SEC'S CROWDFUNDING PROPOSAL: WILL IT WORK FOR SMALL BUSINESSES?

HEARING

BEFORE THE

SUBCOMMITTEE ON INVESTIGATIONS, OVERSIGHT AND REGULATIONS

OF THE

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THURSDAY, JANUARY 16, 2014

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON INVESTIGATIONS, OVERSIGHT AND REGULATIONS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 2360, Rayburn House Office Building. Hon. David Schweikert [chairman of the subcommittee] presiding.

Present: Representatives Schweikert, Chabot, Mulvaney, Herrera Beutler, Rice, Clarke, and Chu.

Chairman SCHWEIKERT. Good morning. We will call our Subcommittee hearing to order.

First, I would like to request that Mr. Mulvaney, the member from South Carolina and a member of the Small Business Committee, be able to participate in today's Subcommittee hearing.

Without objection, so ordered.

Welcome, Mr. Mulvaney. Thank you for participating with us.

As we started to have a little bit of discussion before, this is in regards to the crowdfunding portion of the JOBS Act that was passed in April 2012. For some of us here, we have a certain emotional investing to that JOBS Act. I was blessed to have a couple sections of that that were a piece of legislation that we had been working on for about a year. One of the great thing about the JOBS Act, it was a truly bipartisan, bicameral sort of piece of work. And we built a formula where everyone from Maxine Waters, to Barney Frank, to Spencer Bachus, to even myself, found a way to communicate and grind through a series of small bills, and ideas for capital formation, where much of my frustration is first. And look, we all know the dance that the SEC has gone through the last two years with the chairman, some of the membership, some of those things. But forgive me for reaching down like this, in something that many of us had been hoping would be sort of a smaller, egalitarian opportunity for capital raising for the true beginning entrepreneurs, literally, the ones that are coming out of their basement, coming out of their garage, because we do have a cap of a million dollars. This is the proposed rule set.

And when you start to analyze it, at least as we have from our office, you are starting to see total costs by the time you start to capitalize in your legal costs, your accounting costs, other mechanics, when some of your money will have a 20, 30 percent load factor on that. At this point you are starting to get into the point where should you be doing it on your credit cards or should you be doing it with your neighborhood loan shark. This was not our intention. This was supposed to be the egalitarian access to capital because it did a couple things. It helped create a proof of concept because of the participation from either across the country or from within your community, but also provided a level of optionality, saying I need some capital up to the quarter million, up to this, up to that, to start our idea and sell that idea using today's modern society and Internet.

That is my great frustration. One of the things I am hoping we will acquire from this hearing today is not only sort of an analysis of what is within the rule sets, the proposed rule sets that have come from the SEC, but understanding we have only a couple more weeks for comments to go in. And much of the testimony from here we intend as an office to package up and send in also as comments. So I beg of you, even beyond your written statements, when we hit Q&A, it is not only here is the problem, but also maybe a suggestion that we could relate to the SEC saying here is a way how you do it. Yes, you have investor protections but you do not create a chilling effect for what I am hoping is sort of the next generation of sort of that beginning capital race.

Okay. When the ranking member shows up we are going to let her do an opening statement. So what we are going to do is actually go right now to our witnesses' opening statements.

Jason Best. Our first witness is Jason Best, co-founder and principal of Crowdfund Capital Advisors (CCA), a consulting advisory firm in San Francisco and co-author of the Crowdfunding Investing Framework used in the original JOBS Act. And actually, I remember parts of these documents coming across my desk.

Prior to his work in crowdfunding investment, Mr. Best was a successful healthcare technology entrepreneur, and most recently was on the executive leadership team of Kinnser Software, ranked by Inc. Magazine as one of the fastest growing private companies in the U.S. He is co-author of the book, Crowdfunding Investing for Dummies—you wrote that with me in mind, did you not—and earned his MBA from the Thunderbird School of Global Management in Arizona.

Mr. Best, five minutes.

STATEMENTS OF JASON BEST, PRINCIPAL, CROWDFUND CAPITAL ADVISORS; DANIEL GORFINE, DIRECTOR, FINANCIAL MARKETS POLICY, MILKEN INSTITUTE; MERCER BULLARD, MDLA DISTINGUISHED LECTURER AND ASSOCIATE PROFESSOR OF LAW, DIRECTOR, BUSINESS LAW INSTITUTE, UNIVERSITY OF MISSISSIPPI; DJ PAUL, CO-CHAIR, CROWDFUND INTERMEDIARY REGULATORY ADVOCATES

STATEMENT OF JASON BEST

Mr. BEST. Chairman Schweikert, Ranking Member Clarke, and members of the Committee, thank you very much for the opportunity to discuss the value that crowdfunding can bring to the American small business community, as well as share some new data from the British and U.S. markets that should shed some light on the magnitude of what is really happening in crowdfunding and how the right kind of crowdfunding regulation can enable a new chapter in American small business success.

I would like to thank the members of this Committee and both parties within the House at-large for their bipartisan and overwhelming support of crowdfunding.

As a co-author of The Startup Exemption Framework, I care very deeply about how the market evolves and want to continue to work with Congress and the SEC to create effective regulation for this market. I want to thank the commissions and staff of the SEC for their willingness to engage in a robust conversation with CFIRA, the crowdfunding industry regulatory organization, and I hope that CFIRA's active engagement was able to demonstrate that the crowdfunding industry is focused on creating an orderly market with access to capital, investor protections, and appropriate regulatory oversight.

As a tech entrepreneur and a small business owner, I have real experience in creating products and services raising capital and creating jobs. There are a number of good elements in the proposed regulation, but there is also a number of troubling issues. One of the issues I want to highlight today is the accounting requirements for a full CPA audit on firms raising over a half million dollars. I believe this places an unreasonable burden on entrepreneurs and small business owners and may cause there to be a soft cap on raising money over $500,000 due to the cost that this regulation would impose.

I understand the goal of the regulation. As the size of capital raised increases, investors want increased disclosure and validation of the state of the business, and we should work to create different technology solutions that can help achieve that. Additionally, if I have to spend 30 percent of what I raise just to comply with the legal and accounting requirements, as you said, Mr. Chairman, it is sort of like am I going to use my credit cards or am I going to use this new opportunity?

Now, I wanted to share, really moving to sort of looking at the opportunities for crowdfunding particularly in two studies, most recently a study that was done on the U.K., about the British system, and an example of what light touch regulatory environments can achieve and really what we hope it could achieve here in the U.S. And secondly, one of the most important questions I think is after a company raises the capital, what happens then? What happens then to the business, to follow-on investors, and to job creation?

So first to the U.K. study. When we look specifically at this U.K. study, they have had three years of equity and debt-based crowdfunding up and running and a great deal of experience. The U.K. government utilized a significantly light touch approach, and it has been amazing to see what has developed in that marketplace. The population of the U.K. is about 61 million, so it is about 20 percent of the U.S. population. The size of their crowd finance market doubled nearly between 2012 and 2013. It grew from nearly $800 million in size to over $1.3 billion. And this demonstrates a clear willingness for both buyers and sellers, investors and contributors, to want to engage in this kind of finance. Of those 2013 totals of $1.3 billion, $314 million were individuals lending to small business, and $45 million was equity crowdfunding. That growth rate year over year was over 600 percent growth rate. And equity crowdfunding surpassed rewards-based crowdfunding in the U.K. in 2013. That is pretty amazing.

So collectively, in 2013, in the British system, over half a billion dollars was delivered to early stage and small businesses. That is over 5,000 businesses. And the report predicts that in 2014 that will increase significantly. If you were to equate that in the U.S. market, that would be 25,000 businesses receiving money across the country.

So looking at what businesses are doing post-funding, three questions. One, does crowdfunding have a positive impact on sales after you achieve your goal? And in fact, it does. We saw a 24 percent increase in sales net of the crowdfunding raised when they were successful. Two, were new employees hired? We found that on average, 2.2 new employees were hired for companies that successfully raised funds. So people are creating jobs with this money. And finally, what about follow-on investors? Will angel investors and VCs invest in these companies after they have raised money through crowdfunding? Resounding yes was the answer. Twenty-eight percent. Within 90 days of closing the round, 28 percent had already closed an angel round of investment, and an additional 43 percent were, in fact, in conversations with VCs or with angel investors.

And so that is the data I wanted to share this morning. Again, I want to thank the Committee for this hearing and for your overwhelming support of crowdfunding. I look forward to your questions.

Chairman SCHWEIKERT. Thank you, Mr. Best.

Our next witness is Daniel Gorfine, director of Financial Markets Policies and legal counsel in the Washington office of the Milken Institute, an independent, economic think tank where he researches and has written extensively on issues related to crowdfunding provisions and the JOBS Act. Mr. Gorfine received his B.A. in Economics and International Relations, Brown University, and his law degree from the George Washington University School of Law.

You have five minutes. And as you all know, five minutes. And when you see yellow, just start talking faster.

STATEMENT OF DANIEL GORFINE

Mr. GORFINE. Chairman Schweikert, Ranking Member Clarke, and members of the Committee, thank you for the opportunity to testify on implementation of Title III of the JOBS Act or what I will refer to as the crowd investing provisions.

My name is Daniel Gorfine, and I am the director of Financial Markets Policy at the Milken Institute Center for Financial Markets. Today's discussion fits squarely within a number of pillars that guide our work, including expanding access to capital and developing financial innovations. Indeed, the ultimate goal of crowd investing is to responsibly increase capital access for startups and small businesses, especially within industries or regions disfavored by traditional sources of capital.

In proposing Title III rules, the SEC has largely used its discretion to positively advance that goal in the development of this market. That said, it is an open question whether the current crowd investing rules will significantly increase capital formation for startups and small businesses. Investors will need to consider whether the risk-reward dynamics are sufficiently compelling and whether other factors, such as personal interest and an affinity are a sufficient draw. And for issuers and intermediaries there are concerns that the cost of a Title III raise may exceed the benefit.

Based on these concerns, I will briefly discuss suggestions that may foster the development of crowd investing while limiting the downside risk to investors. This approach will allow for the evolution of this market and an opportunity to assess its central hypothesis that in an interconnected, Internet-centric world there, is wisdom in the crowd.

Two principles from the law guide my suggestions today. First, that this capital-raising tool is intended to be relatively lost cost, and second, that the Internet can facilitate a novel form of crowd-based due diligence in investment. With these principles in mind, I believe as an initial matter that the most efficient way to limit downside risk is through emphasis on investor caps, at least until the market is able to prove itself.

The SEC's current investor self-certification approach properly imposes responsibility on investors. It should go further, however, by requiring platforms to make investors explicitly aware at the point of investment that the cap is not something that can be ignored but rather is required by law and intended to protect investors from the downside risk of early stage investing. Additionally, the SEC should consider precluding an investor who violates the investor caps from bringing a lawsuit against an issuer. With investor caps serving as the most effective way to limit downside risk, the SEC should then minimize nonstatutory disclosure requirements. The law already includes a number of baseline disclosure requirements that will help investors make investment decisions. But in aggregate, if additional disclosures are too extensive and ongoing reporting requirements too onerous, then the cost will exceed the benefit, especially given the questionable value of such disclosure to investors.

The ultimate success of crowd investing hinges on the effectiveness of new vetting methodologies and criteria generated through the wisdom of the crowd, and evidence from overseas demonstrates that discerning crowd investors are likely to invest in what they know, existing companies with known management teams or known businesses and products. Accordingly, the SEC should first limit or require few, if any, incremental disclosures beyond those already required by law, and second, limit ongoing reporting requirements. A third suggestion is to permit funding portals more leeway to select and list offerings as well as to share data and information with investors. The law does not allow a funding portal to provide investment advice or recommendations. At its extreme interpretation, this ban could require a platform to list all offerings proposed by issuers.

In order to permit platforms some flexibility to decide on which offerings they will list, the SEC proposes that a platform can filter and select offerings based on objective criteria. For example, by geographic region. It also creates a duty for a platform to exclude offerings that could be fraudulent or that raise investor protection concerns.

The rules, nevertheless, leave a gap where a platform could have serious doubts about the viability of an offering but not to the level that it is permitted to exclude the offering from its platform. To require a platform to list an offering that it has a strong conviction will fail is contrary to promoting investor protection. Accordingly, portals should have the ability to go further in deciding with whom they do business, so long as they do not advertise that their platform has somehow safer or better opportunities.

The SEC proposed rules may also prevent platforms from sharing key data and information that could assist crowd investors. As we have seen with the development of e-commerce platforms, such as eBay and Amazon, there is significant opportunity for intermediaries to glean and analyze data and develop algorithms to detect fraud or best practices and also collect user feedback. I would like to see the SEC explicitly permit these types of activities for funding portals.

Finally, funding portals should be subject to reduced liability exposure for issue or missteps, given the portals limited promotional activities, limited ability to exclude offerings, and design to serve simply as a bulletin board. The SEC's initial contrary interpretation of the law would likely decrease the number of intermediaries participating in this market, as well as increase costs due to the risk of litigation. If that interpretation holds, however, and a platform can be on the hook for the missteps of an issuer, then the platform should have greater discretion to decide on whether to do business with that issuer.

I would like to thank the Committee again for having me join you today and I look forward to answering any questions that you may have.

Chairman SCHWEIKERT. Thank you, Mr. Gorfine.

I would like to yield to Ranking Member Clarke to introduce the next witness.

Ms. CLARKE. I thank you, Mr. Chairman, and it is my honor and privilege to introduce to everyone here today professor Bullard. Professor Mercer Bullard is a securities law professor at the University of Mississippi School of Law and founder and president of Fund Democracy, a nonprofit investor advocacy organization. He has appeared before congressional committees on more than 20 occasions and is a member of PCAOB's Investor Advisory Group and was a member of the SEC's Inaugural Investor Advisory Committee. With prior experience as an assistant chief counsel at the SEC and practicing securities lawyer, he is an expert on the Commission's enforcement and rule-making practices. He has a J.D. from the University of Virginia, a Master's from Georgetown, and a B.A. from Yale.

I want to thank Professor Bullard for appearing before us today and look forward to your testimony. Thank you.

STATEMENT OF MERCER BULLARD

Mr. BULLARD. Thank you, Ranking Member Clarke and Chairman Schweikert and members of the Committee. It is a pleasure to appear here today, especially a committee that is focused on business, rather than securities, because what I spend most of my time doing is teaching students how to solve business problems.

The Committee has asked whether the SEC's proposal will work for small businesses, and I am afraid the answer is probably not, but it is hard to tell. But the question is somewhat unfair because Congress did establish extremely detailed disclosure and filing requirements that are going to make up most of the burdens that will be imposed by crowdfunding. And I also would add that I do not think the solution is reducing those because I think they are appropriate as investor protection measures to ensure this does not go the way of the penny stock market in terms of the reputation that crowdfunding develops.

As you may know from my prior testimony, my view is that crowdfunding probably could work if investment minimums were so low and the risk of loss was small so that virtually no regulation at all would be required. It is not clear to me why we could not allow any business to offer a $100 share to a company or to an investor simply having provided a business plan on the Internet, leaving only the anti-fraud provisions of the securities laws and general consumer law to protect those investors. But the current law is what we have, so I will turn to some of the specific aspects of the SEC's proposal and their effect on small businesses.

One issue that we talked about before the meeting is there is a million dollar cap on what a crowdfunding issuer is allowed to have sold and the statute clearly indicates that is all securities. And the SEC has interpreted that to mean that it does not include all securities. It includes only crowdfunding securities. So what that means is somebody could go out and raise $10 million or $100 million or a billion dollars and then do a $1 million crowdfunding offering. Congress imposed that $1 million cap because crowdfunding was supposed to be for small issuers. It was supposed to be for issuers raising small dollar amounts. It was supposed to be for issuers that suffer from a perceived funding gap between them and larger businesses. Under the SEC's approach, medium and large businesses may fill the crowdfunding space, crowding out the small businesses for which it was created.

Small businesses should also be concerned about the SEC's position on certain investor protections. The reason is that if it is easy for unscrupulous businesses to raise capital through crowdfunding, the crowdfunding market may become equated, as I mentioned, to the market for penny stocks, rather than the thriving market for exciting investment opportunities that it does have the potential to become.

For example, the Commission would permit investors to offer investors who invest early a larger share of any oversubscription amount. The stampede effect that this promotes is precisely why such first come, first serve tender offers are prohibited under the Williams Act. What kind of businesses are going to allocate oversubscriptions on a first come, first serve basis in order to stampede investors to make commitments? It will be the less scrupulous ones that honest businesses should not want in their crowdfunding marketplace. The Commission would permit issuers to use financial statements that are 16 months stale. That means that you could start a business in December of year one, you could do a crowdfunding offering in April of year three, and your financial statements would cover one month at the beginning of the life of the business covering only one out of a 17 month lifespan.

The Commission would permit crowdfunded issuers that have failed to file their annual report the only post-offering obligation they have for up to 23 months to go ahead and make another crowdfunding offering. What kind of businesses are going to take advantage of the opportunity to file financial information that is 16 months stale or are willing to violate the law by failing to file their annual report? And I believe it is the unscrupulous businesses that honest businesses should not want in their crowdfunding marketplace.

Small businesses should also be concerned about investors suffering financial distress as a result of investment, which is more likely due to certain SEC positions. For example, the Commission would permit investors to self-certify the financial qualifications. And this will result, for example, in some investors mistakenly believing they can count their home toward their net worth, in which case their crowdfunding investment may end up representing a large part of their savings.

Small businesses should be concerned about this issue because the defining feature of the crowdfunding market may end up being the high frequency of investments going to zero and how that plays out. Estimating conservatively, one quarter of crowdfunding investments are going to be worthless in three years. The data suggest the failure rate may be closer to one half. Imagine the reputation of a family of mutual funds in which one-quarter to one-half of the funds lost 100 percent of their value every three years.

So how will this narrative play out? Will the losses be only a small part of an investor's portfolio, money they can afford to lose? Or is the narrative going to be about investors who lost money they could not afford to lose their life savings perhaps. You can stack up a pile of filings and disclosure as high as the sky, but the bottom line is the success or failure of crowdfunding is likely to turn onto the losses that investors suffer and there are going to be a lot of total losses that they can afford.

Thank you, and I would be happy to take questions that you might have.

Chairman SCHWEIKERT. Our next witness is DJ Paul, cofounder of Crowdfund Intermediary Regulatory Advocates. You could not have come up with a shorter name? A trade association for crowdfunding web portals. He is also the co-chief strategy officer with GATE Impact based in New York, where he develops solutions to facilitate and expand private and alternative asset transactions. Prior to joining GATE, Mr. Paul co-founded Crowdfunder, a Los Angeles-based crowdfunding intermediary platform. Mr. Paul earned a B.A. in Philosophy from Brown University.

Well, please wax philosophy towards us. Five minutes, Mr. Paul.

STATEMENT OF DJ PAUL

Mr. PAUL. Chairman Schweikert, Ranking Member Clarke, and other members of the Committee, thank you for the opportunity to testify today. It is an honor to be here.

Given the limited time for testimony, I will confine my comments to four salient issues. These four issues are certainly representative of the kinds of concerns which some of the industry have with respect to the proposed regulations but they are by no means exhaustive.

First, auto requirements, which Mr. Best was good enough to touch on; pooled investment restrictions; intermediary participation restrictions; and funding portal liability.

Auto requirements. As currently proposed, there are three tiers of financial disclosure requirements for Title III offerings, corresponding roughly to the amount raised. First tier is 0 to $100,000; second tier is $100,000 to $500,000; and the third tier is from $5,000 to $1,000,000.

The first tier requires disclosure of financial statements certified by an executive officer of the company. The second tier requires the financial statements reviewed by an accountant. However, the third tier requires CPA-audited financials. Furthermore, these requirements for such CPA-audited financials are on an ongoing basis. Such audited financials to be provided to investors every year following a Title III raise over $500,000.

It is worth noting that these disclosure requirements for the third tier are actually more onerous and exhaustive than the current requirements for Regulation D offerings, which does not mandate audited financial statements for issuers, nor ongoing annual audited disclosures. These overly onerous requirements for third tier security crowdfunding offerings may have the unintended effect of pushing potential issuers away from doing Title III entirely and towards perhaps Regulation D offerings which might be more attractive to potential issuers.

This seems clearly inconsistent with the spirit of the original legislation, and in effect, creates a donut hole between $500,000 and $1,000,000, where offers do not utilize Title III at all. And in addition to creating an artificial market irregularity, this will also have the unfortunate effect of making these offerings unavailable to unaccredited investors since Regulation D, which is the most viable alternative obviously does not permit investment by unaccredited investors.

Moving on to pool of investment restrictions. The proposed regulations exclude funds from utilizing Title III to raise capital, in effect requiring all crowdfunding investments to be direct investments. This rule would restrict pool of investments for hedge funds, private equity, from raising money through crowdfunding. While most of us can agree that most funds are not suitable issuers for crowdfunding, we believe that this restriction may be overbroad as it appears to restrict the fund-raising of special purpose vehicles or single purpose entities, investing only in a single operating company that would otherwise qualify as an eligible Title III issuer. This restriction does not serve to protect investors, but rather, this restriction actually succeeds in denying crowdfunding investors some of the advantages and protections afforded to other investors and institutions in other asset classes, particularly those utilized in Regulation D.

Moving on to intermediary participation restrictions. Current proposed regulations would restrict intermediaries from holding interests in the companies conducting Title III offerings on their platforms. This serves to restrict intermediaries from participating alongside their investors in these offerings. Rather than diminishing a theoretical conflict of interest between intermediaries and investors, as a practical matter this restriction effectively forbids alignment of interests between investors and intermediaries. This concept is often described as "skin in the game." We believe that intermediaries who invest in issuers make for better alignment of interests.

We believe that allowing such co-investment by intermediaries would have two very desirable benefits from investors. First, an investor may take comfort in knowing that the intermediary facilitating the transaction is investing in the same deal and on the same terms in the investment that they are considering. And second, when the intermediary has such skin in the game, that fact itself may encourage the intermediary to take more seriously their assigned roles in the marketplace.

