the escrow agent from being affiliated with the issuer or its officers, directors, managing members or affiliates. Similarly, we think the escrow agent should not be affiliated with any portal for the offering.

Restrictions on resale - WAC 460-99C-170

Although the title of this section refers to “resale”, the text simply says that securities may not be “transferred” by the purchaser during a one-year period, with four specified exceptions. The problem with using the term “transferred” is that even bona fide gifts would not be permitted in the first year. We recognize that the language tracks the Act, but we think the Division has authority to clarify in the Proposed Rules that bona fide gifts may be permitted prior to the one year anniversary of the purchase.

Quarterly reporting requirements - WAC 460-99C-180

The Proposed Rules require the crowdfunding issuer to provide a quarterly report to its shareholders “by making such report publicly accessible, free of charge, at the issuer’s internet website address....” We do not believe the legislature intended that the report be accessible to the public at large, and request clarification that access can be limited to the issuer’s shareholders and the Director (as stated in the statute).

If the Division disagrees and believes that the general public should have access to the quarterly report, we respectfully request that the Division delete item (3), as we think requiring the quarterly and annual financial statements of all crowdfunding issuers to be available to the general public, competitors and news media will discourage issuers from using the crowdfunding exemption and further reduce the likelihood that any capital will be raised under the exemption.

If the preceding comment is also rejected, then at the very least, please correct Item 3, which requires that the **quarterly report** include financial statements for the issuer’s most recent **fiscal year** end. This seems to be a drafting error.

Integration - WAC 460-99C-200:

The Division simply proposes to adopt in the crowdfunding rules essentially the same integration language that is contained in SEC Rule 147 (as well as Rule 502(a) of Regulation D -WAC 460.44A.502(1)).

We think it unnecessary to include the integration provision in WAC 460-99C-200 since SEC Rule 147 already contains the integration principle. Further, as to the State of Washington, we think applying that standard to crowdfunding offerings is a mistake, both in terms of public policy and practicality, and that integration principles need to be reconsidered in light of the adoption of Rule 506(c). While that discussion is likely beyond the scope of the proposed rules, we see no reason to compound the confusion of the application of integration principles by incorporating the provision here.

Activities of portals - WAC 460-99C-210:

As noted above, we are concerned that the Proposed Rules suggest that only portals can conduct the activities listed in *WAC 460-99C-210(2)*. These activities are ministerial in nature, except perhaps the assistance with the development of a business plan, but certainly are within the expertise of many business consultants, accountants and lawyers. See our recommendation contained in our comments on *Definition of Portal - WAC 460-99C-020(4)* above.

Disqualification based on reporting failures – WAC 460-99C-230

Under the Proposed Rules, an issuer that fails to file a quarterly report is disqualified from conducting a crowdfunding offering for two years. The disqualification would seem to apply even if the issuer was simply late in a filing. The penalty for being late seems disproportionate to the offense. We believe that there should be a thirty (30) day grace period for late filings, and the penalty for being late beyond the grace period should be a one year disqualification.

Books and records – Inspection rights - WAC 460-99C-240

This section requires that an issuer keep and maintain written or electronic records relating to offers and sales made in connection with a crowdfunding exemption for at least 6 years following termination of the offering, including “(e) quarterly reports and all other communications with shareholders.” The Proposed Rules thus require issuers to retain information and reports that are completely unrelated to the offers and sales, since those reports will nearly always be made after the investment (so, they are not related to the original “offer and sale”). Further, the requirement that “all communications with shareholders” be retained is a

burdensome requirement, as it may require separating out emails (or even text messages or website messages) from and to shareholders, even well after the sale of securities. We think the Proposed Rules should be modified to lessen the burden on issuers.

Advertising – Filing requirements – WAC 460-99c-250

This section requires that all advertising directed to investors be filed with the director at least 7 days prior to publication or distribution, except for “tombstone advertising,” dividend notices, proxy statements, etc., and sales literature, advertising or market letters prepared in conformity with the applicable regulations of SEC, FINRA or an approved securities exchange.

We understand that the Division would like to review sales literature and summaries of the offering prior to distribution to prospective investors. We suggest that the Division request that these items be submitted to the Division in conjunction with the Washington Crowdfunding Form.

With respect to advertising materials developed after the offering commences, this section has several flaws in our view. First, the Proposed Rules do not define “advertising.” Does the Division view any information provided to prospective investors as “advertising”? How broadly does the Division view “advertising?” For example, must a power point presentation for investors be submitted for review? Is a company able to revise the presentation without first filing it with the Division? What about emails? We think this section should be modified to eliminate the pre-filing requirement if the information provided is consistent with the Washington Crowdfunding Form, so long as the investor receives the Washington Crowdfunding Form prior to making an investment.

We recognize that this requirement is similar to that in typical underwritten public offerings, but the Division fails to recognize that crowdfunding issuers are at a different sophistication level and lack familiarity with the standards involved in a typical underwritten offering. Instead, crowdfunding issuers are more likely to be directly involved in soliciting and responding to requests from prospective investors. We think the Division should recognize that crowdfunding issuers need more lenience on dealing with their prospective investors.

Crowdfunding Form

Item 42 – Financial Statements

“The financial statements must be prepared in accordance with U.S. GAAP, complete with appropriate footnote disclosure.”

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Since *WAC 460-99C-040(5)* does not require footnote disclosures, we understand that the phrase in the Crowdfunding form was a drafting error that will be corrected prior to adoption of the form. We think that approach makes sense, since requiring footnote disclosure prepared in accordance with GAAP would be a significant upfront accounting expense that a company will be required to incur before it is even able to launch an offering.

Conclusion

The Committee is generally supportive of the Division's efforts to facilitate capital formation by smaller companies through the crowdfunding exemption. Considering the relatively small size of the issuers involved, their inexperience with securities laws and regulations, and the inability of those companies to pay the higher fees and expenses of accountants and lawyers proficient and comfortable being associated with public offerings of securities, we believe it important that the Division simplify certain aspects of the Proposed Rules to increase the likelihood that the crowdfunding exemption will have the results desired by the Legislature.

Thank you for your consideration in this matter.

Respectfully,



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