

July 2, 2014

State of Washington
Department of Financial Institutions
Securities Division
150 Israel Rd SW
Tumwater WA 98501

Dear Faith:

Thank you for the wonderful job on issuing the discussion draft rules. I think the Division has made a great start.

My comments are as follows.

Spirit of the Bill

The sponsors of the bill worked hard to keep the bill usable and free from the sort of requirements that would destroy its usefulness to startups.

The preamble to the bill makes it clear that the legislature was intending to help startups. I quote the preamble here, because the concepts in the preamble are important and should inform your rulemaking.

The legislature finds that **start-up companies** play a critical role in creating new jobs and revenues. Crowdfunding, or raising money through small contributions from a large number of investors, allows smaller enterprises to **access the capital they need** to get new businesses **off the ground**. The legislature further finds that **the costs of state securities registration often outweigh the benefits** to Washington **start-ups** seeking to make small securities offerings and that the use of crowdfunding for business financing in Washington is **significantly restricted by state securities laws**. Helping new businesses access equity crowdfunding within certain boundaries will **democratize venture capital and facilitate investment** by Washington residents in Washington **start-ups** while protecting consumers and investors. For these reasons, the legislature intends to provide Washington businesses and investors the opportunity to benefit from equity crowdfunding.

The emphasis in the preamble is on:

- Helping startups access the capital they need;

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- Assisting startups to get their businesses **off the ground** (implying that the bill is for use by companies whose businesses are not yet off the ground and do not have a lot of resources to expend on securities law requirements);
- Keeping the costs of state securities compliance down;
- Easing the restrictiveness of state securities laws; and
- Democratizing capital formation and facilitating investment.

These are all laudable goals that both the House and the Senate overwhelmingly approved (the House twice).

From my perspective, in certain respects the Division has made the bill too hard to use for most startup companies.

First, there is the disallowance of convertible debt offerings. Rule 030. Startups frequently raise money in convertible debt offerings. It is unclear to me why convertible debt offerings are being disallowed. The statute was not limited to stock offerings; it was enacted for “securities” offerings. We are all in agreement that convertible debt is a security. It would seem to me that by disallowing convertible debt offerings the Division is unnecessarily limiting the helpfulness of the bill to startups. In this regard, I would emphasize to you that frequently convertible debt is more protective of an investor than a non-convertible debt instrument or fixed price round because (1) debt sits on top of equity, and (2) if the convertible debt has a valuation cap (which it frequently does), then investors are protected if the company raises money in the future at either a lower or a higher valuation than anticipated.

Second, there is the requirement that financial statements prepared in accordance with GAAP with footnote disclosure. Footnote disclosure is atypical for startup companies raising capital. I have been told by friends in the accounting profession that this will cost companies between \$5,000 to \$10,000, if they don’t have the internal capability to do it themselves. This is a cost that a startup raising funds would not ordinarily incur.

Third, the rules standing by themselves create a lot of uncertainty around who can offer assistance with a crowdfunding offering without having to be a “portal” or become a registered broker dealer. In this regard, I believe the rules can be fixed if they simply incorporate the key concept about what a portal is from the statute. I address this below.

Fourth, there is the requirement of a legal opinion in order for a company to avail itself of the exemption. This is burdensome, costly and unusual for startup company financings (see draft Rule 460-99C-040(10)).

My more specific comments are as follows.

Portals Are Optional.

The statute makes this clear, and sponsors of the bill, testifying before a Senate committee, were specifically asked if portals were optional-- and they answered definitively, “Yes, portals are optional.”

One commenter requested you limit the exemption to companies using portals. This would be contrary to legislative intent. Plus, if you were to require companies to use portals, you would substantially curtail the helpfulness of the bill to startup companies. After speaking with members of the startup community, I strongly recommend that you not do this, despite comments you may have received from others to the contrary.

Please Define “Portal.”

We need you to clarify in the rules when a person has to either be a portal or register as a broker-dealer. Right now the rules do not answer this question. The statute provides the key concept that needs to be incorporated into the rules.

For example, Section 3(1) of the statute says that an offer or sale of a security is exempt if: “a portal working in collaboration with the director ***files the offering with the director on behalf of the issuer*** under section 4 of this act.”

Another example, Section 3(e) of the statute says that the issuer will file with the director an escrow agreement either directly “or through a portal.”

Another example, Section 4 of the statute says:

“The portal shall forward the materials necessary for the applicant to qualify for exemption to the director for filing when the portal is satisfied that the applicant has assembled the necessary information and materials to meet the criteria for exemption under sections 3 and 5 of this act.”

Thus, the statute explains that a portal is a person that specifically takes on the obligation to file the crowdfunding form with the Division “***on behalf of the issuer***” (quoting the statute). This bright line clarification needs to be taken from the statute and incorporated into the rules.

This clarification will make it clear that an exchange, a marketplace, a web site, a business plan service provider, does not constitute a “portal,” unless those persons are filing the crowdfunding form with the DFI by and on behalf of the issuer.

As the rules standing alone are currently written, lawyers will find it very difficult if not impossible to give advice to persons as to whether or not they need to be registered broker-dealers. This will have a chilling effect on the entire ecosystem. I know that you want to write the rules to incorporate all of the key statutory concepts – so that the rules can stand alone.

Rule 210 describes the activities of portals. For example, it says:

The portal may offer services to the issuer that the portal deems appropriate or necessary to meet the criteria for the exemption. Such activities may include:

- (a) Assistance with the development of a business plan;
- (b) Ministerial assistance in completion of crowdfunding exemption filings under these rules;
- (c) Referral to legal services;
- (d) Referral to business consulting and accounting services to assist with compiling and reporting financing information required by these rules; and
- (e) Other technical assistance in preparation for a crowdfunding offering by the issuer.

Standing alone, without the incorporation of the key statutory concept, the above rule creates a lot of confusion. A lot of consultants provide the above types of services in the State of Washington. Are these consultants suddenly portals if the companies they are helping are going to do a crowdfunding offering? Clearly that should not be the result. Still, because the key concept from the statute is not incorporated into the rule, persons providing the above-describes services to a company doing a crowdfunding offering are going to be concerned that suddenly they need to become a registered broker dealer.

Draft rule 010 says that “[i]ssuers **may** work in collaboration with organizations that qualify as portals to develop business plans, complete disclosure documents, to seek out other technical assistance, and to submit filings in connection with a public securities offering.” (Emphasis added.) Standing alone, this sentence seems fine, but again, many people might provide one or more of these services--and does that then require those people to be registered broker dealers?

(By the way--nowhere in the statute does it require that only registered broker dealers could be portals. In my opinion it is very unfortunate that the Division’s proposed rule would not allow businesses that are not broker-dealers to be portals--as long as they are not handling investor funds or making specific investment recommendations.)

In conclusion, the rules need to incorporate the key statutory principle that a person is not a portal unless it is filing the crowdfunding form with the Division “on behalf of the issuer”--to again quote the statute. This bright line rule would allow ancillary service providers such as business plan centers and others, to have legal certainty in their relationships with companies trying to avail themselves of the crowdfunding exemption.

In other words, if I wanted to build a website where companies could list their DFI-approved crowdfunding offerings--that activity alone would not require me to become a portal or a registered broker dealer, unless I also took on the obligation to file the crowdfunding form with the DFI.

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Conclusion

Thank you very much for your consideration of these comments--and thank you very much for your work and that of the other members of the Division on this.

Very truly yours,

Joe Wallin