I see that I am running out of time, so I will just very quickly skip to funding portal liability just so that I will have an opportunity perhaps to answer some questions that you might have with respect to that.

As the regulations are currently written of proposed, it may be subject to the interpretation that intermediaries are considered issuers within the context of the liability of any omissions that might be made by an issuer. This would have a rather bizarre effect of making an intermediary responsible, effectively a guarantor, of any offering that appeared on its platform. I think that it is pretty obvious that that would be problematic on its face, and it is something that we need to address in the next several weeks and certainly before these regulations become finalized.

I will end there, and I will look forward to your questions. Thank you again for the opportunity to testify.

Chairman SCHWEIKERT. Thank you, Mr. Paul.

And I was going to turn to Ranking Member Clarke and let her share with us her opening statement.

Ms. CLARKE. I thank you, Mr. Chairman. And I welcome our witnesses and thank them for their testimony here this morning.

With traditional capital access avenues still relatively constrained an increasing number of entrepreneurs are turning to crowdfunding to launch their enterprises. In 2012 alone, crowdfunding injected $2.7 billion into new ventures, a figure that will likely increase moving forward. In accordance with the Jumpstart Our Business Startup or JOBS Act of 2013, the SEC published its proposed rule for implementing the crowdfunding provisions in October of last year. While the SEC's crowdfunding disclosure requirements are aimed at providing enough information to the public to facilitate prudent investment decisions and minimize fraud, there is some concern that some of the disclosure requirements will make crowdfunding offerings cost prohibitive.

The SEC, for example, has estimated that it could initially cost $15,000 in listing fees and regulatory compliance expenditures to raise $50,000, thus taking resources away from business expansion and working capital. While these costs are likely to decrease over time as equity crowd funding becomes more popular, it is vital that

Congress monitor the SEC's crowdfunding rollout and make changes if necessary to improve access to capital for small businesses, while preventing bad actors from defrauding the public.

I would like to thank our witnesses for lending their expertise and insights to this second examination of today's subject matter, the rule, and the SEC's crowdfunding proposal.

And with that, Mr. Chairman, I yield back.

Chairman SCHWEIKERT. Thank you, Ranking Member Clarke.

I am going to turn to Mr. Mulvaney for the first five minutes of questions.

Mr. MULVANEY. Sure. Just a couple of random questions to the various members of the panel. Thank you, gentlemen, again for doing this. And thank you for participating. I do not think a lot of folk realize how important this is because it helps drive the national debate on the issue. So I appreciate your time.

Mr. Paul, we will start with you, just because you said a couple things that stood out. You said that because of the audited financial requirements to Tier III offerings, it is actually technically easier of cheaper to use a Reg D offering. What does a CPA audit cost these days?

Mr. PAUL. There is some debate about this. I mean, it could be $10,000. It could be $20,000. It could be $5,000. It is not going to be insignificant. There is some discussion about whether or not it will be streamlined. The cost of audited financials, obviously, are going to be contingent to some extent on how much activity the business—how far along it is in its business cycle. A startup, it would be more readily—a company that has no history, pretty much all that you are buying there is the CPA's license.

Mr. MULVANEY. And before I get to the Reg D question, how do you audit a company that does not exist?

Mr. PAUL. I am not smart enough to answer that question. That would be a challenge. I agree.

Mr. MULVANEY. If Mr. Schweikert and I have an idea, my understanding is that this is actually being used in the music industry a good bit. If he and I want to do a record together, we want to cut an album, it sounds like I would be completely excluded from the Tier III because I cannot audit something that does not exist, can I?

Mr. PAUL. You certainly could have an accountant look at what you do not have and say I am certifying that you do not have the thing that you said you do not have.

Mr. MULVANEY. Do not have it. Yeah, that is probably true.

How much can I raise at a Reg D offering?

Mr. PAUL. There is no limit.

Mr. MULVANEY. So if it is easier to do Reg D than it is to do a Tier III, you wonder why anybody would do a Tier III.

Mr. PAUL. Well, you might do it for several reasons. First of all, it is not clear that it is going to be necessarily less expensive. This is one specific requirement that exists in the Tier III of Title III offerings of crowdfunding that does not exist in Regulation D. There are other requirements in Regulation D as well. However, again, Regulation D is limited to accredited investors. And there are certain ideas, certain ventures, perhaps your record idea, that might be more appealing from an investor base of unaccredited investors. So that might be a motivating factor to not go up to Reg D.

Mr. MULVANEY. Thank you, Mr. Paul.

Mr. Gorfine, you said something regarding limited promotional activities. What are you not allowed to do as a portal?

Mr. GORFINE. So funding portals are quite restricted in what they can do with the offerings that are listed on their site. So they cannot be going out and soliciting for that offering or sending out messages saying we have got this great offering on our platform. You should come check out your new record album company. So they really are the idea behind the funding portals as opposed to a registered broker dealer platform which would have more ability to kind of provide advice and recommendations. A funding portal is envisioned to be a bulletin board. It is a Craigslist for offerings. So really you just go to the platform. You will be directed to the platform where you can then sort through the different offerings but the portals themselves cannot do anything further to be promoting those offerings on their site.

Mr. MULVANEY. Gotcha. Finally, Dr. Bullard, I am all for solving problems. I am a little concerned about creating problems that do not exist. If I have just raised a billion dollars in the public markets, why would I raise $250,000 on a crowdfunding site?

Mr. BULLARD. The reason is that I would certainly think Twitter, when it was private, would think it would be a great social media strategy to do a million dollar funding through crowdfunding to reach out to its users who are accredited investors. So I think there are a lot of instances.

But the issue is not necessarily whether it is a billion or $10 million or whatever. The idea is this space will be used more often by larger companies if you allow really large companies to participate. So if you allow companies that are raising $10 million into the space, it is going to have the effect of squeezing out or at least they will be competing with all the small business that it is purportedly designed for. So I do not know if a million is the right cap, but having no cap at all will leave the space open to whoever can pay the most for the services.

Mr. MULVANEY. Right. And I guess I just look at the numbers of it and the math of it. This is fairly expensive money in the greater scheme of things. And that is one of the reasons we are having the hearing. It is not as easy and efficient and as cheap as we had hoped it would be to raise money through crowdfunding. So I guess I am struggling with why I would go raise $250,000, very expensive money, when I just raised some of the cheapest $100 million, billion dollars that I possibly could. So I recognize there are challenges. I am wondering if that is one of the ones we actually spend a lot of our time on.

Anyway, I appreciate the Chairman's time. I yield back.

Chairman SCHWEIKERT. Thank you, Mr. Mulvaney.

Ranking Member Clarke.

Ms. CLARKE. Thank you, Mr. Chairman. I am going to yield the tile to Representative Chu at this time.

Chairman SCHWEIKERT. Ms. Chu, five minutes.

Ms. CHU. Thank you so much for yielding.

I am a member of the Intellectual Property Subcommittee on the Judiciary Committee, and so I am concerned about intellectual property and I know the protection of intellectual property is one of the challenges of crowdfunding. So I have a question for anybody on the panel.

Once an idea is out, the startup of small business runs the risk that the idea will be stolen or copied, how can inventors and artists protect themselves from those consequences, let us say for instance that a tech startup has a new technology that has not been patented but they use crowdfunding to raise capital for their venture, should intermediaries be required to advise or educate issuers on IP protections before a campaign is posted or disclosed?

Mr. PAUL. The same risks exist whenever one raises money. Whether or not intermediaries should be required to advise issuers as to that, it is certainly something that I do not believe that the intermediaries that are part of our organization would have any objection to that being something that we would want to do. There are certainly going to be some ideas that maybe are not welcome or suited to the broad raising of capital through this because of intellectual property concerns. But the majority of the ideas, I think, can be protected. You mentioned patented. And of course, there are other ways of protecting ideas, and it will encourage, we hope, issuers to be organized and get their intellectual property, as well as their other issues in order prior to doing a raise in this manner.

Ms. CHU. Mr. Best?

Mr. BEST. In addition to Mr. Paul's comments, I think that what we are also seeing on a mechanical basis and implementation are the fact that many crowdfunding platforms, and I would assume all, will have deal rooms, online deal rooms, where there is a public facing amount of information that anyone can see but that any IP, anything that would restrict it, the viewer would need to gain an additional level of access from the entrepreneur that they could pass through some sort of screen that the entrepreneur could determine this is a serious investor. This is someone who actually wants to make an investment in my business and I will allow that to happen. The same thing that occurs in the offline world through many 506 offerings.

Mr. BULLARD. Yeah. If I could just add, I would say to answer the question about liability, I think we need to leave intermediaries to just what legal rights the issuers would have under current law. There may be some duties that they would be impliedly having in that scenario, but I certainly would not make it any kind of statutory or rule-based requirement.

Mr. GORFINE. Yeah. I would agree that this is not appropriate to put the requirement on a platform necessarily to educate the entrepreneur or the issuer, but I think it raises an important question which is how do we make sure that issuers and entrepreneurs are educated about some of the risks of a crowdfund or a crowd raise? So I think that education for issuers and entrepreneurs is going to be very important, and one suggestion I would have is that the SEC actually has an investor.gov website that has a lot of great information for investors. Perhaps through the education side of the SEC's organization, you could create some information for issuers and entrepreneurs that they could consult before they go ahead and do a crowd raise. So I think that the education component is important.

Ms. CHU. Thank you for that.

Professor Bullard, given the inherent riskiness of small business investing and the lack of investor sophistication in individual retail investors, it was mentioned today that the best way to limit downside risk is through an emphasis on the investor caps. However, the proposed rules do not require crowdfunding platforms to verify the income and net worth stated by the investors. What are the implications of this and furthermore, what mechanism should be used to ensure the compliance of the investor caps?

Mr. BULLARD. Well, there are really two problems here. One is the very real possibility that people will lose a significant amount of money that they cannot lose. And obviously, that will have happened only because something has gone wrong in the application of the Act. One of the really great things the Job Act did was actually to impose percentage limits, so that implies that you can only put a certain amount of risk, which is a great defense to allowing people to take those kinds of risks.

But people will slip through the cracks. It is inevitable. And something more needs to be done than simply to allow an investor to go on a website on an unguided basis and just say I have got a million dollars of net worth. And I can tell you, most investors are going to think that their house is included in that, which it is not, and most investors are going to neglect the fact that they do not own their house; the bank actually does. So you could have people investing perhaps all of their savings in an offering because of that confusion. You cannot go out and sit down in a room with an investor and go over all their qualifications.

But on the other hand, Mr. Gorfine suggests that we actually sue investors who violate the provision. Well, you cannot violate the provision. The provision does not say that investors are required to be X. It says that issuers are not allowed to sell to those people. The obligation is on the part of the issuer and the intermediary, and they are the ones who are really responsible. So the SEC needs to step it up a little bit, but we all know that it cannot be sending lots of papers that have to be reviewed on a detail basis.

Ms. CHU. I see my time has run out so I will yield back.

Chairman SCHWEIKERT. Thank you for that.

Mr. Rice, five minutes.

Mr. RICE. I will yield.

Chairman SCHWEIKERT. And who do you want to yield to?

In that case I get to. And what is always dangerous here, and Ms. Clarke and I have teased over this in the past and I am trying to do questions without too much in tirades, but I do need to actually just sort of throw a personal philosophic sharing, particularly for my philosophy major at the end, as much of the political side and the latest political discussion is income disparities. But yet, in many ways we have diced up part of our opportunity within our society saying I am a qualified investor so I am part of this fraction of a fraction of a fraction represent of my U.S. population. You get to participate. You get to know what is going on. You get to take risk. But the vast majority of our society and population, you are walled off from opportunities. And yes, people lose money. But as we have all had in our experiences, we invest in three things. One we do okay in and actually over time we do well in it. The other two go nowhere, but that is how we have built our nest egg for our retirements and our future.

And as some of the rule sets become more paternalistic, my fear is we just expanded that income and inequality by sort of almost a financial apartheid where we say if you have this wealth you get to participate; if you do not, you do not get to even know. So I do have an underlying belief system here that we have sort of this egalitarian obligation to reach out. If you are an electrical engineer and you are an expert but you do not have the million dollars in the bank, but damn it, you have $2,000 and you are an expert. Should you be allowed to invest it? And that was actually one of my great hopes underneath the crowdfunding is how do I really create an opportunity society and not one that is walled off where you have it so you get to continue to participate.

And this sort of makes the circle back to Mr. Paul, back to sort of the question. My fear was in some of the reading our office did within the proposed rule sets that a platform, an intermediary, may actually find itself within the tree of liability. Do they get to sort of choose who they post up? If so, do they now start to sort of only choose opportunities that they feel are perfectly safe or do they have to post up anything within their general box and geographic or these things, and do they end up carrying liability for a failed disclosure of someone's bad act?

Mr. PAUL. There are a few questions in there, so let me start with what I think was the first one.

Understand that, and I am sure you do because I know you participated in the creation of the statute itself, but investment advice is not permitted to be given by funding portals to investors. So the question that you are asking about whether or not a portal can pick and choose which offerings it puts up gets close to the line of whether or not that in effect if you exclude something and you include something, if that constitutes investment advice.

CFIRA, the organization I work with, has been working with the SEC to fine tune that a little bit, put a little bit more shape on exactly what that is so that we do not have a situation where all portals have to list everything, which would be a bulletin board and not really in keeping with what the intent was. Nor can they be quite so selective that it is pretty obvious that they are picking the winners because they cannot offer the investment advice. So I think that might be responsive to the first part of your question.

Chairman SCHWEIKERT. Okay. Go onto the second part because——

Mr. PAUL. In terms of the liability. Yeah. The definition of issuer as it relates to Title III offerings is broad enough now to include not just the issuer itself but to include the portal. And then the liabilities that the issuer quite rightly has for being truthful and disclosing accurately, if the portal is considered an issuer then the responsibility and the liability would then fall to the portal. That seems overbroad. That seems like it is going to dissuade would-be portals from participating in the process.

Chairman SCHWEIKERT. Can I put a hold on you at that point?

Mr. PAUL. Certainly.

Chairman SCHWEIKERT. Does everyone on the panel agree that a clean reading of sort of the proposed rule set does that cascade of liability?

Mr. BULLARD. What Mr. Paul is talking about is there is liability for violating Section 5, which basically means you have not complied with the exemption. As it turns out, it was not available. And generally, issues, the intermediaries are not going to be subject to that, and to the sense that they might be, that is certainly a legitimate concern.

Chairman SCHWEIKERT. Okay.

Mr. BULLARD. And then there is the secondary liability, which you are also talking about, which is material misstatements, and they are squarely in the crosshairs on that. And Congress specifically put 12(a)(2) in the act, so there is no question there.

Chairman SCHWEIKERT. Mr. Gorfine, do you agree?

Mr. GORFINE. I would say the SEC has interpreted the Title III to potentially impose that liability on funding portals. I think that there is something think it is not clear from the statute though whether a funding portal should fall within the purview of that type of liability because they are not able to fully decide who they are listing on their platform, and there is a limited promotional aspect of what they are doing. There is a limited solicitation aspect of what they are doing, which raises questions. How can you be held liable for the misstatement of an issuer or an admission of an issuer if you did not have the ultimate discretion of whether to list that offering on your platform or not.

So I view this on a bit of a sliding scale. To the extent that platforms do not have the discretion to decide with whom they do business, it seems like a poor outcome for them to be liable.

Chairman SCHWEIKERT. Mr. Best?

Mr. BEST. I think from my perspective we believe that the portals should have the ability to decide who is and is not on their platform because then it becomes more than a bulletin board.

Chairman SCHWEIKERT. But on the taking liability for if——

Mr. BULLARD. I agree. There is a significant disagreement we have not covered.

Mr. MULVANEY. I am going to come back to you, Mr. Paul, because there were a couple things in your written testimony that were actually very interesting.

Mr. Paul?

Mr. PAUL. Yes, sir.

Chairman SCHWEIKERT. I interrupted you when I went on my tirade.

Mr. PAUL. Yes, I was not sure if that was a tirade or you were just looking for confirmation.

Chairman SCHWEIKERT. Actually, believe it or not, within your written testimonies I have a bit of a split on the discussion of does the portal—what level of liability it takes for a screwed up offering or someone forgetting a disclosure. And so that is what I am trying to——

Mr. PAUL. It will always get back down to when there is a claim, if there is a claim, you know, what did the portal know and when? And the liability could be significant. I mean, it could be significant enough that effectively, and I mentioned this very briefly in my oral testimony, but it is in my written testimony, in the broadest interpretation the portal could be 100 percent liable for reimbursing an investor, even after the investor perhaps does not even own the security any longer, which would effectively make the portal a guarantor for everything that is listed on the platform.

Chairman SCHWEIKERT. And I am concerned about the potential chilling effect and just cleaning up that language.

Professor, you actually had—you sort of brushed alongside this. Can I throw a scenario at you and have you sort of game theory this with me?

There are actually a group of friends and supporters, it is a Korean business association. At one time, if it was a few years ago, they were trying to put up a community bank but the difficulties and the capital that is required to that, and they have been looking at the idea of, hey, if we could produce a portal and we could reach out to the Southwest and the California market and help folk within our association group have basic capital raise and their level of comfort because these are often folks, either they know reputation wise or they know the industries, do I have problems with something that borders on a fraternal or business or chamber or specialty organization, setting up a portal saying this is what we are going to fund? That is the first question. Do you see anything there in a portal being that specific to its charter?

Mr. BULLARD. Yeah. The disagreement is that there is no restriction on your ability to say no to issuers. That is simply incorrect. To be fair to the SEC, the investment advice issue, that goes to the communications with the public, the investor. Deciding who is going to list is a communication with the issuer.

Chairman SCHWEIKERT. Okay. So my Korean business association——

Mr. BULLARD. So that is not an issue.

Chairman SCHWEIKERT. Instead of a community bank, this is how we are going to help folks in our community.

Mr. BULLARD. So there should be no problem.

Now, you cannot say you should invest in these affinity entities because you will get better returns. But you can say you can invest in these affiliated entities and you can probably say because we think they have values that we share. But there is no conceivable possibility that you chose the group on that basis or you went out and you only accepted issuers you thought would be 10-baggers that you would be liable for that. That is simply not realistic.

Chairman SCHWEIKERT. Well, as a professor of securities law, as you probably remember a decade or two ago, there was a movement to try to create specialty community banks to be able to deal with underserved populations. Do you see where some of this model could actually be part of that opportunity?

Mr. BULLARD. Yes. But we talked before the hearing about the issue of whether you can actually do bricks and mortar selling, and I am still not totally clear on that. But I think that to the extent the SEC has put——

Chairman SCHWEIKERT. Could you explain that for everyone else here because this one actually could be a bottleneck.

Mr. BULLARD. Right. Well, the SEC talks about kind of an online-only approach, and if I am correct, that would preclude you from running an offering out of your bank. You would still have to have a website, but you would not be limited to the website. Then I think that would severely handicap what is really the sweet spot of crowdfunding. That is the community business that somebody might want to start up based on local relationships. For example, the organization you mentioned.

Chairman SCHWEIKERT. Okay.

And Mr. Best, as the professor was just touching on, is not the second part of the beauty within sort of the crowd sourcing, crowdfunding concept, is just that? It is a proof of concept?

Mr. BEST. Absolutely.

Chairman SCHWEIKERT. It is not only maybe raising money in my community but also an A&B test of not only I can access some money but I can also access folks that have enthusiasm for the concept?

Mr. BEST. Absolutely, Mr. Chairman. I think what we are seeing, there are a number of angel investors who now are beginning to look at crowdfunding as a qualifying step before they will look at a deal because do you have a customer for your product? Do you have a customer for your service? And being able to, whether it be through awards or through equity or debt, being able to establish that does several things. It is proof of concept of your product. It is proof of concept of you as an entrepreneur, the ability to execute, and your ability to raise capital, both very important aspects.

Chairman SCHWEIKERT. Mr. Gorfine, in that sort of model, let us say I actually need a few million dollars for my concept, but I am going to use crowdfunding to raise $499,000. And we will discuss whether ultimately I have a soft cap, a small raise because in that population, most likely I am not going to have many people able to invest over $2,000, and at some point we really do need to talk that there are these investment caps already built into here to limit someone's downside. But I use that as my proof of concept. Then I take my proof of concept, and can I then go to my qualified investors and raise my next $2 million and then go to more institutional money to round out my fund-raise?

Mr. GORFINE. Yeah, I think that is right. And the SEC, I think, did a great job in clarifying that point. That you would be able to use Title III alongside or before, subsequent to, certain other exemptions. So if you think about this in its totality, what I like about the JOBS Act vision is that it creates this kind of seamless capital access pipeline, if implemented effectively, so that you can go from each stage of the development of a company and be able to access capital that suits your needs at whatever stage of development you are at so that you could certainly start with Title III and then potentially use that to move up to a Title IV, you know, Reg A-Plus type raise.

Chairman SCHWEIKERT. Thank you. That was one of the concepts I wanted to make sure we addressed.

Ranking Member Clarke.

Ms. CLARKE. Thank you, Mr. Chairman.

Mr. Paul, the SEC has estimated that commissions to intermediaries will account for about 5 to 15 percent of the crowdfunding issuance, higher than other funding sources such as public stock offerings or bond issuances. Do you expect this higher cost to come down and become competitive with traditional forms of capital as crowdfunding expands? And then I will open it up to the rest of the panel.

Mr. PAUL. I think it is going to be a competitive marketplace, so if you are asking if over time that these commissions, there will be some sort of competition, I think the answer is probably yes. I would, however, note that comparing the commissions for crowdfunding offerings to IPOs or public markets is perhaps not the most apt analogy. I mean, it is an appropriate one, but there are other types of securities that exist that might be a closer analogy. For example, Regulation D or 506, which is another type of private placement. And in that universe, these proposed commissions are fairly consistent. Maybe a touch higher but not quite as many multiples higher as the private-public markets.

Ms. CLARKE. Would you agree with Mr. Paul's assessment?

Mr. BEST. I would. Yes.

Ms. CLARKE. Okay. Professor Bullard, the rule outlines a number of investment limits based on an investor's income level. However, you invest concerns that the rule lack an income verification scheme. What risk does this pose for investors interested in crowdfunding?

Mr. BULLARD. The risk is not that they will invest in accordance with the rules. I think the rules are good rules, particularly that they limit the percentage with respect to that person's income or net worth. This is a slip-through-the-cracks problem, and is most likely to happen when you put the entire analysis in the investors' hands and you do not give them clear markers as the things they need to look out for.

So, for example, one obvious one would be they should not be allowed to self-certify if there has not been a button they had to push saying I have not included the value of my home. They should not accept that they have read the investor education material which is required unless there are a couple screens where a box has said in big, bold letters the percentage of small businesses that fail to really drive home the point that this happens. Instead, what the SEC suggested is you can just click on a box that says "I have read this" and the thing is not even there or something you would have to scroll down 20 pages. And we all check that box all the time saying we read it, but we are lying, are we not? Right? But it is also crazy to think anybody is going to read these things. So the SEC has always been unwilling to say, well, you know, the literal letter of the law is the only path we can go down with no requirement. Just be creative and say, look, there are four or five boxes with big fat letters that will lay out the key things they need to think about and that should do it. That is the kind of thing we need to deal with but I think submitting a paystub should be a requirement. That is just too easy. Or some electronic verification of income, for example.

Ms. CLARKE. So discuss that ambiguity in a rule that could allow large companies to raise $1 million through crowdfunding while simultaneously raising more via other public offerings. Can you elaborate on how this will impact startups and small businesses that are experiencing a funding gap and want to seek crowdfunding?

Mr. BULLARD. This is the issue Representative Mulvaney raised, and I agree that the $1 million cap on the total offerings that a crowdfunding issuer is allowed is too low, but I think as a business matter—this is not an investor protection issue at all—but as a business matter, if you really want crowdfunding to work, I think that larger issuers are going to squeeze out smaller issuers. And you all know in the regulatory space who calls the shots. In the regulatory space, it is going to be the largest regulated entities. So if you let larger entities in this regulatory space, they are going to have more influence with the SEC and the rules are going to reflect their interests. So definitely, I think the $1 million is not high enough. I do not think the SEC has the authority to do what it is doing because the statute is so unambiguous, but the fact that somebody can be very successful raising significant amounts elsewhere, they should not be allowed to use crowdfunding because I think the way it is going to work is they will squeeze out the small businesses.

Ms. CLARKE. Let me open this up to the rest of the panel. I saw, I guess, a glimmer in our eye, Mr. Paul. Would you like to share your thoughts?

Mr. PAUL. It might have been a glimmer.

Yeah. With all due respect to Professor Bullard, I just do not agree. I do not think that the larger issue—if the larger issuers, or whatever, larger entities are allowed to do crowdfunding offerings, that it is going to squeeze anybody out. It will simply make it a more diverse marketplace. I am trying to think of a large corporation that might choose to utilize Title III almost as a marketing opportunity or a way of extending their brand. It is still going to be limited to a million, at least for the time being. Why would we restrict that? Why is that a bad thing? Why not allow the opportunity to invest for unaccredited investors that would not otherwise have had that opportunity? I am cognizant, of course, that this is the Small Business Committee, and so we want to foster small businesses, and certainly Professor Bullard's comments are consistent with that. However, the other side of the rationale for Title III was to democratize wealth creation as well. So it is not just democratizing the capital formation, but also democratizing the opportunity for investors to participate in the types of investments that they might not otherwise, and previously did not otherwise have. So I do not see the need to restrict them.

Ms. CLARKE. Mr. Gorfine? Mr. Best?

Mr. BEST. Well, in talking to a couple major corporations about this who have been interested in crowdfunding—their interest really is more on the reward side because of the rewards crowdfunding, like Kickstarter or using services like that because it allows them to raise capital—there are no limits, and far fewer restrictions. And knowing how general counsels at corporations tend to work, that would be the way that a marketing department might have a better chance at actually executing one of these campaigns.

So I do not believe it will crowd out small businesses. I think that those major corporations will utilize other means, rewards or otherwise.

Mr. GORFINE. Yeah, I mean, just to add, I tend to agree with that. I think let the marketplace determine what the crowd wants to invest in. And I think more opportunities, more offerings and options is not necessarily a bad thing.

And if I may, can I come back to the investor cap question that you were asking before? I do want to just clarify one thing. By no means do I think the SEC should be going after investors with lawsuits if they violate the cap. So I actually do agree to a significant extent with Professor Bullard that this idea of how do we make sure investors just understand what these caps are all about. So what I would propose is just literally at the point that an investor is about to click their commitment, there can be a popup that explains the rule and how you calculate what your cap may be, and just explains why that is important. So I do agree with the self-certification aspect of it, but it could just be an explicit popup that occurs at the point of the commitment that explains what the parameters are.

And my point on the lawsuits is if an investor violates that cap, you could consider whether they should not have the right to bring a cause of action against an issuer. That is what I was bringing up in terms of lawsuits. Just to help enforce the importance of that cap.

Ms. CLARKE. Very well. Thank you.

Just one final question, and I am going to start with Professor Bullard.

The SEC cost estimates for crowdfunding do not look promising for small issuers. Are there ways the SEC could reduce the cost without impacting investor protection?

Mr. BULLARD. That depends on to what extent the SEC believes it can disregard what was expressly required in the statute. And the SEC has shown a great willingness to do that in its proposal. So if that is what it is going to do, then yes. And one example that really stands out is the requirement that you explained how you valued the shares and how you are going to value them in the future, which you do not have to do anything similar for an IPO. And it is also sort of in contravention of the general rule that you are trying to sell things for the highest price you can get. Although ironically, in IPOs you are often trying to sell them for less than you can get in order to have an effect on the aftermarket. So that should go away. It is unreasonable. The very detailed instructions when explaining your capital structure should go away. The very detailed explanations on a dilution. What they need to know is you can make subsequent offerings of shares and it can result in reducing the value of our shares. And we have the authority to do that.

So a lot of the things just are not the kinds of things that are going to go to the real issue here, which is that there are going to be a lot of losses. And who are the people who suffered those losses going to be? Right? And I do not think this is going to be about disclosure, but the cost is certainly going to go to disclosure and the perceived liability is going to go to that as well.

Ms. CLARKE. Thank you, Professor.

Is there anyone else who would want to? Mr. Best?

Mr. BEST. Just one thing about education. I think that is one of the good things in the statute, was the requirement for robust investor education. And we have already begun seeing some of the portals who are going to be implementing solutions that look very much like what Professor Bullard was talking about, whether they be a video, much like the seatbelt video you watch when you get on the airplane, or something that has large check boxes and really requires much more engagement. There were other solutions that used to require you to spend a certain amount of time on the page and sort of monitor that.

Also, because all this is happening on websites, everything is tracked. And so there will be a digital footprint of everything that was done by that investor on those sites. And so you will know how many minutes they spent on each page of disclosure, how many times they watched the video, how many times they did everything. And so it will provide much more transparency than we have ever had before about what people are doing when they are reviewing documents.

Ms. CLARKE. Very well. I yield back, Mr. Chairman. Thank you all for your expertise today.

Chairman SCHWEIKERT. Thank you, Ranking Member Clarke.

And I am going to go to Mr. Rice, but Professor, I want to chime in on this one just quickly. I actually see substantially more benefits for its larger organizations. From their standpoint, they get to do a proof of concept, but I actually also saw that as they would have the resources to have good documentation, good video, good information, maybe a nice blog that explains what they are doing. And it is a way of their resources helping introduce hopefully this next class of investor to this concept. And as we keep saying, education, education, education. Well, I would love to exploit some of their resources to do that. So that is where I have some optimism.

Mr. Rice, five minutes.

Mr. RICE. I was a tax lawyer and a CPA for 25 years before I came to Congress, and I represented a thousand small businesses. And I have seen the effect of federal securities laws on their ability to raise capital. For a truly small business, it simply is out of reach. Banks being the primary source of capital, the new Dodd-Frank regulations are certainly going to limit that even further. So this is an incredibly important concept, very innovative concept. Could solve a big problem of growing small businesses. I totally agree.

I would ask each one of you for one suggestion. We cannot make this so complex and complicated and expensive that it, like the rest of the federal securities laws, is out of reach of the average small business. So I would ask each one of you for one concrete change or suggestion that we could do with these regulations in this law to make it more accessible.

And I will start with you, Mr. Best.

Mr. BEST. I think it would be to modify the requirement of a full CPA audit at above a half million to potentially the CPA review that was required in the $100,000 to half a million range.

I would say in the same vein, I would limit any nonstatutory disclosure requirements, and that also includes limiting some of the ongoing compliance requirements. I would just add to the point on audits above $500,000, for a Reg A offering up to $5 million, we do not have that same financial audit requirement. So you want to kind of square how these different exemptions fit together.

Mr. RICE. Mr. Best, at what level would you require an audit?

Mr. BEST. I do not have the benefit of 25 years of tax CPA experience. I just come at this as a small business person, as a small business owner. I think there is some level, but I think if you wanted to say that maybe at the end of year one, after you were successful at raising the capital at the end of year one and you wanted to then provide something back, to deliver back to those people. I think one of the things, too, is that these investors, because they are investing most of the time, historically the data we have to date is that 80 percent of the time these are people who are first or secondary connections to the small business owner who are making these either investments or contributions. And so these are people they have ongoing relationships with. And so there will be a lot of mandated disclosure, but what we are seeing is the people who are successful are the people who provide ongoing sort of fulsome disclosure in the course of doing business because that is what people want to know.

Mr. RICE. Well, do not get me wrong. I hold a CPA, but I agree with you that an audit is an onerous requirement for a small business, particularly when it has been ongoing for five years and never had an audit. And so to go back and redo all that from ground zero to establish a starting point is ridiculously expensive and would prohibit any small business from being able to utilize this. So I agree with you and I think that that threshold, if there is not going to be an audit required, should be very high because it is going to cost so much to get the money it is not going to be worth it.

Mr. Bullard?

Mr. BULLARD. I guess the one change I would make would be to have a $100 investment maximum and then strip everything out except for the requirement to do it through a mediary and the requirement to have some business plan that is at least 500 words.

Mr. RICE. I think 100 would be too small, but I hear what you are saying.

Mr. BULLARD. A thousand times 100. There is your 100,000.

Mr. RICE. Mr. Paul?

Mr. PAUL. My suggestion would be addressing—it may seem indirect, but addressing the portal liability issue is rather crucial to a facilitating small business's ability to raise money. If it is not clear, we may end up with perhaps the more gun-slinging actors participating in a market that we really do not want to be perceived that way.

Just getting back to the audit question, the only reason that was not my choice was because it had already been mentioned. I think an audit should be required when it is required by the owners. I think when the market says, you know what? We are not comfortable with you, the investors, we want to see how you got here. When that happens then I think the company should be required to, but I think setting an arbitrary cut with respect to how much is raised feels, well, arbitrary and it should be based more on necessity and the desire of the shareholders.

Mr. RICE. Thank you very much for your time. I completely agree that the way this is proceeding is going to make this pretty much useless to small businesses unless we make changes. I appreciate your input. I like the idea of limiting investment but I think $100, it needs to be significantly higher than that.

Thank you, Mr. Chairman.

Chairman SCHWEIKERT. And thank you, Mr. Rice.

They are about to call votes. I think that still gives us a few minutes because as we have all learned around here the first 15 minute vote means a half an hour.

Mr. Mulvaney, you had a couple.

Mr. MULVANEY. I did. Thank you.

And I forgot, Mr. Best, you actually opened your testimony by talking about the British system and the theory that good ideas can come from anyplace. Would you just give us a quick summary of where you think the significant difference are between the British system and the one we have adopted and maybe someplace where it might be better, someplace where our system might be a little better?

Mr. BEST. What is interesting about the British system is a lot of it has sprung up in the absence of strong regulation. And it is only this year that the British government will be issuing more formalized crowdfunding and crowd lending regulation.

Mr. MULVANEY. The caps that we are talking about, the disclosure requirements, the liability rules are nonexistent? They are organic? What are they in the British system?

Mr. BEST. Well, they are much less structured in the British system. And so what we are seeing is you are seeing a wide range of investors and lenders. Now, I will say that the products of choice in the U.K. tend to be the loan products, the debt-based products. That is about 10 times more crowd-debt as there is equity. I think there is a degree to which that is cultural, as well as the fact that for a lot of small businesses who will never have an IPO or a 10X multiple, asking the question where is my exit on this investment. If it is a debt-based product, I know that I am going to get my loan payment every month over the next four years. So that makes sense as well.

Mr. MULVANEY. To the chairman's issue on democratization of investment, you said that there is a wide array of investors in the British system. Tell us who they are. Who is participating in this, not on the issuer's end but on the investor's end?

Mr. BEST. Well, on the largest debt-based platform in the U.K., it is called Funding Circle, they have now raised over 180 million British pounds. That is over a quarter billion dollars through their platform. And they have, I believe, it is 65,000 investors that have invested individuals into small businesses. And they come from a wide range of folks. And if you look at the average investment, it is about the average of about $3,000 USD. And so these are people who are not investing large amounts of money but are investing a few thousand dollars into a local business that they are familiar with. And I think that is a size of investment that, number one, we did research a couple years ago before the law passed just to ask people, what do you think your investment would be if you had this opportunity? And the number was between $3,000 and $4,000. So we are seeing, at least in the British system, those numbers are somewhat consistent. And so I think that while the limits may be up to 10 percent of someone's restrictions, what we are seeing in the U.K. after tens of thousands of people have used this system, that people are going into this fairly carefully.

Mr. MULVANEY. I heard Professor Bullard mention in his testimony that he was concerned that something between a quarter and a half of these issuers, if I got that right, might fail. Do you happen to know the failure rate in the British system so far or not?

Mr. BEST. No, sir. I do not know the British system. I can give you some data from Australia. I think that there will be failure. Absolutely. Businesses fail. We have never run away from that in this entire conversation about this.

In the Australian system, they have had crowdfund investing, a form of it for now almost eight years, and the platform there is called the Australian Small-Scale Offering Board. And they have run about 145 companies through that platform, through that crowdfunding platform. One of the interesting things is that the survival rate of those businesses who have used that system has been 86 percent. That is kind of a very surprising high number. And when asked about that, the CEO of the platform has said he does not have the exact reason but certainly believes that adding structure and transparency to a business earlier than it typically would have as a startup, because you have to sort of have a lot more structure around your business because you are now offering this security out to the public, and also the transparency of having to make regular engagement with your investors, whether it be informally or formally, provides people with better decision-making opportunities and more transparency. I am doing this on stage. I have to do a better job. I have to live up to the expectations of the public.

And so we will see if that plays out in U.K. system and in the U.S. system, but it is an interesting data point.

Mr. MULVANEY. Fascinating.

Thank you, Mr. Chairman. I appreciate it, gentlemen.

Chairman SCHWEIKERT. Thank you, Mr. Mulvaney. And thank you for joining us.

Just one last, a takeoff of where you were, Mr. Best, or anyone that wants to participate. Let us articulate so we have it on the record. What are the caps? It is $2,000?

Mr. BEST. Two thousand dollars above $50,000—$50,000 to $100,000 in income. It is up to 5 percent of your annual income or net worth, and above $100,000 it is 10 percent of your annual income or net worth excluding the value of your home.

Chairman SCHWEIKERT. Professor.

Mr. BULLARD. There is actually a flat contradiction in the statute, so we do not really know the answer to that, which is it says if you are either at 100 or below as to income or net worth, you are subject to the lower limit. And then the next provision says if you are either at 100 or more.

Also, it is not clear what the 5 percent applies to. There I think the SEC should interpret it to be the greater of.

Chairman SCHWEIKERT. And Professor, did not the SEC sort of broach that in their rule set?

Mr. BULLARD. Right. But they took the investor protection ambiguity and they ruled against more investor protection, allowing someone to invest more. But as a practical matter, what that means is someone who has $100,000 in savings would be able to invest $10,000 instead of $5,000. It is not going to be the end of the world but I do not think the SEC, when there is such a clear ambiguity, should be erring on the side of higher investments when this is an investment protection provision.

Chairman SCHWEIKERT. Last thing I wanted to share, and this was actually something—and those of you who have actually been involved in intermediaries, I am from sort of the world that believe that crowdsourcing of data information and crowdsourcing of money and other things, there is a purifying effect of information, sunlight, and the fact of the matter is having seen—because I have looked at some of the ones actually, the Netherlands, Sweden, Great Britain. And many of them actually had blogs running alongside of it saying, "We go to Mary's Bakery. We like this. That is why we are willing to put 1,000 pounds into this." It was a narrative that came with not only the posting in the investment.

Do you believe U.S. portals will actually make sure that they also, if they are asking for egalitarian participation, democratization of investment as you have used the term, will also be doing democratization of information and comments?

Mr. PAUL. I think absolutely. I think that it will be in both senses, in the example that you gave of Mary's Bakery, customers will talk, "This place is great and they make great scones." And there will be a discussion about that. But I think that there will also be blogs or a running dialogue about the offering itself where certain people will say, "All right. So I looked at the offering and this thing does not totally make sense to me. Does anybody have any clarity on that?" And then a dialogue, someone will respond, perhaps even the principal. And so I do think that there will be that level of transparency.

Chairman SCHWEIKERT. Would anyone disagree with me that particularly in this investor class, that is the ultimate type of regulation? Because we are all comfortable going to Yelp and others to get portions of information. As long as they have built the mechanics within there to avoid the scamming, that access to information has an ultimate regulator?

Mr. PAUL. I think it is a great contributing factor to that level of regulation, and I think that it may come to pass that it actually ends up being something that is expected in other asset classes. I think it is going to be very successful on Title III, and I think 5, 10 years from now that might be one of the legacies of this entire legislation, is that that level of transparency is actually required for other things, which will be great.

Chairman SCHWEIKERT. And now we do the scamper to go vote.

Thank you for your participation today. Your testimony has helped us to better understand how the SEC proposal will affect the future of crowdfunding. As I shared with you earlier, I am a bit emotionally invested in this, and I really do want to move to this democratization of access to capital where all of our U.S. citizens have the opportunity to take risks but also benefit from that participation and risk.

I will ask unanimous consent to have five legislative days to submit statements and supporting materials for the record. Do understand our office also intends to take portions of this and turn it into the SEC as part of sort of a comment coming from us.

Without objection, the hearing is adjourned.

[Whereupon, at 11:28 a.m., the Subcommittee was adjourned.]

APPENDIX

Congressional Testimony

United States House of Representatives

Committee on Small Business

Subcommittee on Investigations, Oversight and Regulations

For the Hearing: "SEC's Crowdfunding Proposal: Will it work for small business?"

Jan 16, 2014

Chairman Schweikert, Ranking Member Clarke and members of the committee, thank you very much for the opportunity to discuss the function that crowdfunding serve in delivering much needed capital to address the funding crisis for small businesses in the United States. I come here today not as a lawyer or government official, but as an entrepreneur who has had my share of both success and failure in starting and building businesses. In addition to sharing that real world perspective, I would like to introduce some new data from the UK and US markets that should shed some light on the magnitude of what is taking place outside the US in crowdfunding to ignite significant opportunities for small businesses to get funding, and the very real risk we run if we overburden issuers, platforms and investors with overly complex regulations. There are still many opportunities to strengthen and improve these draft rules and an opportunity to use new technologies and services to enable better oversight than has ever been available before; but it is up to the SEC to continue working with the public and industry as it finalizes its rules and Congress to determine what are the best actions to accelerate economic growth and create jobs in the United States.

I'd like to begin by thanking the members of this committee and both parties within the House at large, for their bipartisan and overwhelming support for crowdfunding. It was a wonderful example of the ability for both parties to work together in support of small businesses and entrepreneurs, which we all know are America's economic engine. When entrepreneurs have access to capital to grow their organizations, it translates into new American jobs, economic renewal for cities and towns across this county through hard work and American innovation.

As a co-author of the Startup Exemption Framework, the initial proposal for securities-based crowdfunding, and a close collaborator with Rep. Patrick McHenry and Senators Merkley, Bennett and Brown on the passage of the JOBS Act, I was thrilled when Title II draft rules became final and available for use and more recently when the SEC issued Title III draft rules for Regulation Crowdfunding. I want to take a moment in my testimony to give my sincere thanks to Chair White, the Commissioners, Lona Nallengara, David Blass and the rest of the staff that worked on Titles II, III, for their willingness to engage in a robust conversation with the industry while they were drafting their initial rules. While the rule making process did not occur as quickly as I personally may have liked, I want this committee to know that senior staff at the SEC met with myself and other industry leaders over a dozen times, were receptive to our public comments, and were responsive to our information and clarification requests during their rule making process. We hope that the engagement of the industry trade group that I co-founded, Crowdfunding Regulatory Intermediate Advocates (CFIRA), was able to demonstrate that the crowdfunding industry is very focused on creating a stable, orderly market. The industry will only succeed if it can grow and succeed over the long term, and take its place as a new asset class within the private capital market. We as an industry will continue to work with the SEC and the legislative and executive branches of government, to advocate for what we believe will best balance three requirements of good financial regulation: 1) providing cost-effective access to capital for small and medium-sized businesses 2) providing potential investors with protections from bad actors through both proactive education and appropriate regulation and 3) transparency to enable regulators and elected officials with the ability to provide responsible oversight and ongoing regulatory modification.

Ongoing regulatory modification is more important and more possible today than ever because of the access to real time data that will now be available via crowdfunding platforms for both accredited and unaccredited investors. This real time data can enable regulators and legislators to separate fact from guesswork in a more efficient manner than ever before. Online platforms like SeedInvest and OfferBoard are providing issuers and investors with open information and near real time data feeds and indexes from companies like Crowdnetic help to ensure effective information availability, as opposed to the private capital markets of the past where speed and transparency may have been more a wish than a reality. I hope that the SEC can use the JOBS Act, and specifically the online platforms created with Title II and Title III, will deliver better data, more rapidly and more easily to improve investor protection while delivering capital efficiently to small business. As a tech entrepreneur and also now a small business owner, I have real experience in creating products and services, raising capital and creating jobs. That is the perspective that I bring to this conversation. If the proposed regulations are implemented, there are some elements that I think are structured in ways that meet the needs of all three parties (investors, issuers and regulators). Two examples of this are:

- Robust investor education requirements on crowdfunding platforms: Every investor should understand before they invest a single dollar into a small business or entrepreneurial venture that they are inherently high risk and that it is entirely possible they will looks their entire investment. They also should gain access to educational materials that allows them to understand basic due diligence questions and learn online from experts who can provide advice for evaluating these kinds of investments.
- The opportunity to make parallel offerings (Regulation Crowdfunding offerings with other types of private offerings to accredited investors): This enables companies to raise capital from different audiences at the same time and helps companies to efficiently raise more than $1M from accredited investors, if they need to do so (in addition to a crowdfunding round to unaccredited investors).

However there are other elements that I believe must be modified so this market can reach its full potential and we will not loose our leadership position in the new economy.

- The requirements for using CPA audited financials for raises above $500,000.
    - This places an unreasonable burden on entrepreneurs and small businesses and may cause a "soft cap" on raising money above $500,000 due to the cost of capital this regulatory burden imposes. I believe that a "soft cap" that reduces the opportunity by 50% was not within the legislative intent for this act.
    - I understand the goal of this regulation: as the size of the capital raised increases, investors will want increased disclosure and validation of the state of the business. However auditing a business with zero or very little revenue is a waste of time for both the business owner and the accountant.
    - Another potential issue is that it is my understanding that to have a full audit on a corporation usually requires that the company follow accrual accounting process. Most small businesses operate on a cash accounting process. This change also adds to the cost and to the increased level of sophistication required for ongoing use of accrual accounting.
    - Additionally, if I have to spend 30% of what I raise to just comply with legal and accounting requirements, will that significantly reduce the number of legitimate businesses that will use this new funding

> vehicle? At the end of the day, we don't want to create a new way to raise capital that ends up costing business owners more than it would have cost them in credit card interest fees. We must create a better, more efficient way to raise capital for hard working Americans.

I believe it may reduce the positive impact of the JOBS Act but there is still ample opportunity to fix this issue. There must be a new way to harness technology to meet the needs of increased due diligence and transparency while not imposing the significant burden of a full audit. I have confidence that technologies are and will be created to lower the cost of these burdens, but in the meantime, I don't want for these regulations to cause a chilling effect on the industry. How can we make modifications to this regulation so that it does not damage this market before it can get started?

To quote Douglas Ellenoff, the Managing Partner of Ellenoff, Grossman and Schole, a leading securities law firm in New York City, "For the last 80 years, friends and family – those with so called "pre-existing and substantial relationships" with entrepreneurs have invested billions of dollars every year, pursuant to long established securities law exemptions in private financings, without any meaningful disclosures or procedural responsibilities. Now with Title III Crowdfunding, we have designed an online, centralized technology-based process for more efficiently and responsibly managing what has been done in the offline world before – and doing so within full sight of Federal and State Regulators – not merely person to person inconsistent solicitations in kitchens and near water coolers."

I agree with Mr. Ellenoff, and I believe that with crowdfunding, we actually will have better oversight than has ever existed in the private capital markets before.

I would like to use the rest of my testimony to deliver data-driven perspectives about crowdfunding:

1) Where is this market going and how will it develop
2) The UK case study about what does a Light-Touch Regulatory Environment do for crowdfunding: 3 years of data released November, 2013.
3) What happens to companies after they raise money with crowdfunding? New data released January 15, 2014.

Models to understand where the crowdfunding market is going and how will it develop

"The opportunity for regulators is to implement oversight of crowdfunding in a way that is data intensive and prescriptive light" (Bholat, David. 2013. The future of central bank data. Journal of Banking Regulation 14(3): 185-194). In October, 2013 during the First Global Crowdfunding Academic Symposium at University of California, Berkeley's Program on Innovation on Entrepreneurial and Social Finance attended by 100 academics from 15 countries, we were able to learn a great deal about what is going on globally in this new form of modern finance. I think it is a quote worth considering for JOBS Act regulation generally, and regulation crowdfunding in specific.

While some may suggest that the current draft regulation will kill regulation crowdfunding, I would strongly disagree. I believe that the potential of crowdfunding is not about a single company or single crowdfunding platform. It is about a radical evolution of the largely institutional framework for allocating capital (e.g. banks, funds, foundations) to a more individually driven framework that is enabled via both existing and yet-to-be-created technologies. Some of these technologies will also have broader adoption potential throughout the rest of the private capital markets. This is an evolutionary path that is similar to the ways in which other industries in the technology space that have developed over the last 15 years. Below are three examples of similar kinds of radical evolutions in other markets that were driven by innovation that created both new companies and industries.

(1) Online Advertising: Redefining largely offline activities into online activities (e.g. the shift to online advertising and the ability to measure outcomes and improve results)

(2) Social Web: Creating new and unique connections between individuals and brands (e.g. the social Web as a primary communication channel for both individuals and businesses)

(3) Cloud Computing: Transforming the way business can and should be done (e.g. cloud computing – gaining significant scalability and efficiency at radically lower costs)

This thesis also leverages the convergence of these three examples to unlock the opportunity of the JOBS Act to build a new ecosystem in early stage finance and potentially the broader private capital markets. Each of these trends has created new business models, companies and in some cases new industries.

Examples of radical evolutions that have disrupted established markets include:

- Delivery of goods and services / ecommerce: Amazon
- Moving offline tractions to online transactions: EBay
- Facilitating payments: PayPal
- Leveraging social networks to bring offline transactions online with increased scale, transparency, efficiency and with lower friction: Crowdfunding

I believe that the emergence of crowdfunding may offer a similar magnitude of opportunity.

In my opinion, crowdfund investing can be viewed as being analogous to the disruptive innovations created in the social networking, online advertising and online trading industries. Again, this is shifting offline institutional transactions into online personal transactions. Each of these industries faced initial consumer concern arising from the fear of fraud and the comfort with the status quo. Over time, however, the online advertising, online music and online trading industries developed sophisticated analytics, measurement tools, marketplaces, rating systems, provided rapid access to information, and evolved to become both sophisticated and commonplace industries of our daily lives. As shown in the e-commerce and online trading businesses, disruptive technologies can ultimately expand the market for a particular good or service.[1] In the case of e-commerce, the industry was able to achieve a 5% market penetration rate within the first 5 years.[2] When online trading was first introduced in 1991, only about 5% of the U.S. population invested in publicly traded securities. By the mid 1990's, more than 20% of the U.S. population was engaged in the investment of public securities.[3] Similar to e-commerce and online trading, crowdfund investing is disruptive. As shown in the e-commerce and online trading businesses, disruptive technologies can ultimately expand the market for a particular good or service.[4] I anticipate that crowdfund investing will likely have the same impact of expanding the market for participation of private capital in the funding of start-ups and the SME market globally.

The UK case study about what does a Light-Touch Regulatory Environment do for crowdfunding: 3 years of data released November, 2013

The creation of an ecosystem of crowdfunding is occurring globally. Outside of the United States, crowdfunding is legal and being conducted in the United Kingdom, Australia, Italy, Netherlands, Denmark and Estonia. When we look specifically at the UK, where both equity and debt based crowdfunding have been functioning for the last 3 years, we learn a great deal from their experience. The UK government

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[1] *e-business 2.0 – Roadmap for Success*, Dr. Ravi Kalakota,p.2
http://books.google.com/books?hl=en&lr=&id=fkXSp2Me0KAC&oi=fnd&pg=PR15&dq=As+shown+in+the+e-commerce+and+online+trading+businesses,+disruptive+technologies+can+ultimately+expand+the+market+for+a+particular+good+or+service&ots=4BLmzjbyis&sig=E_GpPdmupBQQrxGIaAkYL4FCs0U#v=onepage&q&f=false

[2] ibid p.4

[3] [3]http://www.stock-trading-warrior.com/History-of-Online-Stock-Trading.html

[4] See, footnote 6

has utilized a significantly "lighter touch regulatory environment" and the market has delivered very interesting results. A study released November, 2013 by The University of California, Berkeley, Cambridge University and NESTA provided an excellent map of the industry. I have provided the entire report in Appendix 2 of my testimony and I would encourage the committee members and staff to see the results of a light-touch regulatory environment for this new form of finance. I agree with Julia Groves of the UK Crowdfunding association who said that soon, crowdfinance will not be called "alternative finance" but rather "modern finance". A few key highlights from this very important study:

- More than 50 crowdfinance companies participated in the study which included every member of the UK crowdfunding association and every member of the UK peer-to-peer lending association.
- The population of the UK is approximately 61M (roughly 20% of the US population)
- The size of the crowdfinance market nearly doubled from 2012 to 2013 from GBP492 to GBP939 ($797M to $1.3B)
- There is clearly a wiliness to engage in this market from both investors/contributors and issuers/project owners
- In 2013, of the above totals,:
    - $314M were individuals lending money to businesses (211% annual growth rate)
    - $45.6M from equity crowdfunding (618% annual growth rate).

  - Equity crowdfunding surpassed rewards-based crowdfunding in 2013 (rewards total $33.4M)
- Collectively in 2013, crowdfinance in the UK contributed $541M in early stage and working capital to over 5,000 start-ups.
- The report makes "cautious predictions" that the crowdfinance market may grow to $2.6B with $1.37B going to provide funding for startups and SMEs

If we extrapolated these numbers to the US, based on our population, crowdfinance would deliver $2.7B in start-up and small business financing to approximately 25,000 businesses across the United States. That equates to 1 successfully crowdfunded company for every 12,800 in state population.

What happens to companies after they raise money with crowdfunding? New data released January 15, 2014

Now, I would like to move on to a survey just released yesterday by my firm, Crowdfund Capital Advisors, that focuses on post-funding activities and what is actually happening to companies after they complete a successful crowdfunding campaign. I believe one of the the benefits of crowdfunding has been that by sourcing money from the crowd, you can enforce structure and transparency on companies, earlier in their lives that can help them to demonstrate a market for their product or service, make potentially more informed decisions, and to help raise them above the noise to find follow-on investors.

In order to learn more about what is going on post-funding in the US, UK and Europe, we surveyed 87 companies that were successful in raising money via crowdfunding campaigns and we looked companies that had used either rewards, debt or equity crowdfunding to ask:

- Does a crowdfunding campaign have any effect on sales (outside of what is raised from the campaign)? To do so we looked at quarter on quarter sales (excluding the value of the crowdfunded round)
    - Among all companies that concluded successful rewards, equity or debt campaigns, quarterly revenues increased by an average of 24% post crowdfunding (not including amounts raised by crowdfunding).
    - Of particular note: When we filtered for equity-based campaigns, we saw a shocking increase of 351% quarterly revenue increase. The results indicate that crowdfunding positively impacts sales and those that run equity-based campaigns see the greatest quarterly increase.
    - Initial research from interviews turns out that the funders see themselves as "active investors" rather than passive investors in large, pubic companies and want to be "loyal to the brand" and "act as an extended sales force" with a "vested interest in the success" of their investment.
    - Crowdfunding acted as a marketing campaign that was able to not only raise money directly, but also raise awareness and drive additional sales.

- Did the company hire any new employees following the crowdfunding round? And if so, how many?

- From our research we uncovered the average company spent 100% of the proceeds within 90 days of the end of the campaign.
- Much of that money went to or was planned to go into hiring people to help the company accomplish the goals of the crowdfunding campaign.
- 39% of companies hired an average of 2.2 new employees per company after crowdfunding.
- An additional 48% of companies said they intended to use crowdfunding proceeds to hire new staff.

- Has there been any activity with angel investors/groups/VC's since you completed the crowdfunding campaign? The resounding answer was yes. It seems that savvy investors are using crowdfunding as a new deal flow engine.
  - Within three months of a crowdfunding campaign:
    - 28% of the companies had closed an angel investor or venture capital round.
    - An additional 43% were in discussions with institutional investors.
    - This means that a total of 71% of companies that were successful with crowdfunding were had already received or were in conversations to accept follow on investors.
  - It provided "Social Proof" to their communities, customers and other investors to demonstrate they were worthy of doing business with.

- It de-risked follow-on investment because they had demonstrated they were able to both execute and to successfully raise capital before.
- Investors (be it crowdfunders, private money or public markets) want to invest in companies that have a great story, a great product, a great business model and a great team. These were all characteristics that successful campaigns seemed to demonstrate.

- Were there any other business benefits to completing a crowdfunding round? Respondents said there were indeed benefits other than the cash:
    - Feedback on their product that they were able to incorporate prior to full-scale production.
    - Marketing advice that changed their marketing plans.
    - Investor knowledge and experience that they "would have had to pay hefty advisor fees to receive" but instead got that "in addition to a check" from their investors/contributors.
- Feedback on their product that they were able to incorporate prior to full-scale production.
- Marketing advice that changed their marketing plans.
- Investor knowledge and experience that they "would have had to pay hefty advisor fees to receive" but instead got that "in addition to a check" from their investors/contributors.

Conclusion

My thanks again to the committee for calling holding this important hearing and for its continued focus on seeing that their legislative intent was executed on the JOBS Act. Crowdfunding is delivering on its promise in the UK and other countries because it is leveraging the power of technology, appropriate regulation and the crowd to provide better access to capital for small business and new investment opportunities for their citizens. The question for the United States is: will we put ourselves on a competitive playing field or will we restrict our economic opportunities by over regulating one of the most important new opportunities for small businesses in a generation? I hope that the SEC, in consultation with the Congress and the industry can strike the right balance to help our economy move forward again.

Appendix 1:

Crowdfund Capital Advisors Report: <u>Crowdfund Investing has a Positive Impact on Company Revenue, Investor Interest and Job Creation</u>

Authors: Jason Best, Sherwood Neiss and Richard Swart

While there are dozens of articles and columns speculating whether crowdfunding works or not, the research team at Crowdfund Capital Advisors has recently completed a study of the actual impacts of crowdfunding on companies that raised money using this new form of finance.

Companies in the US, Europe and elsewhere that raised capital via rewards, equity and debt-based crowdfunding were questioned about the marketing benefits, job creation, follow-on investment and the return on investment (ROI). Key questions asked and findings from the survey include:

1. Does crowdfunding have a marketing benefit that translates into sales?
    a. Crowdfunded companies (via rewards, equity or debt) increased quarterly revenues by an average of 24% post crowdfunding (not including amounts raised by crowdfunding).
    b. Equity-based crowdfunding companies increased revenue by 351%.
2. Does crowdfunding create jobs?
    a. 39% of companies hired an average of 2.2 new employees per company after crowdfunding.
    b. An additional 48% of companies said they intended to use crowdfunding proceeds to hire new staff.
3. Does crowdfunding deter follow-on investment?

   a. Within three months of a crowdfunding campaign, 28% of the companies had closed an angel investor or venture capital round.
   b. An additional 43% were in discussions with institutional investors.
4. What was the ROI of a successful crowdfunding campaign?
   a. Every hour invested in a successful crowdfunding campaign returned $813.

Research Methodology

In August 2013, our research team surveyed several hundred companies in the North America, Europe and Africa that had completed successful rewards, debt or equity-based crowdfunding campaigns from June 2012 to June 2013. The team randomly selected companies from major platforms including Kickstarter, Indiegogo. Symbid, Crowdcube, Seedrs, WiSeed and several others. None of the campaigns were for philanthropic causes, meaning that each campaign had to be for a for-profit business to understand the impact crowdfunding has on this type of entity.

We collected data from companies headquartered in the US, Canada, France, Finland, Ireland, the Netherlands, UK, Kenya and Namibia. Each country has its own specific laws regarding crowdfunding. The companies were offered anonymity or could select to disclose their contact information. About 8% completed an online survey (n=87, complete survey replies were gathered from 73 firms). Each company was also offered the opportunity to conduct an in-depth phone interview with our researchers, and 23 of the 73 completed a 30-minute phone interview where the research team discussed their experience with crowdfunding in more detail.

It should be noted that there might be some bias in the data since companies self-selected to participate and hence these findings represent those that had a positive experience with crowdfunding.

Crowdfunding Can Provide Significant Capital in a Rational Manner

- Across all forms of crowdfunding, from rewards to equity, the average amount raised in US dollar equivalents, was $107,810 (the mean was lower, $40,300, with the average skewed by some of the larger equity raises).

- The average equity raised, in US dollar equivalents was $178,790.

- The minimum and maximum amounts raised in US dollar equivalents via debt or equity crowdfunding ranged from $15,600 to $936,000.

- Firms sold between 5% and 50% of their company for an equity round with an average of 15%.

The results show that market participants are acting in a rational manner. Issuers are not seeking more capital than they need and investors are not seeking unreasonable yields. The data also signal that debt campaigns took the place of traditional bank loans since this type of funding has slowed since the global financial crisis of 2008.

There is a Direct Benefit of a Crowdfunding Campaign When Compared to Cost

The average company invested 135 hours of staff time in their campaign, with an average of 45 days engagement. Putting this into return on hours invested, the average crowdfunding campaign returns $813 dollars for every hour invested. The average company spent just over $2,100 on the campaign itself (video, marketing, social media marketing, etc). From this sample, a successful crowdfunding campaign appears to be a very effective marketing and revenue-enhancing use of a firm's time and resources.

Companies also deploy this capital quickly. The average company spent 100% of their crowdfunding raise within 90 days of the end of the campaign. This can be attributed to the tendency of the firms to (a) spend more than anticipated on fulfillment and (b) hiring new employees soon after successfully using crowdfunding.

The most interesting statistic in the study was quarterly revenue growth—defined as quarter over quarter change. This growth was calculated net of the crowdfunding raise. We recognize that running a crowdfunding campaign is time and labor intensive, so we compared revenue figures for the quarter preceding crowdfunding to the quarter after the close of the crowdfunding campaign. The average increase in quarterly revenue across all types of crowdfunding was $12,675. This represents an average increase of 24% quarter over quarter.

While pledge or donation crowdfunding lead to an increase of 24% in revenues, equity-based crowdfunding resulted in a quarterly increase of 351%—not including funds raised via the equity round.

Crowdfunding Campaigns are Used by Smaller Entities but Represent Job Potential

The survey also considered the size of the firms:

- The most common firm using reward-based crowdfunding only had one employee—the founder.
- 15% of the firms had more than two employees, with the largest firm having 15 employees.
- The average company size for debt or equity campaign companies was 2.1 employees.

What was the impact on job creation in these companies?

- Among firms using rewards-based crowdfunding, the median number of new hires was 2.0 with a maximum of 10 new employees hired after crowdfunding success.
- 28% of firms who had had success with pledge and donation-based crowdfunding hired new employees.
- 39% of firms who had success with equity or debt-based crowdfunding hired new employees. These firms hired an average of 2.2 new employees
- In total, 87% of firms either had, or intended to, hire new employees as a direct result of having raised equity or debt financing via crowdfunding.
- The larger the firm size, the more likely the firm would reinvest crowdfunding proceedings into new employee hires.
- Firms with only one employee were extremely unlikely to hire new staff—they reinvested proceeds into product development.

This data indicate that crowdfunding may be a viable form of financing for small teams that would not qualify for institutional financing. It may allow teams to practice fundraising and leverage the proceeds to hire additional resources. It may also signal that companies using rewards campaigns might be testing market validation while equity and debt campaign companies might be looking for growth capital.

Crowdfunding Success Case Study: Microco.sm

Based in London, Microco.sm provides a portal that host's discussion forums, bulletin boards, and communities. CEO David Kitchen describes his portal as the social media platform for the introverted community, turning the notion of Facebook on its head. The company is scheduled to go live in mid-January 2014.

Building on his untraditional past, David's is a true story of "rags to riches" in the making. Years ago, David was homeless, living on the streets of London. Turning his life around, he returned to school and landed jobs programming for Merrill Lynch, the British government and Microsoft.

Microco.sm chose to use the crowdfunding platform Seeders to list its offering.

Unlike other crowdfunding platforms, Seeders acts as a holding company for a group of investors, in turn being treated as a single investor for a given business. The first campaign had a fairly high threshold— £50,000 for 10 percent equity—but was met within 15 hours. About 90 percent of the investors were users of David's prototype.

The second campaign had a threshold of £100,000 for just 5 percent equity—four times the price per share of the first offering—yet was met in a staggering 2.5 hours—again with 90+ percent of investors being users of the prototype. David believes that his ***success can be attributed to the emotional connection of investors*** who believe in him and his portal.

Soon after the first crowdfunding campaign, several angel investors and venture-capital firms approached Microco.sm. David declined their interests and decided to stay on his own for a little longer.

After the second and even more successful campaign, Microco.sm was approached by many of the A-grade venture-capital firms in the UK. Out of these many firms that approached David, only one had a concern with the number of crowdfund investors. That concern was quickly resolved when the firm realized that they would be working with only one other legal shareholder: Seeders.

David attributes crowdfunding as a key part of Microco.sm's success thus far.

Crowdfunding Is Not the Option of Last Resort but Rather the First Choice

One of the main issues in crowdfunding is whether it is a first option for firms with potential or if it is used by firms that have had failures in other capital markets.

The data on pledge and donation-based crowdfunding showed:

- 56% of firms used crowdfunding as their first choice in fundraising.

- 44% of firms had tried—and some with success—to raise funds using other methods.

Among UK and European firms who raised money on equity and debt platforms:

- 52% chose crowdfunding as their first means of fundraising.
- 48% had previously tried other forms of financing.

In this sample, the only form of financing companies had received was personal loans or credit financing—none had been able to raise money from the capital markets.

This may indicate that crowdfunding will be used by small enterprises as the first means of financing. Companies that previously did not qualify for traditional financing may be able to use a crowdfunding success as a reason to qualify for traditional financing later on.

Do Professional Investors Engage with Crowdfunded Companies for Follow-on Investment?

There is a consistent refrain that professional investors will not want to work with companies that have received crowdfunding investments. The data from this study suggest the exact opposite. Within three months of the closing of the crowdfund investing round, 28% of companies had completed a round of investment from either angel groups or venture capital firms. Another 43% reported that they were in discussions with institutional investors. Notwithstanding any limitations from the nature of the survey, this data shows that ***success with crowdfund investing leads to expression of interest from professional investors rapidly after the close of the round.***

Several other firms reported being able to secure business or personal loans on the basis of their success with crowdfund investing. Success with crowdfunding opens the door to traditional forms of investment capital—allowing many firms to establish revenues, customer acceptance and demonstrate the ability to execute—thus gaining trust from established investors. Several founders remarked that they received calls from angel groups that had not even allowed them to pitch, and were receiving term sheets from these same angel groups on the basis of their crowdfunding success. Twenty-seven percent of US-based companies that had successfully used crowdfunding on Kickstarter or Indiegogo had secured angel financing within six months of closing their crowdfunding campaign.

These findings indicate that angels and venture capital groups may look to entrepreneurs to prove their ability to execute and fundraise from the crowd prior to investing. Doing so may de-risk their investment if they can see an entrepreneur has traction from the crowd.

Crowdfunding is More than Money—Product Validation, Market Insight and Strategy

During our interviews we attempted to determine how success with crowdfunding affected business plans, strategy and operations. We used a Likert scale to collect responses from companies on the degree to which crowdfunding success had impacted their marketing plans, business plans and plans for future financing.

The most significant impact of crowdfunding was on marketing planning (mean of 5.6 on 1-10 scale). Firms reported being made aware of new market opportunities, learning which product features resonated with funders, and gaining new insights into competitive products or consumer demand. ***Many firms that had exceeded their funding goals scrapped their marketing plans and created entirely new marketing plans based on their successful crowdfunding round.***

Strategy was nearly as significantly impacted as marketing—with a mean of 4.7 on a scale of 1-to-10. There was a wide variation across firms but responses and interviews suggested that the interaction with the crowd led the founders to re-evaluate their products and go-to-market strategy.

Financing plans shifted dramatically with successful crowdfunding. Given the fact that these firms had either not attempted professional financing, or had been rejected by institutional investors, it is not surprising that many firms had not considered future funding from professional investors. Many of the firms that had raised funds from debt and equity-based platforms reported having less interest in bringing institutional investors on board—essentially an attitude that "I may be able to go it alone", or a plan to fund growth from operations.

Firms with success in pledge- and donation-based crowdfunding often expressed surprise at the degree of interest from angels or venture capital. Opinions and plans varied dramatically but two themes emerged: first, a sense of confidence—these owners believed they could raise money from private investors if they wished; and second, a sense of skepticism, that they were not as motivated to accept the first offer, that their belief in their product/service had been bolstered by their success with crowdfunding and that they felt they had more bargaining power in interactions with investors.

Success Building on Success

While a relatively small survey, this study shows that crowdfunding has significant impacts on strategy, finance, job creation and business finance, and also in how founders perceive themselves and their products. More research is underway to both validate and expand this research. Success with crowdfunding opens the door to new investors and partners, and appears to boost confidence in founders. Contrary to expectation, it also leads to interest and investment activity from angel and venture capital groups. This suggests that institutional investors see success with crowdfunding as a strong indicator of potential success for their early-stage firms.

Equity crowdfunding appears to dramatically accelerate the growth of these early-stage companies suggesting that equity crowdfunding should be considered as one of the main mechanisms for economic development and job growth policy interventions. When a relatively small investment results in several hundred percent growth in revenue and an average of nearly 2.2 new jobs, equity and debt-based crowdfunding deserves the serious attention of policy makers. For more information visit www.theccagroup.com

Appendix 2:

The UK Alternative Finance Benchmarking Report

Authors: Liam Collins, Nesta, Richard Swart, University of California, Berkeley and Crowdfund Capital Advisors, and Bryan Zhang, University of Cambridge

Executive Summary

Alternative finance activities such as crowdfunding, peer-to-peer lending and invoice trading have emerged as a significant funding mechanism and source of capital in the United Kingdom in recent years. Meeting the capital needs of both individuals and businesses, facilitating fundraising activities for civic projects and social causes, alternative finance intermediaries have become online marketplaces where individuals, rather than institutions, work collaboratively to form capital. As the alternative finance market continues to grow significantly in the UK and the government looks to regulate the area, this benchmarking report offers a timely snapshot of this fledgling and dynamic sector in order to understand its size, growth and the fluid development of respective segments. In turn, this report aims to inform regulators, brief policymakers, update industrial leaders and educate the wider public about this growing and important industry.

This benchmarking research is a joint project between Nesta, the University of Cambridge and the University of California, Berkeley. It represents the first intensive, comprehensive and empirical country-level study of an alternative finance market anywhere in the world. Primary data gathering was facilitated by a questionnaire-based survey, which was able to capture more than 95% of all UK-based alternative finance activities such as crowdfunding, peer-to-peer lending and invoice trading. Results were obtained from more than 50 alternative finance intermediaries, including almost all members of the United Kingdom Crowdfunding Association (UKCFA) and the Peer-to-Peer Finance Association (P2PFA).

Market size

This benchmarking survey reveals that the UK alternative finance market grew by 91% from £492m in 2012 to £939m in 2013. Accumulatively, the overall market had an average growth rate of 75.1% over the last three years and contributed £1.74b of personal, business and charitable financing to the British economy. While the peer-to-peer charitable fundraising and donation-based crowdfunding still represents the largest segment with £310m in 2013, the vitality and diversity of the alternative market is on full display. This includes peer-to-peer lending, which takes in nearly £287m in 2013, peer-to-business lending achieving a notable £193m, invoice trading platforms recording £97m, equity crowdfunding registering £28m, and reward-based crowdfunding attaining a further £20.5m.

Market growth

Perhaps even more impressive than their already considerable transaction volumes, their accumulative and year-on-year growth rates are high. Equity-based crowdfunding grew 618% from 2012 to 2013, peer-to-business lending grew 211% in the same period, while peer-to-peer grew 126%, reward-based crowdfunding grew 387%, invoice trading grew 167% and debt-based securities grew 170%.

SME finance and future projection

Collectively, the UK alternative finance market provided £463m worth of early-stage, growth and working capital to over 5,000 start-ups and SMEs in the UK during the period 2011-13, of which £332m was accumulated in 2013 alone. Based on the average growth rates of between 2011 and 2013, we can cautiously predict that the UK alternative finance market will grow to £1.6b next year and provide £840m worth of business finance for start-ups and SMEs in 2014.

Introduction: Research Rationale, Objectives and Methodology

The UK alternative finance market has witnessed unprecedented development, unparalleled innovation and unmatched growth in the years since the global financial crisis. As commercial banks restrict business lending and venture capital industries scale back on investment, a new brand of innovative, decentralized and potentially disruptive online financial intermediaries are burgeoning in Britain. From equity-based crowdfunding to peer-to-peer lending, from invoice trading to reward-based crowdfunding, these alternative finance providers are supplying credit to SMEs, providing early-stage investments to start-ups, stimulating regional economies and funding worthwhile causes. The UK Government has actively encouraged the growth of the alternative finance sector by direct capital investment through the Business Finance Partnership, and the Financial Conduct Authority (the FCA) is currently publicly consulting on forthcoming regulation in the area.

However, little information is presently available regarding the overall size of the alternative finance market or the growth of the crowdfunding, peer-to-peer and invoice trading transaction volumes in the UK. While there has been some industry reporting by for-profit organisations on crowdfunding, no independent, reliable and systematic academic research exists to scientifically benchmark the British alternative finance market. It is imperative, particularly at this early stage of the market development, to gather comprehensive information to brief policymakers, inform regulators and update industrial associations and other key stakeholders in alternative finance. It is in this context that UC Berkeley, which has the world's first dedicated research programme for entrepreneurial and social finance, has collaborated with Nesta and Cambridge University to collect and analyse aggregate-level data for the UK alternative finance market and produce this benchmarking report.

Research Strategy and Source of Data

To ensure the consistency, rigour and validity of this benchmarking exercise, this research collected aggregate-level market data directly from alternative finance intermediaries via a secure web-based questionnaire. Leveraging existing research relationships and industry contacts, the benchmarking survey aimed to capture over 95% of all online alternative financing activities in the UK from crowdfunding, peer-to-peer lending to invoice trading. As a country-specific study, we specifically focused on alternative finance intermediaries that are facilitating funding for UK individuals and businesses. Therefore, our survey sample consists of both British intermediaries and some of the international platforms that have significant activity in the UK. The primary data submitted by individual intermediaries were then analysed and aggregated to provide in-depth analysis in order to produce a comprehensive benchmark report. In the very few cases where primary data was not obtainable through survey, secondary data such as public information, annual reports and press releases were utilised to provide the best estimations.

As this benchmarking research is aimed at collecting aggregate-level market data, all individual alternative finance intermediaries were anonymised and all identifying information was stripped from the analytical process. Therefore, no individual or particular survey participants are identified in this final report. The questionnaire-based survey itself was securely hosted on a dedicated account accessible only to the core research team. Commercial exploitation of the data is strictly prohibited.

Research Schedule and Survey Participants

The joint Berkeley-Nesta-Cambridge UK Alternative Finance Benchmarking Survey opened on 25 November and closed on 5 December. Results were obtained from more than 50 alternative finance intermediaries, including almost all members of the United Kingdom Crowdfunding Association (UKCFA) and every member of the Peer-to-Peer Finance Association (P2PFA). Judging by the quality and breadth of the data collected, the research team is confident that more than 95% of all online alternative finance activities in the UK were captured through the benchmarking exercise.

Data Cleaning and Data Analysis

All primary data was exported into an Excel spreadsheet and all intermediary identifying and/or confidential information was stripped from the cleaned data set. Based on the preferences registered by participating intermediaries, a working taxonomy for different segments and models of the alternative finance market was constructed. As a result, donation-based crowdfunding and/or peer-to-peer fundraising are now one category. Peer-to-peer lending and peer-to-business lending are now two separate models to reflect their distinctive lending functions and mechanisms. Invoice trading is classified as a stand-alone model, whilst microfinance and community shares are merged together. The other models of alternative finance are identified as reward-based crowdfunding, revenue/profit sharing crowdfunding, equity-based crowdfunding and debt-based securities, which all have their characteristic mechanisms, dynamics, as well as risk profiles. Hybridised crowdfunding activities, which leverage more than one type of alternative finance model (e.g. reward and equity), were broken down and added separately to the above-mentioned categories.

From the aggregated data of each alternative finance model, the accumulative transaction volumes as well as average yearly growth rates were derived for the last three years. The 2013 figures were predicted by each participating intermediary based on the trading statistics to date, captured during the survey window (25 November-5 December) and the expected volumes for the reminder of the year. The total alternative finance for Small and Medium Enterprises (SMEs) in the UK were obtained by aggregating the empirical data from peer-to-business lending, equity-based crowdfunding, invoice trading, debt-based securities and estimated data (through manual and theoretical sampling) on reward-based crowdfunding. The total number of SMEs that raised alternative finance was derived by the same method, except that figures from reward crowdfunding platforms were excluded to research a conservative, but perhaps statistically more reliable estimation.

The data for the number of total ventures (including all fundraising ventures for personal finance, business finance, social causes and project-based campaigns) and for the number of active investors (including donors, backers or lenders) are gathered directly from the survey entries provided by participating intermediaries. Therefore, these figures are likely to be overestimated and inevitably involve double counting. However, as a snapshot of the UK alternative finance industry, these statistics are still valuable in highlighting the depth of the market and the breadth of people's participation in this important economic sector.

The Size and Growth of the UK Alternative Finance Market

In recent years, the UK alternative finance market has more than tripled from £309m in 2011 to £939m in 2013. Accumulatively, the alternative finance sector has delivered funding of £1.74b to UK individuals and businesses in the last three years. Discounting the donation-based crowdfunding and peer-to-peer fundraising for charitable causes, the UK alternative finance industry still contributed over £955m worth of personal and business finance to the British economy from 2011 to 2013.

In 2013, all sectors of the UK alternative finance market recorded considerable growth and rapid expansion. These market sectors are identified by their alternative finance models, which are summarised and contrasted in the table below. The figures on the right-hand column provide a useful snapshot of the latest market data for these sectors in 2013.

Donation-based crowdfunding/Peer-to-peer online fundraising	No legally binding financial obligation incurred by recipient to donor; no financial or material	**(2013)** £310m

	returns are expected by the donor	
Peer-to-peer lending	Debt-based transactions between individuals; mostly are unsecured personal loans	£287m
Peer-to-business lending	Debt-based transactions between individuals and existing businesses which are mostly SMEs	£193m
Invoice trading	Firms sell their invoices or receivables to a pool of individual or institutional investors	£97m
Equity-based crowdfunding	Sale of registered security by mostly early stage firms to investors	£28m
Reward-based crowdfunding	Donors have an expectation that recipients will provide a tangible (but non-financial) reward or product in exchange for their contribution	£20.5m
Debt securities	Lenders receive a non-collateralised debt obligation typically paid back over an	£2.7m

	extended period of time. Similar in structure to purchasing a bond, but with different rights and obligations	
Revenue/Profit sharing	Issuers incur an obligation to repay lenders, but these payments are variable and a function of the revenues or profits of the firm	£1.5m
Microfinance/Community Shares	Microfinance refers to the lending of small sums to entrepreneurs who are often economically disadvantaged and financially marginalised. There is a debt obligation incurred, but the amounts lent are very small. Community shares refer to the sale of shares in social enterprises serving a community purpose in a particular locality.	£0.8m

The Diversity of the UK Alternative Finance Market

As the diagram below illustrates, perhaps the most encouraging indicator of the UK alternative finance market is its strong and diversified growth in a wide array of models across the board during the period 2011-2013.

The **donation sector**, which consists of donation-based crowdfunding and peer-to-peer online fundraising activities, remains the largest sector in the market with £785m funding raised through it in the last three years. This more established sector has shown a relatively steady growth of about 20% year on year in contrast to some of the other more recent models.

For instance, both **peer-to-peer lending** and **peer-to-business lending** models have developed rapidly in recent years and funded £482m and £276m respectively over the last two years. This sector has significantly outperformed the interest rates available to investors with a relatively low-risk profile. The peer-to-business lending sector is more than doubling each year and the UK is the undisputable world leader of this alternative financing model. The peer-to-business lending intermediaries allow SMEs to receive loans from a pool of online investors in a very short period of time by bypassing the most complicated bank lending processes. For many firms, the speed with which they are able to obtain funding, often in a matter of days, makes this model significantly more attractive than traditional banking.[i] The default rates on peer-to-business loans are also often less than that experienced by commercial banks, demonstrating the ability of a crowd of investors to select and fund quality firms.

Invoice trading is another relatively nascent, but no less innovative, alternative finance model that is burgeoning in the UK. Invoice trading intermediaries enable SMEs to sell their invoices or receivables to many individual or institutional investors and, in turn, effectively drive down the cost of funding. This sector has raised £137m in finance for businesses in the three years from 2011 to 2013 with an annualised growth rate of 487%.

Equity-based crowdfunding grew by more than 600% between 2012 and 2013, from just under £4m in 2012 to slightly over £28m in 2013. This is consistent with the rise of equity-based activities in Western Europe and elsewhere. Data reported in the World Bank report on Crowdfunding shows that, in the past three years, some form of equity crowdfunding has emerged in 27 nations around the world. Given the rapid expansion of crowdfunding markets internationally, particularly in the USA after the recent implementation of Title II of the JOBS Act, it is expected that equity-based crowdfunding will grow significantly over the next few years, depending on the policy decisions and the evolvement of the regulatory framework in the UK. Data reported by Paul Niderer, CEO of the Australia Small Scale Offering Board (ASSOB), shows that, over the past seven years of equity crowdfunding in Australia, 83% of funded firms are still in operation, significantly outperforming comparable firms who were financed using traditional means. Whilst the Australian ASSOB market has structural differences from the UK, it is nonetheless encouraging to see high survival rates among firms raising funds through equity crowdfunding.

Rewards-based crowdfunding is also showing explosive growth, with a growth rate of more than 370% year-on-year and funding £25.6m in the last three years. This sector represents a significant area of growth potential as start-ups and SMEs, rather than just individuals, can leverage this model to conduct early marketing testing and pre-sell inventory, thus shortening product development time, demonstrating market validation and acquiring social proof. Many firms that have utilised reward crowdfunding can go on to approach institutional investors or participate in equity crowdfunding markets once they have demonstrated their capability. **Profit/revenue sharing crowdfunding** totalled £1.6m from 2011 to 2013 and is potentially a high-growth sector, particularly for gaming development, music, books and other forms of entertainment ventures.

Debt-based securities, which is an alternative finance model that offers long-term investment spanning normally 20-25 years, has also recorded an impressive accumulative growth rate of 170% in the last three years, reaching £3.7m. This investment model is often associated with renewable energy projects that offer a very low-risk-profile and make fixed-term interest payments (plus part of the principal) to investors every year. **Microfinance and community shares** financing by individuals or businesses in the UK is still a relatively niche activity. Looking forward, both have demonstrable growth potential to offer hyper-local and community-based alternative funding solutions leveraging people's social and geographical affinities.

The Vitality of the Alternative Finance Market for SMEs in the UK

There is strong evidence to suggest that the alternative finance sector is already a meaningful and effective source of funding for SMEs in the UK. In 2011, online alternative finance intermediaries provided only £26.7m worth of finance to British SMEs. By 2013, from peer-to-business lending to equity-based crowdfunding, from invoice trading to revenue/profit-sharing crowdfunding, the alternative finance market has supplied £332m to SMEs in the UK – a more than 12-fold increase in just three years. By a rather conservative estimation, without including reward crowdfunding, more than 5,000 SMEs have utilised these alternative financing mechanisms in the UK between 2011 and 2013.

On the whole, the alternative financing activities for SMEs have been growing at an average rate of 254% per year total finance raised since 2011. The number of firms participating in these markets has also been growing by an average of 139% in the same period. The difference between these growth rates demonstrates that firms have been able to raise more significant sums of money through alternative financing over time.

This significant growth in alternative finance for SMEs reflects broader national and international socio-economic trends. First, the global financial crisis forced many older adults to start companies in order to protect their retirement accounts or supplement their income. This trend of well-connected, well-networked adults starting firms in mid-life or later is a relatively new development. But, these older entrepreneurs often enjoy significant social networks, which they can leverage to finance new ventures via alternative means, an advantage recent college graduates usually lack. Data from the Global Entrepreneurship Monitor illustrates this trend and identifies a significant increase in entrepreneurial activity in the UK since 2009.[ii]

Second, in many countries, financial reforms have been instituted which, whilst stabilising banking and reducing risk profiles, also had the effect of limiting access to capital for entrepreneurs – many of whom do not have the collateral or credit scores necessary to secure bank financing. Eurostat data indicates that, in the UK, and across Europe more broadly, rejection rates for SMEs applying for loans increased significantly in the wake of the financial crisis.[iii]

Third, there are significant barriers that prevent many entrepreneurs from accessing capital based on gender, race or other non-business factors.[iv] Empirical data demonstrates that investors prefer to invest in companies that match their profiles – in terms of race, gender and socio-economic status. For example, in the United States, investors from elite venture capital firms show a strong preference to invest in companies where the founders graduated from a very small set of elite private universities – usually preferring to invest in fellow alumni. The unintended effect of this homophily is that entrepreneurs who do not enjoy access to these networks of investors based on shared characteristics are often locked out of angel investing and venture capital markets. Alternative finance can be successfully utilised by women, minorities and other financially marginalised entrepreneurs, where its funding mechanisms are often more democratic and less biased. In fact, women entrepreneurs are found to be starting firms in significant numbers on alternative finance intermediaries[v] and they are at least as effective as men at being successful in meeting crowdfunding targets.

Fourth, the widespread application of social media and web-based financial tranasctions has enabled entrepreneurs to seek funding directly and effective from their online communities and through their social relationships. Data from the Wharton Business School[vi] shows that at times 81% of investors or donors in crowdfunding are connected to the founders of the fundraising firm at the first or second degree of separation. Thus, entrepreneurs can essentially monetise their web of relationships, whether from existing customers or social media connections, to raise money directly for growth SMEs or start-ups. This monetisation of social networks could not have occurred without the ubiquitous presence of social media, coupled with the growing trust in online commerce models. The rapid growth of alternative finance for SMEs in the UK is a function of all of these socio-economic trends and an indicator of evolving forms of entrepreneurship and enterprise in the digital era.

The Power of People and the Potential of Alternative Finance

The socio-economic foundation of alternative finance is built upon financial disintermediation, direct interaction and exchange between individuals without the need for orthodox institutions. Therefore, more than purely financial transaction volumes or growth trends, the breadth and depth of individuals and communities' engagement in this sector is fundamental to the health and sustainability of the alternative finance industry.

Number of ventures funded

In 2013, over 647,000 projects, individual or business financing campaigns were fully funded through alternative finance intermediaries. In 2011 and 2012, the figures were just over 448,000 and 503,000 respectively, representing a steady, sustainable and sizable increase of 20.4% per year. Although, in actuality, these figures will tend to be smaller due to potential issues of doubt counting, they still reflect the scale and depth of a vibrant, dynamic and growing alternative finance sector.

Number of new funders

As with most social networking or social-based mechanisms, there are digital divides based on computer literacy, access to the Internet/Mobile technology, and comfort with web-based financial transactions. Despite these well-documented barriers, the UK alternative finance intermediaries have attracted and sustained more than 9.4m active donors, backers and investors on their platforms in 2013. The figures for 2011 and 2012 are 6.35m and 7.69m respectively, realizing a healthy and steady increase of 21.5% per year. Again, these figures will be overestimated in the survey, as many investors, backers and donors will likely be double counted if they contribute funds through more than one alternative finance intermediary in the UK. Nevertheless, the number of people and their level of engagement with alternative finance activities are definitely on the rise in Britain.

According to the benchmarking survey, most of these backers, investors and donors would also have participated in mostly donation and rewards-based crowdfunding and peer-to-peer fundraising activities. However, there is also now a sizable investor community for peer-to-peer, peer-to-business lending, equity-based crowdfunding and other forms of alternative financing activities. Collectively, they represent a major social movement towards an alternative paradigm of funding mechanisms, as well as a significant source of systematic disruption in the evolving financing system.

Growth looking forward

While one cannot make any specific predictions of growth rates based on the early years of a nascent industry propelled by disruptive technology, evidence from the rise of social media, e-commence, mobile technology and the rise of innovative entrepreneurship suggests that alternative finance in the UK will likely grow to be a several billion-pound-a-year market within the next 3-5 years. From the benchmarking data to date and the global growth context, it is almost certain that Britain will continue to experience substantial growth in the number of campaigns, intermediaries, individual borrowers and lenders, and also in the total capital raised to fund businesses through alternative means. Based on the average growth rates of between 2011 and 2013, we can cautiously predict that the UK alternative finance market will grow to £1.6b next year and provide £840m worth of business finance for start-ups and SMEs in 2014.

Endnotes:

[i] http://www.nesta.org.uk/sites/default/files/banking_on_each_other.pdf
[ii] http://www.gemconsortium.org/visualizations
[iii] http://www.nesta.org.uk/sites/default/files/banking_on_each_other.pdf
[iv] Ola Bengtsson and David H. Hsu, "Ethnic Matching in the U.S. Venture Capital" under 2nd round review at Journal of Business Venturing.
[v] See, e.g., GENDER DYNAMICS IN CROWDFUNDING: EVIDENCE ON ENTREPRENEURS, INVESTORS, AND DEALS FROM KICKSTARTER, Marom, Robb, Sade (2013). http://www.funginstitute.berkeley.edu/sites/default/files/Gender%20Dynamics%20in%20Crowdfunding.pdf)
[vi] The Dynamics of Crowdfunding: An Exploratory Study, Ethan R. Mollick, University of Pennsylvania - Wharton School, June 26, 2013, Journal of Business Venturing, Volume 29, Issue 1, January 2014, Pages 1–16.

WRITTEN TESTIMONY OF

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BEFORE THE
SUBCOMMITTEE ON INVESTIGATIONS, OVERSIGHT AND REGULATIONS
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

"SEC'S CROWDFUNDING PROPOSAL: WILL IT WORK FOR SMALL BUSINESSES?"

JANUARY 16, 2014

Summary: The Jumpstart Our Business Startups Act (the JOBS Act) employs a holistic approach to promote an enhanced and well-functioning capital-access pipeline for American businesses at each stage of their development. To fulfill this objective for startups and small businesses, the SEC – subject to the constraint of specific requirements set forth by Title III of the law – should foster the development of "crowd investing" by minimizing costs and constraints associated with this new capital-raising tool, while simultaneously limiting downside risk to investors through an emphasis on investor caps. This approach will allow for the evolution of this market innovation and the related opportunity to assess its central hypothesis: that in an interconnected Internet-centric world there is "wisdom in the crowd."

Chairman Schweikert, Ranking Member Clarke, and members of the committee, thank you for the opportunity to testify on implementation of Title III of the Jumpstart Our Business Startups Act (the JOBS Act) – or the "crowd investing"[1] provisions.

The ultimate goal of crowd investing is to responsibly increase capital access for startups and small businesses, particularly within industry sectors or geographic regions that are disfavored by traditional sources of capital. In proposing Title III rules, the SEC has largely used its discretion to positively advance that goal and the development of a crowd investing market,[2] especially given the novelty of this capital-raising mechanism, the constraints imposed by the law itself, and the risk investors face when investing in startup companies.

It is an open question, however, whether this new capital-raising tool will significantly increase capital formation for startups and small businesses. Investors will need to consider whether the risk/reward dynamics are sufficiently compelling, and whether other non-financial factors, such as personal interest/affinity,[3] are a sufficient draw. For issuers and intermediaries, there are concerns that Title III's statutory requirements

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[1] In order to differentiate non-financial-return "crowdfunding" (or the donation and rewards model) and the financial-return model envisioned by Title III of the JOBS Act, I will use the term "crowd investing" when referring to the capital-raising model created by the law.
[2] For example, there are numerous instances where the SEC uses its discretion to allow for greater participation by the crowd in this new market, and permits broad activities by platform intermediaries. Where there was ambiguity in interpretation of the statutory investor caps, the SEC proposed an interpretation that would allow investors to invest up to the greater cap limit suggested by the law. *See* Proposed Rule: Crowdfunding; Release No. 34-70741; File No. S7-09-13 (hereinafter "Proposal Release"), at 24; Proposed 17 CFR § 227.100. And, the SEC proposes the creation of a fairly broad safe harbor of acceptable funding portal activities in order to enhance the utility of these portals. *See id.* at 228-229; Proposed 17 CFR § 227.402.
[3] *See* Elizabeth M. Gerber, Julie S. Hui, and Pei-Yi Kuo, "Crowdfunding: Why People Are Motivated to Post and Fund Projects on Crowdfunding Platforms," Northwestern University, Creative Action Lab (2012), available at http://www.juliehui.org/wp-content/uploads/2013/04/CSCW_Crowdfunding_Final.pdf (noting that funders of crowdfunding projects seek rewards, support creators and causes with similar values, and enjoy engaging with and contributing to a creative community).

coupled with the SEC's use of its discretion to propose additional requirements, constraints, or potential liability exposure may at times result in the cost exceeding the benefit of this capital-raising tool. Additionally, in a few cases, the SEC's proposed rules may inadvertently reduce investor protection by limiting what information platforms can share with investors or how they curate offerings, and not fully reflect the crowd-vetting dynamic that makes this innovation unique.

Accordingly, I discuss below the potential impact of the proposed rules, and offer implementation suggestions that emphasize investor caps in order to limit downside risk, while decreasing overall regulatory costs and burdens in order to permit the marketplace time and space to develop new methods of vetting investment opportunities.

Key Regulatory Objectives

In proposing rules implementing Title III of the JOBS Act, the SEC makes two critical observations which inform my testimony: first, "[t]he crowdfunding provisions of the JOBS Act were designed to help provide startups and small businesses with capital by making relatively low dollar offerings of securities *less costly*"; and second, "[i]ndividuals interested in the crowdfunding campaign – members of the 'crowd' – may share information about the project, cause, idea or business with each other and use the information to decide whether or not to fund the campaign based on the collective 'wisdom of the crowd.'"[4]

Two principles emerge from the SEC's observations that should guide implementation of Title III. The first principle is the need to ensure that legal and regulatory compliance costs are properly calibrated relative to the sums being raised. If the overall costs to crowd-investing issuers and intermediaries are too great relative to the fundraising limit of $1 million (and the likely lower amounts many issuers will seek to raise), then crowd investing will not be an economically viable capital-raising mechanism.

Related to the issue of economic viability, it is important to view the various capital-raising tools in the JOBS Act holistically to ensure that each helps to foster a seamless capital access pipeline for a business along its various stages of development. The law appears to intend that a startup or small business might utilize Title III for a relatively small capital raise, and then graduate to a Title IV (Regulation A+) raise at a later stage of development. For this to happen, however, the costs and benefits of each capital-raising mechanism must be calibrated along a sliding scale, with the Title III requirements less onerous relative to Title IV in order to render crowd investing an attractive option for startups and small businesses.

The second principle begins to capture the essence of what makes the crowd-investing innovation unique: namely the use of the Internet to connect individuals with each other and online sources of information in order to perform a novel form of due diligence on securities issuers. As the SEC notes, the communication channels afforded by the Internet (and proposed to be required on investment platforms) "should provide transparency and accountability, and thereby further the protection of investors."[5] This tenant of the crowd investing innovation differentiates it from traditional investment approaches, and this entire ecosystem requires space to develop new modes of vetting investment opportunities.

Observations and Recommendations

The following are observations regarding the potential impact of certain proposed rules, as well as recommendations drawn from the principles discussed above that would arguably promote the development of crowd investing for startups and small businesses, while limiting the downside risk to investors.

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[4] Proposal Release at 6-7 (italics added). *See also id.* at 176-179.
[5] *Id.* at 177.

A. *The Best Way to Limit Downside Risk is Through an Emphasis on Investor Caps.*

Investing in startups and small businesses is an inherently risky enterprise. The SEC in its proposing release highlights a number of sobering studies, including one from the Kauffman Foundation in 2010 that found that out of 4,022 hi-tech startups founded in 2004, nearly one-third had failed by 2008.[6] Research also finds that venture-capital-backed companies may not fare much better, despite the involvement of professional investors.[7]

The reason for relatively high failure rates amongst startups and small businesses should be obvious to investors: whether it be untested management teams or products, unexpected competition, or simply bad luck, there are numerous obstacles that must be overcome by a company to ensure success. The volatility, uncertainty, and unpredictability of early-stage companies lead many professional investors to focus on the promise of business concepts and ideas, as well as the capability of a management team, while potentially de-emphasizing the importance of revenue projections. Indeed, two well-known venture capital investors note that "[t]he only thing that we know about financial predictions of startups is that 100 percent of them are wrong."[8]

Given the inherent riskiness of startup or small-business investing, the best way to limit downside risk to investors is through an admittedly paternalistic emphasis on investor caps – at least until the crowdfunding innovation has a chance to develop and demonstrate its ability to, on a relative basis, effectively vet investment opportunities. I am cautiously optimistic that crowd investing will demonstrate this ability based on results from overseas where crowd investing is already 'live,' and a discerning crowd has backed a relatively limited number of offerings largely from known management teams with known products and businesses.[9]

With respect to investor caps, the current proposed SEC rules envision an investor self-certification mechanism whereby issuers will be able to rely on the affirmative representations of the investors. This approach properly imposes responsibility for compliance on the investors, but should include requirements on the intermediary platforms to flag for investors the importance of compliance. More specifically, investors must be made aware that compliance with the investor cap is not optional (or simply a requirement that can be ignored), but is both required by law and intended to protect them from the potential downside risk of early-stage investing. To this end, intermediaries should be required to provide a detailed statement regarding the parameters and importance of the investor caps to investors before accepting an investment commitment. Additionally, the SEC should consider precluding an investor who violates the investor caps from bringing a cause of action against an issuer under Section 4A(c).[10]

Ultimately, emphasizing compliance (and penalizing non-compliance) with investor caps is the best way to limit downside risk. As discussed in the next section, once the downside risk is capped, rather than requiring

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[6] *Id.* at 334 (citing Alicia Robb, E.J. Reedy, Janice Ballou, David DesRoches, Frank Potter and Zhanyun Zhao, An Overview of the Kauffman Firm Survey: Results from the 2004-2008 Data, Kauffman Foundation, available at http://www.kauffman.org/uploadedFiles/kfs_2010_report.pdf).

[7] *Id.* at 334-35. Indeed, because early-stage investing is so risky, most professional investors pursue a fund approach whereby they invest in a large universe of companies with the expectation that many will fail and the hope that the few successes will more than compensate for those failures. For this reason, I would encourage lawmakers and regulators to consider ways to facilitate retail investor participation in funds that invest in startup companies.

[8] Brad Feld and Jason Mendelson, Venture Deals: Be Smarter Than Your Lawyer and Venture Capitalist 21(2d ed. 2013).

[9] *See* Art Patnaude, *'Crowdfunding' Takes Hold in the U.K.*, Wall St. J., Mar. 27, 2013, available at http://online.wsj.com/news/articles/SB10001424127887324789504578384572203305456 (detailing the crowdfunding success of an existing UK food company that raised funds through Crowdcube when it already had products available in store); *see also* JD Alois, "*Top Ten Equity Crowdfunding Offerings on Crowdcube*, Crowdfundinsider.com, Aug. 8, 2013, available at http://www.crowdfundinsider.com/2013/08/20248-top-ten-equity-crowdfunding-offerings-on-equity-crowdfunding-site-crowdcube/ (demonstrating that a number of the largest equity raises on the UK platform Crowdcube have been by existing companies, which increases the chance for investors to develop familiarity with the management team, products, or services before choosing to invest).

[10] Though perhaps not necessary, other ways to emphasize or strengthen enforcement of the caps include requiring investor certification under penalty of perjury. Alternatively, the SEC could incentivize platforms to limit permitted investment totals per individual below the statutory cap or create a shared industry central database with investor investment data, by linking such practice with a safe harbor that exempts a platform from liability for an issuer's misstatement or omission of a material fact (absent gross negligence).

additional traditional disclosures that will add cost with potentially little marginal benefit to investor protection, the SEC should focus on promoting the development of crowd-driven methods of vetting investment offerings.

B. *The SEC Should Minimize Non-Statutory Disclosure Requirements in Order to Decrease Costs and Allow the Development of Crowd-Driven Vetting Mechanisms and Criteria.*

Title III includes a number of statutory issuer disclosure requirements that reflect a minimized version of traditional Regulation A or public offering registration statements. There is little doubt that certain baseline issuer disclosures are necessary for investors to make sound investment decisions, and that well-prepared disclosures may provide a signal to the crowd about the competence and credibility of an issuer and its management team. The difficulty is in determining the right balance of required disclosures that materially assist investors but that do not add undue cost and burden to issuers.

As highlighted in the second principle above, it is likely that crowd-investors will determine new criteria and methods for vetting offerings, and it is unclear how much they will rely on traditional, and oftentimes boilerplate, disclosures. The SEC properly expects that the crowd will use communication channels on platforms to share thoughts about an offering and ask specific questions of the issuer. I would also expect that the crowd will use tools outside of investment platforms, including social-networking sites and company websites to learn more about an issuer's management team and business, or choose to invest in companies in which the investor has familiarity. As we have seen from overseas examples, the maxim "invest in what you know" is likely to guide many crowd-investors.

With respect to the SEC proposed rules, there are a number of additional proposed disclosures that go beyond those required by statute.[11] While each one – in and of itself – appears reasonable and intended to provide investors with more information, there are two potential unintended effects. The first is that in aggregate, together with the statutory disclosure requirements, and a substantial ongoing annual filing requirement regardless of the size of the offering, the overall disclosure and compliance burden for issuers begins to look significant, especially in light of the relatively small sums of capital that can be raised under Title III.[12] This burden violates our first principle above and could appreciably limit the participation of issuers seeking small sums of money (for example, less than $100,000).[13] Given the potentially small marginal benefit to investors of requiring startup issuers to provide traditional disclosures required of more mature companies, the additional costs of more disclosure (and significant ongoing reporting) may not be justified.

A second concern is that too many requirements will inadvertently give unsophisticated investors an artificial sense of comfort with an offering (especially given the likelihood that the plans of an early-stage issuer will change or that projections will prove wrong), and may blunt the development of crowd-driven investment methods and criteria. Unlike a Reg A filing or a formal public offering registration, Form C will not be reviewed and approved by the SEC, and accordingly should not give investors a false sense that the offering is

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[11] *See* Proposal Release at 58-65; Proposed 17 CFR § 227.201.

[12] *See* Gibson Dunn Client Memorandum, *SEC Proposes Rules To Implement Crowdfunding Exemption: What Factors Will Affect Its Success?*, Nov. 11, 2013, at 4, available at http://www.gibsondunn.com/publications/pages/SEC-Proposes-Rules-to-Implement-Crowdfunding-Exemption-What-Factors-Will-Affect-Its-Success.aspx (noting that while the SEC's proposed additional disclosures "may be advisable for the protection of investors, they meaningfully increase the disclosure burden on crowdfunding issuers"); Davis Polk Client Memorandum, *SEC Proposes Rules for Crowdfunding Intermediaries*, Nov. 18, 2013, at 1, available at http://www.davispolk.com/sites/default/files/11.18.13.SEC_.Proposes.Rules_.Crowdfunding.Intermediaries.pdf ("While the crowdfunding exemption under the JOBS Act was intended to make it less costly for small businesses to raise relatively small amounts of capital, the statutory requirements and Proposed SEC Rules would condition the Securities Act exemption on compliance by issuers and intermediaries with a significant number of potentially costly regulatory obligations . . . [leading some to question] whether the benefits of raising capital through crowdfunding or acting as a crowdfunding intermediary would be great enough to justify the compliance costs and potential liability risks.").

[13] The investment platform SeedInvest has created a useful spreadsheet tool that can be used to project/estimate the anticipated cost to an issuer of a Title III capital raise over a period of time. *See* http://www.seedinvest.com/blog/crowdsourcing-title-iii-crowdfunding-cost-model/. The assumptions can be changed within the spreadsheet, but even applying conservative numbers demonstrates high costs to issuers with questionable benefit to investor protection. Given potentially significant costs, even issuers at the higher end of the Title III range may be incentivized to postpone an offering until a Reg A or Reg A+ offering makes economic sense given the larger caps on a raise and unrestricted nature of issued securities.

somehow less risky or not in need of careful vetting. Moreover, the burden may simply be too great on this ecosystem if issuers must comply with significant disclosure requirements, and then begin responding to crowd-based questions and demands.

Ultimately, the success of crowd investing hinges on the effectiveness of new vetting methodologies and criteria generated through the "wisdom of the crowd." Much like financial innovators are looking at new Internet-based methods of assessing an individual's credit-worthiness beyond traditional FICO scores,[14] the same can be said for crowd-investors looking at Title III investment opportunities. Beyond baseline disclosures as required by Title III, it is not clear that traditional SEC disclosure requirements will do much to assist the development of new vetting criteria and methodologies. Accordingly, overall costs would be reduced and the space for market development increased if the SEC errs on the side of requiring few, if any, incremental disclosures beyond those required by law.

C. *Investor Protection Will Be Enhanced by Enumerating Additional 'Investment Advice' Safe Harbors That Allow Platforms to Further Curate and Share Data and Information with Investors.*

It is understandable and prudent that lawmakers do not want investors relying on an intermediary's investment advice or recommendations related to offerings available on that platform absent the intermediary being registered as an investment adviser or broker/dealer. The issue with implementing this statutory requirement is that neither the JOBS Act nor federal securities law define "investment advice," which is typically construed broadly by regulators.[15] At its extreme, this ban could require a platform to list all offerings proposed by issuers.

In order to permit platforms some flexibility to decide which offerings they will list, the SEC proposes a safe harbor that would permit a platform to filter and select offerings for listing based on objective criteria (for example, by geographic region or industry sector).[16] It also recognizes that an overly broad interpretation of the investment advice/recommendation ban could -- to the detriment of investor protection -- prevent funding portals from excluding highly suspicious investment offerings. As a result, the SEC interprets the duty of a platform to exclude offerings that could be fraudulent or that raise investor protection fears broadly.

While this approach is a step in the right direction, the rules nevertheless leave an ambiguous gap where a platform could have serious doubts about the viability of an offering, but not to the level that it is permitted to exclude the offering from its platform. Additionally, as proposed, the SEC's rules may prevent platforms from sharing data and information with investors that would assist the development of crowd-based vetting methods. Accordingly, the SEC should create the following additional safe harbors or issue guidance enabling the following activities.

First, the SEC should permit funding portals wider leeway in excluding offerings when an offering technically satisfies objective platform criteria and cannot be said specifically to raise concerns of fraud or investor protection. It is troubling that the proposals note that "a funding portal may not use criteria based on an assessment of the merits or the shortcomings of a particular issuer or offering,"[17] especially when, as discussed below, the SEC goes on to envision potential intermediary liability for issuer missteps.

To require a platform to list an offering that it has a strong conviction will fail is contrary to promoting investor protection. Instead, portals should have the ability to go further in curating offerings so long as they do not advertise or make statements that offerings listed on their platform are somehow safer or better than other platforms. If the market determines based on results that certain platforms are indeed yielding better investment outcomes, then I see little (if any) harm and only benefit to investors.

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[14] *See* Katie Lobosco, *Facebook friends could change your credit score*, CNNMoney, Aug. 27, 2013, available at http://money.cnn.com/2013/08/26/technology/social/facebook-credit-score/.
[15] *See* Proposal Release at 227 n. 585; Proposed 17 CFR § 227.402.
[16] *See* Proposal Release at 229-231; Proposed 17 CFR § 227.402.
[17] *See* Proposal Release at 231; Proposed 17 CFR § 227.301 and 17 CFR § 227.402.

Second, as we have seen with the development of e-commerce platforms, such as eBay and Amazon, there is significant opportunity for intermediaries to glean and analyze data about offerings on the platform, develop algorithms to detect fraud or issuer best practices, and collect user feedback about transactions. Applied to funding portals, these capabilities could enable a platform to share with investors data on crowd investing raises and outcomes, information learned about an issuer, or even a crowd-based rating system of specific entrepreneurs/issuers. Without further guidance from the SEC, however, there is a risk that such information-sharing might be deemed the provision of impermissible investment advice.

Finally, the SEC does imply in the proposed rules that a partnership between a registered broker/dealer and funding portal could allow a funding portal to go further in providing information to investors.[18] However, the parameters of what is allowable here are unclear. For example, the SEC should explicitly state that a funding portal is allowed to provide offering ratings from a third-party broker/dealer or credit rating agency on the portal website. In this way investors would be provided with important information -- for example, a credit rating on a debt security.

D. *Allowing for Reduced Platform Liability Exposure Will Promote Participation and Decrease Systemic Costs.*

While the statute is silent on intermediary liability for potential issuer missteps, the SEC reads the law to include for liability purposes an intermediary as "any person who offers or sells the security in such offering."[19] This interpretation would likely decrease the number of intermediaries willing to participate in this marketplace, as well as increase overall systemic costs due to the risk of litigation.

As a preliminary matter, it is difficult to reconcile permitting an intermediary to be found liable for an issuer misstatement or omission, and not permitting an intermediary to exclude an offering "based on an assessment of the merits or the shortcomings" of the offering or its issuer. If intermediaries can be on the hook for the missteps of an issuer, then the intermediary should have greater discretion to decide on whether to do business with that issuer.

Given the statutory silence on intermediary liability and the proposed rules limiting curation, it would make for sound policy to explicitly exclude intermediaries as being potentially liable for the material misstatements or omissions of an issuer, except for instances where the intermediary is grossly negligent. To impose potential liability on an intermediary would require increased due diligence into issuers, which would be costly and inexact given the early-stage and risky nature of these offerings. Intermediaries would need to pass along the cost of such due diligence to issuers, as well as purchase higher levels of insurance. Because the economic viability of the funding portal model is already unknown, additional costs on platforms could have a detrimental impact on platform participation.

Accordingly, the SEC should reconsider its position on intermediary liability for an issuer misstatement or omission. As noted above,[20] the SEC could incentivize preferred platform behavior (for example, creating a centralized investor database with other platforms) by linking a limitation of liability on platforms with such voluntary behavior.

[18] *See* Proposal Release at 238; Proposed 17 CFR § 227.402.
[19] *See* Proposal Release at 280.
[20] *See supra* note 10.

Testimony of Mercer E. Bullard

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before the

Subcommittee on Investigations, Oversight and Regulations

Committee on Small Business

United States House of Representatives

on

SEC's Crowdfunding Proposal:

Will it Work for Small Businesses?

January 16, 2014

Chairman Schweikert, Ranking Member Clarke and members of the Committee, thank you for the opportunity to appear before you today to discuss the SEC's rulemaking on crowdfunding. It is an honor and a privilege to appear before the Committee today.*

I am the Founder and President of Fund Democracy, a nonprofit investor advocacy group, and a MDLA Distinguished Lecturer, Associate Professor of Law and Director of the Business Law Institute at the University of Mississippi School of Law. I am also a Vice President of the financial planning firm, Plancorp LLC; a member of the PCAOB's Investor Advisory Group; and an Accredited Investment Fiduciary. I was formerly a member of the SEC's Investor Advisory Committee and chaired its Investor as Purchaser Subcommittee; an Assistant Chief Counsel in the SEC's Division of Investment Management; and an attorney in the securities practice of Wilmer, Cutler & Pickering (now WilmerHale).

This testimony is based on my general experience over a number of years as an investor advocate, journalist, academic, regulator, financial planner, private practitioner and expert witness and consultant. I have been engaged in securities regulation issues from a variety of perspectives and attempt to provide testimony that reflects the interests of investors, diverse views of various constituents, and the practical exigencies of real-world legal practice and compliance.

I. Introduction

This is the second occasion on which I have testified on crowdfunding. On the first occasion in 2012, a bill had not gotten out of Committee. Two years later, implementing rules have been proposed. Some have complained about how much time this rulemaking has taken, but it is extraordinary how quickly the crowdfunding concept has taken on concrete form. On the whole, the Commission and its staff should be applauded for their hard work on this rulemaking.

*I would like to thank University of Mississippi law student Justin Bouchard for his assistance in preparing this testimony.

The title of this hearing poses the question: SEC's Crowdfunding Proposal: Will it Work for Small Businesses? I am afraid that the answer is probably "no." However, the question is somewhat unfair. Much of what is normally left to agency rulemaking has been set in stone by the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 ("Crowdfund Act" or "Act"). The Act is as extraordinary in its level of detail as it is extraordinary in the speed of its evolution. It specifically imposes numerous disclosure requirements that permit no leeway in their application. The Commission has very little wiggle room to make the Act work better for small businesses.

However, in many respects the Commission has asserted authority to change the law where no such authority exists. There are many instances in which the Commission proposes something different from the very specific requirements of the Act. In some cases, the Commission asserts the authority to dilute investor protections, in other cases to impose additional burdens on small businesses, and in each case its approach would contravene specific directions from Congress. For example, the Commission is considering requiring CEO-certified financials for issuers with more than $100,000 in crowdfunding offerings,[1] whereas Congress specifically directed that this requirement apply only to issuers that have raised $100,000 or less.[2] The Commission is considering lowering the $2,000 minimum for investors with very low income and net worth,[3] but it does not have the authority to amend the $2,000 minimum chosen by Congress.

To illustrate the same over-reaching with respect to specific investor protections prescribed by Congress, the Commission is considering eliminating investment limits for accredited and institutional investors.[4] This might be good policy, but it is flatly inconsistent with the Act's purpose of permitting greater access to investment

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[1] Proposing Release at 83.

[2] Securities Act § 4A(b)(1)(D)(i)(II).

[3] Proposing Release at 29.

[4] *Id.* at 28 – 29.

opportunities for small investors, not to mention the very specific dollar amounts set forth in the Act.

There is no authority in the Act for the Commission to supplant Congress's judgment with the SEC's own. The provisions of the Act reflect a reasoned compromise among members of Congress. Members voted for or against the Act based on its specific terms, but they might have voted differently on the amendments being considered by the Commission. Thus, one general concern regarding the SEC's rulemaking is that often it does not respect the limits of its authority and upsets the compromise negotiated by the legislative branch.

Another concern is that the Commission ignores the dark side of crowd behavior, choosing instead only to laud its strengths and virtues. The Commission praises the potential to tap the "wisdom of the crowd," but does not acknowledge, much less discuss, the negative behavior that is often associated with crowds. As the Commission knows, crowds are often destructive, particularly with respect to markets.

In fact, the most-cited work on destructive crowd dynamics in markets is entitled: Extraordinary Popular Delusions and the ***Madness*** of Crowds. The book discusses, among other things, the crowd dynamics underlying the Dutch tulip mania, Mississippi Company bubble, and South Sea Company bubble. If its author, Charles MacKay, were alive today, he would most certainly be writing about the behavior of the crowd during the recent Internet and subprime bubbles. When thinking of crowd dynamics, Citigroup CEO Chuck Prince's widely quoted comment made in 2007 seems apropos: "As long as the music is playing, you've got to get up and dance." Will investors actually discuss hot crowdfunding offerings and think about them before investing? Or will they simply "get up and dance"?

This is not to say that the promise of crowdfunding is a false one. Rather, it is to say that the Commission should approach rulemaking with its eyes open to the potential downside of crowd dynamics, especially in a market where the data show that one-third to one-half of investments are likely to become worthless. Instead, the Commission seems to see crowdfunding through rose-colored glasses. It rarely discusses how things might go wrong, so one wonders whether its rulemaking adequately reflects that possibility. Crowdfunding will not work for small businesses if a minority of crowdfunding issuers are allowed to give it a bad reputation.

The remainder of this testimony discusses specific aspects of the SEC's proposed rules. One aspect that should be of particular concern to small businesses is the SEC's position that the aggregate, 12-month $1 million limit on offerings applies only to crowdfunding offerings (as discussed in Part III at page 14). The SEC's position not only contravenes the plain meaning of the Act, it also risks allowing large- and medium-size companies to enter the crowdfunding market and squeeze out the startups and small businesses for which it was created.

The SEC's interpretation would permit, for example, a large issuer to sell $1 billion in securities, then sell $1 million in crowdfunding securities, and then sell another $1 billion in securities, because the Commission would subject only the crowdfunding securities to the $1 million limit. Crowdfunding will not work for small businesses if it becomes a market for all businesses, regardless of size. Members of Congress who voted for the Act did so on the assumption that it was intended to help small businesses and not to create a social media opportunity for medium- and large-size businesses. Congress ensured that the crowdfunding market would be a market for small businesses precisely by limiting ***total*** securities offerings within any 12-month period to $1 million. The Commission has proposed to repeal this requirement, which will allow businesses of unlimited size to fill out the crowdfunding space, notwithstanding that they have no difficulty raising capital. The crowd will not be the investors, it will be the issuers, and as always is the case, the large will crowd out the small, just as the large currently crowd out the small in the securities offering space at large. Congress did not write the Act to allow large businesses to capture a marketplace that was designed for small businesses. The Commission may hear from crowdfunding intermediaries that amending the $1 million limit would improve crowding, but that it because they naturally prefer the largest possible crowdfunding market, which would generate the largest revenue. The Committee should listen closely to small business's thoughts on their becoming incidental players in a market that Congress created for them.

Other concerns go to the kind of reputation that crowdfunding is likely to develop under the SEC's rules. Various proposals would allow crowdfunding issuers to use stale financial statements, intermediaries to accept investment from ineligible investors, and issuers to engage in public advertising under the guise of a concurrent private offering. Each of these proposals will degrade the quality of the crowdfunding marketplace. They will also create an unfair advantage for less scrupulous issuers over small businesses that play by the rules.

The overriding issue for crowdfunding is likely to be how the narrative of investors frequently losing their entire investment plays out. If investors are perceived as losing only a small part of their portfolios because of business failures rather than fraud, or if their crowdfunding losses are set off by gains in other investments through diversification, the crowdfunding market could weather large losses and thrive. However, if fraudsters are easily able to scam investors under the cover of a crowdfunding offering, or stale financial statements routinely turn out to have hidden more recent, undisclosed financial declines, or there are investors who can't afford the losses they incur, resulting in stories of personal financial distress – then crowdfunding markets will never become a credible tool for raising capital.

The remainder of this testimony highlights some, but by no means all of the SEC's specific proposals. I expect to submit a complete comment letter on the proposals, which I hope the Committee will consider in its oversight of this rulemaking. The sections of the remainder of this testimony are paginated as follows:

II. Integration with Other Offerings

The problem of "integration" arises because concurrent offerings under different exemptions can allow an issuer to engage in permitted activities under one exemption that are not permitted under the other.[5] For example, one exemption might permit public advertising and allow sales only to accredited investors, while another prohibits public advertising but allows sales to any investor. Without integration rules, public advertising in the first offering could be used, in effect, to engage in indirect, illegal advertising of the second. In other words, by publicly advertising under the first exemption, the issuer would be able to reach potential nonaccredited investors where the issuer was prohibited from using public advertising to reach them. Unfortunately, the foregoing problem is exactly what the Commission would permit with respect to crowdfunding offerings.

Crowdfunding offerings are subject to strict limits on advertising. The Act provides that issuers may "not advertise the terms of the offering, except for notices which direct

[5] In the SEC's words: "The integration doctrine seeks to prevent an issuer from improperly avoiding registration by artificially dividing a single offering into multiple offerings such that Securities Act exemptions would apply to multiple offerings that would not be available for the combined offering." Proposing Release at note 27.

investors to the funding portal or broker."[6] Even within the context of communications on the website for an offering, that is, "communication channels provided by the intermediary on the intermediary's platform,"[7] issuers may not compensate any person for promoting an offering unless the receipt of the compensation is disclosed "upon each instance of such promotional communication."

The restrictions are necessary because, unlike private offerings in which public advertising is permitted,[8] issuers may sell crowdfunded securities to anyone. Congress believed that, if a desperate investor with no income and $2,000 in savings was to be permitted to invest their last penny in crowdfunded securities, then issuers should not be allowed to lure them by running ads in public media. Public advertisements using exaggerated pitches -- "LAST CHANCE," "SALE ENDS SOON," "EVERYTHING MUST GO" – may be allowable in the marketplace at large, but America's century-long dominance of the world's securities markets is substantially attributable to prohibitions against this kind of misleading sales practices.[9] Nothing is more likely to expose the madness of crowds than permitting public advertising to infiltrate the crowdfunding space.

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[6] Securities Act § 4A(b)(2). The phrase "*terms of the offering* means the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period." Proposed Rule 204.

[7] Proposed Rule 204(c).

[8] Although the "private" offering exemption was intended to limit public communications, the JOBS Act required that the Commission permit public advertising in "private" offerings.

[9] The kind of public advertising that has begun to emerge in the wake of rules permitting such advertising in private offerings illustrates what unrestrained crowdfunding advertising might look like. For example, a slide deck for a private offering by a fund that invests in Bitcoins includes a chart ("Bitcoin Upside") that shows the value of bitcoins rising to equal the value of 5 percent of the world's gold supply ($340 billion). *See* Investor Presentation, Bitcoin Investment Trust (Jan. 2014) available at http://www.bitcointrust.co/. *See also* Gail Liberman, Palm Beach Discussion Group Invests in Single Bitcoin (Jan. 12, 2014) (after initially approving investments in the Bitcoin Investment Trust in self-directed IRAs, Fidelity reversed its position). In the Act, Congress decided to limit crowdfunding issuers to making this type of claim only on crowdfunding platforms and their disclosure documents.

Nonetheless, the Commission would allow issuers to make exaggerated claims in public advertisements during a crowdfunding offering. Issuers need only conduct their public advertising campaign under cover of a concurrent "private" offering. Crowdfunding issuers would be able to say anything, subject only to general antifraud rules, about the issuer's prospects in precisely the public context that Congress specifically proscribed for crowdfunding. Integration rules are designed to prevent precisely this method of circumventing the requirements of offering exemptions. Integration rules also provide clarity to issuers and intermediaries that have legitimate reasons for raising funds under different exemptions but are concerned that permitted activities under exemption might be viewed as violating another exemption under which they are not permitted. Clear rules save money while providing the foundation for a reputable, albeit risky market.

Integration problems are addressed in a variety of ways under the securities laws. For example, when issuers raise funds through public and private offerings, and the private offering does not opt to engage in public advertising,[10] the public registration statement could be viewed as a form of public advertising. Conversely, private communications made pursuant to the private offering could be viewed as offers that violate investor communication rules governing the public offering. The Commission has adopted a safe harbor that generally provides that a private offering that ceases at least 30 days before a registration statement is filed in a public offering will not be considered part of (be integrated with) the public offering. A public offering that is withdrawn at least 30 days before a private offering commences will not be considered part of the private offering.

The integration safe harbor is nonexclusive; concurrent offerings will not necessarily be integrated. For example, the Commission has taken the position that a non-advertised private offering could be undertaken concurrently with a public offering if the issuer could

[10] As noted in footnote, the JOBS Act permitted public advertising in private offerings if securities are sold only to accredited investors. Issuers can still conduct private offerings and opt not to engage in public advertising subject to slightly different rules. *See* Securities Act § 4(a)(2).

demonstrate that the investors in the private offering were reached by means other than the registration statement.[11]

It is worth noting here that concerns regarding a registration statement serving as a form of illegal public advertising are not nearly as great as when public advertising occurs in connection with a private offering. The content of registration statements and other permissible public communications in public offerings are severely constrained, and these communications often would be impracticable for a billboard or advertisement in a newspaper, magazine or similar public media. The advertising concern is also mitigated by the fact that only accredited (presumably more sophisticated) investors can invest in a private offering, and they are less likely to be misled by publicly available information. Indeed, this is precisely the argument for the JOBS Act's recent elimination of the blanket prohibition on public advertising of private offerings -- that sophisticated investors can fend for themselves.

In contrast, the problem of public advertising in private offerings being used to communicate with potential crowdfunding investors is heightened. Anyone can invest in a crowdfunding offering, regardless of their income or net worth. The potential for investor losses is greater with start-ups than for any other category of businesses, and low- or no-income and low- or no-net-worth investors are those who are least able to bear losses. These factors argue for ***greater*** integration restrictions that ensure that crowdfunding rules are not circumvented through the use of concurrent offerings under other exemptions. In addition, the ability of a business to raise capital through a private offering generally is not the kind business for which crowdfunding was intended; crowdfunding was intended to enable access to capital when not otherwise practicable, *i.e.*, to close the "funding gap."[12]

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[11] *See* Revisions of Limited Offering Exemptions in Regulation D, Part II.C (Aug. 3, 2007).

[12] Proposing Release at 17 (crowdfunding is intended to promote "the goal of alleviating the funding gap faced by startups and small businesses"). In fact, recent data published by the Commission itself shows that the claim that crowdfunding is needed because small amounts of capital cannot be efficiently raised under private offering rules is patently false. *See infra*

Where the Commission should be ***most*** concerned about fraudulent securities offerings, it has chosen the ***least*** protective approach. Despite the greater fraud risk in concurrent private and crowdfunding offerings than in concurrent private and public offerings, and the greater investor harm that fraud in the crowdfunding will impose, the Commission has proposed to impose a ***less*** restrictive standard for the former. In fact, it is not just a less restrictive standard; the Commission has proposed that no integration restrictions apply whatsoever. The only limitation that the Commission proposes to apply is that any "concurrent exempt offering for which general solicitation is permitted could not include an advertisement of the terms of an offering made in reliance on Section 4(a)(6) that would not be permitted under Section 4(a)(6) and the proposed rules."[13] This "restriction" would provide no impediment to publicly advertising a crowdfunding offering under cover of a private offering.

With respect to restrictions on crowdfunding advertising, the Commission states that:

> [l]imiting the advertising of the terms of the offering to the information permitted in the notice is intended to direct investors to the intermediary's platform and to make investment decisions with access to the disclosures necessary for them to make informed investment decisions.[14]

Permitting public advertising in concurrent offerings directly contradicts this position. Public advertising of other offerings will encourage investors to make crowdfunding investment decisions based on information that is ***not*** on the intermediary's platform. This public information will be more accessible than information on the intermediary's platform and may be more likely to be relied on that information on the intermediary's platform. Crowdfunding issuers will have an inventive to engage in concurrent private offerings precisely to enable them to reach a wider audience. This is exactly what Congress intended

note 17. The JOBS Act's elimination of the ban on public advertising in private offerings will make private offerings even more amenable to small issuances.

[13] Proposing Release at 19.

[14] *Id.* at 109.

to prevent by restricting advertising to the intermediary's platform. And this is precisely what the Commission would permit by imposing no integration restrictions on such public advertising.

The Commission interprets the following provision in the Act (the "Integration Proviso") to prevent it from imposing integration restrictions:

> Nothing in this section or section 4(6) shall be construed as preventing an issuer from raising capital through methods not described under section 4(6).[15]

Rather than suggesting that integration concerns be entirely ignored by the Commission, the Integration Proviso actually assumes that some degree of integration is likely, if not inevitable. The Proviso warns the Commission not to impose integration tests that would "prevent" offerings under exemptions because Congress was well aware that the Commission would find that some integration restrictions would be necessary to ensure compliance with, for example, the restriction of crowdfunding advertising to the intermediary's platform. Yet rather than taking the Proviso as a warning not to apply integration restrictions too broadly, the Commission has distorted its meaning into a command that no integration restrictions be applied at all. Despite the patently obvious loophole that permitting general solicitations in concurrent private offerings -- and even somewhat less problematic communications in a concurrent public offerings[16] -- would create, the Commission has proposed to repeal, in effect, the crowdfunding restriction on advertising.

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[15] Securities Act § 4A(g).

[16] As noted above, concurrent public offering is arguably of less concern because the content of a public information made available in a concurrent public would be more regulated that public information in a private offering. However, a concurrent public offering, in which any investor could invest an unlimited amount, might beg the question of why a crowdfunding offering that adds investor investment limits was appropriate at all. However, this is mitigated by the fact that public companies are not permitted to rely on the crowdfunding exemption and crowdfunding may not raise more than $1 million in any 12-month period. *See infra* Part III.

The Integration Proviso should be read according to what it says: integration rules should not ***prevent*** other offerings. Congress could have but did not use the word "delay." Congress could have but did not use the word "impede." Congress could have but did not use the phrase "interfere with." Congress was well aware that existing integration rules "delay," "impede" and "interfere with" securities offerings, but it chose to warn the Commission only against intergration rules' "preventing" other offerings.

Congress used the term "prevent" in the sense of keeping something from happening. Existing integration rules do not prevent offerings, nor would any reasonable application of these rules to crowdfunding offerings prevent other offerings. Requiring that no public advertising of an offering by an issuer occur, for example, within 60 days before the initiation of a crowdfunding offering by that issuer could not be said to "prevent" the other offering. It would only require that it terminate before a subsequent crowdfunding offering. This rule would, however, "prevent" issuers from indirectly publicly advertising their crowdfunding offerings. In view of the regulatory risks that crowdfunding entails, such a bright line rule would be preferable to a fact-based determination. It would be impracticable to adopt the SEC's position on concurrent public and private offerings because one could not demonstrate that no crowdfunding investor was solicited through public advertising.

Members of Congress should urge the Commission to ensure that crowdfunding rules do not effectively repeal the restrictions on crowdfunding advertising by permitting public advertising in offerings that are concurrent with a crowdfunding offering. Moreover, Congress should urge the Commission to prohibit the initiation of a crowdfunding offering less that 60 days after a public communication in an offering by the same issuer.

III. $1 Million Cap on Funds Raised

Congress intended that crowdfunding offerings remedy perceived difficulties encountered by issuers when raising small amounts of capital.[17] The crowdfunding exemption was not intended to cover large offerings, much less issuers that routinely raised substantial amounts by other means. Congress accordingly limited the aggregate amount of securities raised by a crowdfunding issuer in any 12-month period to $1 million. It also required that the Commission adjust this limit at least once every five years to reflect inflation.[18] Thus, an issuer that was able to raise $1 million through a private offering, for example, would not be able to avail itself of the crowdfunding exemption during the 12 months following the private offering, but it would be able to raise up to $1 million every year.

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[17] Recently published data undermines this assumption. From 2009 - 2012, there were 43,683 offerings under Rule 504, 505 and 506, and more than half - 22,126 - were for less than $1 million. *See* Ivanov and Bauguess, Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D exemption, 2009 - 2012 at 8 (July 2013) available at http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf. These data do not even include all alternative offering exemptions, much less additional offerings that will be made as a result of the removal of the ban on public advertising in private offerings. Thus, offerings of less than $1 million are not just feasible under other offering exemption. They are ***routine***.

The Commission cites this data in the Proposing Release, but it provides no analysis as to what types of startups and small businesses are having success with Reg D and what types are not. Why are some businesses able to find accredited investors and others are not? The fact that the accredited investor standard is based on wealth, one might speculate that some start-ups and small businesses are excluded from the kinds of networks in which they would have personal contact with accredited investors or with those who provide financial services to these investors. One might speculate further that crowdfunding's greatest potential may be its ability to remove arbitrary socio-economic constraints from capital allocation decisions.

Finally, the Commission acknowledges that Reg D offerings now may be publicly advertised, but it does not discuss what effect this might have on the ability of start-ups and small businesses to raise capital under that exemption. Again, it seems that thinking about the effect of this change would be necessary for the Commission to engage in informed rulemaking.

[18] Securities Act § 4A(g)(1).

This $1 million cap is not limited to non-crowdfunding offerings. Congress makes that expressly clear in the Act. The relevant provision Act states as follows:

> (6) transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that—
>
> (A) the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12- month period preceding the date of such transaction, is not more than $1,000,000; . . ..[19]

Paragraph (6) applies to "the offer or sale of securities by an issuer," and subparagraph (A) limits "aggregate amount sold to all investors by the issuer" to "not more than $1,000,000." By its terms, "the offer and sale of securities" would mean all securities, including crowdfunding securities, a point further reinforced by the reference to "all" investors (not just crowdfunding investors).

However, there is a potential ambiguity. The limit might be viewed as ensuring that issuers that are able to raise $1 million by ***other*** means should not be able to avail themselves of the crowdfunding exemption. Under this interpretation, an issuer could, consecutively within a 12-month period, issue $500,000 in crowdfunding securities, $500,000 in privately offered securities, and $500,000 securities. If the $1 million in crowdfunding securities were not aggregated with the private offering, the second $500,000 offering would be permitted. Congress intended that crowdfunding securities be included in applying the $1 million cap. It intend that the issuer be free to raise additional capital through noncrowdfunding means, but if it was able to raise $1 million in a 12-month period it should not be allowed to exploit the crowdfunding's lowered investor protection at least until 12 months has passed.

[19] Securities Act § 4(a)(6).

Congress decided to make it absolutely clear that crowdfunding securities were to be included in the aggregate $1 million cap[20] and accordingly added the clarification that is italicized and bolded below:

> (A) the aggregate amount sold to all investors by the issuer, ***including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction,*** is not more than $1,000,000 . . .[21]

In the event that it was not clear that the "aggregate amount sold" included crowdfunding securities, Congress stated expressly that these securities were included. There was no need to explain that the "aggregate amount sold" included securities issued in other offerings. Indeed, the fact that Congress believed it necessary to note that crowdfunding securities were "included" must mean that Congress also believed that other securities were included in the "aggregate amount sold." It is an obvious rule of statutory construction, easily understood by any lay person, that the term "including" means "illustrative of," and not, for example, "limited to."[22]

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[20] *See* Willheim v. Murchison, 342 F.2d 33, 41 (2d Cir. 1965) ("Definitions in securities and other legislation often use the word 'include' out of abundant caution, and this serves a clear purpose when one or more of the things stated as included would not be so in the ordinary meaning of the term defined . . ..").

[21] Securities Act § 4(a)(6)(A).

[22] *See, e.g.,* Fed. Land Bank of St. Paul v. Bismarck Lumber Co., 314 U.S. 95, 99-100, 62 S. Ct. 1, 4, 86 L. Ed. 65 (1941) ("We recently had occasion under other circumstances to point out that the term 'including' is not one of all-embracing definition, but connotes simply an illustrative application of the general principle. (citing Phelps Dodge Corp. v. National Labor Relations Board, 313 U.S. 177, 189, 61 S.Ct. 845, 850, 85 L.Ed. 1271, 133 A.L.R. 1217; Helvering v. Morgan's, Inc., 293 U.S. 121, 125, 55 S.Ct. 60, 61, 79 L.Ed. 232); Stansell v. Revolutionary Armed Forces of Colombia, 704 F.3d 910, 915 (11th Cir. 2013)("When a statutory definition declares what a term "means" rather than "includes," any meaning not stated is excluded. Colautti v. Franklin, 439 U.S. 379, 392–93 & n. 10, 99 S.Ct. 675, 684 & n. 10, 58 L.Ed.2d 596 (1979). This is because the term "means" denotes an exhaustive definition, while "includes" is merely illustrative. United States v. Probel, 214 F.3d 1285, 1288–89 (11th Cir.2000)."); Citizens for Responsible Gov't State Political Action Comm. v. Davidson, 236 F.3d 1174, 1190-91 (10th Cir. 2000) ("Colorado is among "the overwhelming majority of jurisdictions" that read the word "includes" as "a term of extension or enlargement when used in a statutory definition." *Colorado Common Cause v. Meyer,* 758 P.2d 153, 163–64 (Colo.1988) (en banc)."); Dong v. Smithsonian Inst., 125 F.3d 877, 880 (D.C. Cir. 1997) ("We recognize, of course, that the word "includes" normally does not introduce an exhaustive list but

merely sets out examples of some "general principle." *Federal Land Bank of St. Paul v. Bismarck Lumber Co.,* 314 U.S. 95, 100, 62 S.Ct. 1, 4, 86 L.Ed. 65 (1941)."); Federal Election Com'n v. Massachusetts Citizens for Life, Inc., 769 F.2d 13, 17 (1st Cir. 1985) ("'A term whose statutory definition declares what it 'includes' is more susceptible to extension of meaning by construction than where the definition declares what a term 'means.' It has been said 'the word "includes" is usually a term of enlargement, and not of limitation." ... It, therefore, conveys the conclusion that there are other items includable, though not specifically enumerated ... (*quoting* N. Singer, 2A Sutherland Statutes and Statutory Construction 133 (4th ed. 1984) (*quoting* Argosy Ltd. v. Hennigan, 404 F.2d 14, 20 (5th Cir.1968))); United States v. Mass. Bay Transportation Authority, 614 F.2d 27, 28 (1st Cir.1980) ("Includes is not a finite word of limitation."); Bautista v. Star Cruises, 286 F. Supp. 2d 1352, 1360 (S.D. Fla. 2003) aff'd, 396 F.3d 1289 (11th Cir. 2005) ("Plaintiffs' interpretation of the Convention Act overlooks the significance of the word "including" in § 202. "A term whose statutory definition declares what it 'includes' is more susceptible to extension of meaning by construction than where the definition declares what the terms 'means.' " Singer, *supra,* § 47:07. In fact, "the word 'includes' is usually a term of enlargement, and not of limitation ... It, therefore, conveys the conclusion that there are other items includable, though not specifically enumerated by the statutes." *See Argosy Limited v. Hennigan,* 404 F.2d 14, 20 (5th Cir.1968) (internal citations omitted). Based on these principles of statutory construction, the term "including" instructs that the transactions, contracts and agreements described in § 2 of the FAA are covered by the Convention Act, as well as other arbitration agreements that arise out of commercial legal relationships."); Argosy Ltd. v. Hennigan, 404 F.2d 14, 20 (5th Cir. 1968) ("In both of these statutes, we think the word 'including' is not to be restricted to the 'rate and amount of duties chargeable,' but read in relation to the phrase, 'all decisions entering into same.' 'The word 'includes' is usually a term of enlargement, and not of limitation.' United States v. Gertz, 9 Cir. 1957, 249 F.2d 662, 666. It therefore conveys the conclusion that there are other items includable, though not specifically enumerated by the statutes."); United States v. Gertz, 249 F.2d 662, 666 (9th Cir. 1957) ("The word 'includes' is usually a term of enlargement, and not of limitation. As stated in Federal Land Bank of St. Paul v. Bismarck Lumber Co., 314 U.S. 95, 100, 62 S.Ct. 1, 4, 86 L.Ed. 65, "including' is not one of all-embracing definition, but connotes simply an illustrative application of the general principle."); Braun v. Wal-Mart Stores, Inc., 2011 PA Super 121, 24 A.3d 875, 963-64 (Pa. Super. Ct. 2011); ("With respect to the term "include," "[t]he term 'include' is to be dealt with as a word of 'enlargement and not limitation.' " *Pa. Human Relations Comm'n v. Alto–Reste Park Cemetery Ass'n,* 453 Pa. 124, 130–31, 306 A.2d 881, 885 (1973) (alterations omitted); *accord Samantar v. Yousuf,* — U.S. —, — n. 10, 130 S.Ct. 2278, 2287 n. 10, 176 L.Ed.2d 1047, 1062 n. 10 (2010)."); Vassiliu v. Daimler Chrysler Corp., 178 N.J. 286, 295, 839 A.2d 863, 868-69 (2004) ("Rather, "the word 'includes' is usually a term of enlargement, and not of limitation.... It, therefore, conveys the conclusion that there are other items includable, though not specifically enumerated [.]" 2A Norman Singer, Sutherland Statutory Construction § 47:07 at 231 (6th ed. 2000) (internal quotation marks and footnote omitted); accord Fraser v. Robin Dee Day **869 Camp, 44 N.J. 480, 485, 210 A.2d 208, 210–11 (1965)."); Brown v. Scott Paper Worldwide Co., 143 Wash. 2d 349, 359, 20 P.3d 921, 926 (2001) ("RCW 49.60.040(3) contains the word "includes," which is a term of enlargement."); Ornelas v. Randolph, 4 Cal. 4th 1095, 1101, 847 P.2d 560, 563 (1993) ("The statutory definition of 'recreational purpose' begins with the word 'includes,' ordinarily a term of enlargement rather than limitation." (citing People v. Western Air Lines, Inc. (1954) 42 Cal.2d 621, 639, 268 P.2d 723; 2A Sutherland, Statutory Construction (4th ed. 1973) § 47.07, pp. 81–82.)); Matter of Estate of Corwin, 1987-NMCA-100, 106 N.M. 316, 317, 742 P.2d 528, 529 ("This appeal requires us to apply principles of statutory construction. We find the correct approach in 2A N. Singer, However, the Commission interprets the term "including" to mean "limited to." Of course, if the only securities that Congress intended the $1 million to apply to were crowdfunding securities, then it would have said:

> the aggregate amount of securities ***sold in reliance on this exemption*** during the 12-month period preceding the date of such transaction, is not more than $1,000,000,

and not what Congress actually said:

> the aggregate amount sold to all investors by the issuer, ***including any amount sold in reliance on the exemption provided under this paragraph during the 12- month period preceding the date of such transaction,*** is not more than $1,000,000.[23]

Yet the Commission interprets "including" to mean "only." I am not aware of ***any*** support for this interpretation of "including" in this context. Courts have consistently interpreted "include" and "including" to be a nonexclusive example of the set of things that it follows. The sentence, "All cars must be registered, including blue cars" cannot mean that only blue cars must be registered. The sentence, "All felons must report to their parole officer, including felons who have served sentences of less than one year" cannot mean that murderers are not required to report to their parole officers.

Sutherland Statutory Construction Section 47.07 (Sands 4th ed. 1984): 'A term whose statutory definition declares what it "includes" is more susceptible to extension of meaning by construction than where the definition declares what a term "means." It has been said "the word 'includes' is usually a term of enlargement, and not of limitation. * * * It, therefore, conveys the conclusion that there are other items includable, though not specifically enumerated. * * *"' (Footnote omitted.) This rule has found support in other jurisdictions. Federal Land Bank of St. Paul v. Bismarck Lumber Co., 314 U.S. 95, 62 S.Ct. 1, 86 L.Ed. 65 (1941); Smyers v. Workers' Comp. Appeals Bd., 157 Cal.App.3d 36, 203 Cal.Rptr. 521 (1984); Schwab v. Ariyoshi, 58 Hawaii 25, 564 P.2d 135 (1977); Janssen v. Janssen, 331 N.W.2d 752 (Minn.1983).").

[23] *See* Coastal Barge Corp. v. Coastal Zone Indus. Control Bd., 492 A.2d 1242, 1246-47 (Del. 1985) ("We are mindful of the fact that the General Assembly used the words 'bulk product transfer facility means' rather than 'bulk product transfer facility includes' and that a term whose statutory definition declares what it 'includes' is more susceptible to extension of meaning by construction than where the definition declares what a term 'means.'" (citing 2A. Sutherland, Statutes and Statutory Construction § 47.07 (4th ed. 1984)).

Congress knows how to limit a provision to crowdfunding offerings. In fact, Congress proved as much in this very same Act and to a similar offering limitation. Section 4A(a)(8) requires crowdfunding intermediaries to comply with SEC rules designed:

> 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) . . ..

This provision prohibits the sale of crowdfunding securities – and only crowdfunding securities -- to an investor if the sale would result in the investor's total purchases in the preceding 12 months exceeding the investor investment limits (5% of net income, *etc.*). Thus, an investor whose income and net worth are less that $40,000 purchased his investment limit of $2,000, a different issuer could not sell the investor another dollar in crowdfunding securities until 12 months had passed.

This limit is important here because it shows that Congress knew how to draft a 12-month dollar limit that applies only to aggregate sales of crowdfunding securities. It use the words: "has purchased securities offered pursuant to section 4(6) that, in the aggregate, ..." It did not say: has purchased securities, ***including those*** offered pursuant to section 4(6) that, in the aggregate, ..." Congress used different terms to impose separate 12-month dollar limits on sales of only crowdfunding securities for a reason. It specifically identified crowdfunding securities and only crowdfunding securities where the limit applied only to crowdfunding securities. In contrast, it used "including" in the $1 million issuer cap to clarify that crowdfunding securities were "included" in the aggregate amount but not the only securities to which the provision applied. The only rational reading of the $1 million issuer cap is that it applies to all securities sold by the issuer.

The Commission's interpretation of the $1 million cap provision also violates the spirit and intent of the Act. The Commission's interpretation would allow, for example, an issuer to raise $1 ***billion*** in a private or public offering and follow up with a $1 million crowdfunding offering. Conversely, a business could raise $1 million and immediately follow that with a $1 ***billion*** private of public offering. Every large issuer will consider whether it would be an effective social strategy to conduct a crowdfunding offering in order to "reach out" to their small shareholders while the issuer is a conducting a concurrent private offering from which small investors would be excluded.

It could not have been further from Congress's intent to help startups and small businesses by creating an exemption for billion-dollar businesses. The Commission contends that:

> requiring aggregation of amounts raised in any exempt transaction – would be inconsistent with the goal of alleviating the funding gap faced by startups and small businesses because it would place a cap on the amount of capital startups and small business could raise.[24]

How, exactly, is there a "funding gap" for a business that raises millions or even billions in a mere 12 months through non-crowdfunding offerings? Such a business definitionally does ***not*** have a "funding gap." Nor is it a startup or the kind of small business for which Congress created the crowdfunding exemption. The SEC's statement also exaggerates the facts because the cap would apply only during the 12-month period; issuers would be free to engage in offerings outside of the 12-month window. My plain reading of the statute discussed above is not, as the Commission contends, "inconsistent" with the statute because no reasonable person would argue that the crowdfunding exemption was created to enable large businesses to raise capital.

Moreover, the Commission also stated that the:

> offering exemption in Section 4(a)(6) was designed to help alleviate the funding gap and the accompanying regulatory concerns faced by startups and small businesses, many of which ***may not be familiar with the federal securities laws.***[25]

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[24] Proposing Release at 17.

[25] *Id.* at 269.

The startup or small business that is "not familiar with the federal securities laws" is not the business that would be able to raise substantial capital through a private offering and other methods.

The Commission stated further:

> As discussed above, the crowdfunding provisions of the JOBS Act, which we would implement through this proposed regulation, were designed to help alleviate the funding gap and accompanying regulatory concerns faced by small businesses by making ***relatively low dollar offerings*** of securities less costly and by providing crowdfunding platforms a means by which to facilitate the offer and sale of securities without registering as brokers, with a framework for regulatory oversight to protect investors.

and:

> We understand that Title III was designed to help alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses in connection with raising capital in ***relatively low dollar amounts.***[26]

and:

> [T]he crowdfunding exemption] is intended to alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses in connection with raising capital in ***relatively low dollar amounts.***

It is unclear why the Commission believes that interpreting a statute to allow businesses to raise ***more*** than $1 million in a 12-month period reflects its view that crowdfunding was "designed" or "intended" for small businesses "making relatively low dollar offerings of securities" or offerings in "relatively low dollar amounts."

It is not reasonable to read the Act as intended to help businesses that raise tens, hundreds or even thousands of millions of dollars by allowing them to raise an extra $1 million through crowdfunding. In contrast, it is entirely logical to read the statute to mean that

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[26] *Id.* at 11.

Congress decided that $1 million was more than a "low dollar amount." Under the SEC's interpretation, billions of dollars would qualify as a "low dollar amount."

The effect of allowing medium-size and large businesses to engage in crowdfunding will be to squeeze out the small businesses for which it was intended. Crowdfunding intermediaries, which have actively lobbied Congress on crowdfunding would prefer the largest market possible. However, the effect of allowing any non-public company to engage in crowdfunding will be to perpetuate the competitive disadvantage of the smallest businesses that crowdfunding was designed to remedy. The Commission's interpretation of the provision benefits medium-size and large businesses, and crowdfunding intermediaries, at the expense of startups and small businesses.

The Commission attempts to support its interpretation by referencing the Integration Proviso, which, as discussed above, is clearly intended to address the problem of using one offering to circumvent the rules of another, concurrent offering. First, the $1 million limit is not ambiguous; it allows for only one reasonable reading. Second, the Integration Proviso refers to "preventing" offerings, whereas the $1 million cap would only limit the amount raised and even then for no longer than 12 months. It would "prevent" nothing. The Commission states:

> An issuer that already sold $1 million in reliance on the exemption provided under Section 4(a)(6), for example, would be prevented from raising capital through other exempt methods and, conversely, an issuer that sold $1 million through other exempt methods would be prevented from raising capital under Section 4(a)(6).

This is incorrect, however, because an issuer would never be subject to the limit for longer than 12 months. An offering would never be prevented; it could only be delayed.

The $1 million cap provision states that the "aggregate" amount of "securities" "sold to all investors" shall not exceed the $1 million limit in any 12-month period. These terms are unambiguous. The SEC's interpretation makes a mockery of Congress's plain English use of the phrase in the provision: "including any amount sold in reliance on the exemption provided under this paragraph." The only rational interpretation is that the term "including" means that the category of offerings to which the $1 million cap applies "includes" crowdfunding offerings. It is irrational to interpret the term "including" crowdfunding offerings to mean "only" crowdfunding offerings, just as it would be irrational to twist the meaning of a statute to enable billion-dollar businesses that conduct billion-dollar offerings the ability to rely on the crowdfunding exemption. Finally, the Commission's interpretation flatly contradicts its repeated characterization of the entities for which crowdfunding was intended as "small businesses" raising "small dollar amounts" in order to remedy existing "funding gaps."

Congress should communicate to the Commission that the Act was intended to provide a limited crowdfunding exemption for low dollar-amount offerings by startups and businesses that might otherwise experience a genuine funding gap. Congress should explain to the Commission that the $1 million "aggregate" limit on the "offer and sale of securities" (not only crowdfunding securities) to "all" investors (not just crowdfunding investors) reflects the understanding of Congress that a business that is able to raise more than $1 million within a mere 12 months is not the kind of funding-gap business or low-dollar amount offering contemplated by the Act.

IV. Limit on Investments by Investors

Virtually every member of Congress who has spoken about the Act has affirmed the importance of investor protection, and the Act's most important investor protection provision is its limit on the amount that investors may invest. This provision is critical because typically one-third to half of small businesses fail within the first few years of their founding.[27] Crowdfunding businesses may have a higher concentration of businesses that were rejected by angel investors, which suggests that their failure rate may be even higher,

[27] The data varies greatly as to small business failure rates, but most show about a 40 to 50 percent failure rate after three years. *See, e.g.*, Scott Shane, Small Business Failure Rates by Industry: The Real Numbers, www.smallbiztrends.com (Sep. 24, 2012). The Commission cites various studies that show similarly high failure rates. *See* Proposing Release at 335 ("There is broad evidence that many of these potential issuers are likely to fail after receiving funding.").

a view with which the Commission agrees.[28] Thus, a substantial percentage of investments made in small businesses will be worthless within a few years. Investors in these firms will lose their entire investment.

Small business failures are not typically the result of fraud. They are *business* failures that result from incompetence and/or inexperience. This means that, no matter what disclosures are provided, sophistication tests are applied, or intermediary rules are adopted, about half of crowdfunding investments in crowdfunded startups may be a total loss. This would not necessarily reflect negatively on crowdfunding, although one hopes that crowdfunding would result in improved survival rates. The only way to protect investors from excessive losses is to limit the amount that they are permitted to invest.

The Act imposes two forms of investment limits on crowdfunding investors as follows:

- The aggregate dollar amount of investments in any 12-month period in securities of a single crowdfunding issuer (including crowdfunding securities); and
- The aggregate dollar amount of investments in all crowdfunding securities in any 12-month period.

In each case the dollar limit is the same: between $2,000 and $100,000, depending on the investors' wealth and net worth. Thus, the limits protection investors against the two primary risks: (1) issuer risk (the risk that a single crowdfunding issuer will fail), and (2) crowdfunding risk (the risk of investing in crowdfunding offerings by multiple issuers). In addition, the limits are generally based on a percentage of net worth/income, which more closely aligns the dollar amount at risk on one hand, with the ability of the investor to bear the loss on the other. This is a significant improvement over the application of investment limits in other scenarios. In contrast, the SEC's Reg D allows an investor with $1 million in

[28] *See id.* at 335 ("Because we expect that issuers that would engage in offerings made in reliance on Section 4(a)(6) would potentially be in an earlier stage of business development than the businesses included in the above studies, we believe that issuers that engage in securities-based crowdfunding may have higher failure rates than those in the studies cited above.").

new worth to bet all of it on a single offering, while an investor with only $999,999 can invest nothing. While the particular dollar limits that Congress chose are questionable (they allow someone with no income and $2,000 in assets to invest their last penny in a crowdfunding offering), and over a number of 12-month periods any crowdfunding invesors could experience devastating losses, Congress should be applauded for designing a structure that provides greater protection against financially devastating losses.

The Commission recognizes the investor protection purpose of the limits on crowdfunding investments by investors. It stated in the Proposing Release:

> Congress provided important investor protections for crowdfunding transactions under Section 4(a)(6), including individual investment limits. [29]

However, where there is any ambiguity in the operation of these investor protection limits, the Commission seems to have opted to interpret them to permit *larger* investments by *less wealthy* investors. Under the status quo, issuers may sell securities to investors who are below certain net worth and income floors only pursuant to a public offering and under a limited number of exemptions. Where the law departs from the status quo with respect to the protection of investors, as is the case with crowdfunding, it is incumbent that any reduction in investor protection occur only where the law is clear. Where there is doubt, the regulator should err on the side of the status quo unless Congress has expressed its clear intent. However, the Commission seems to view every provision of the Act as intended to increase access to capital for small businesses without any regard for investor protection goals (notwithstanding that weak investor protection is likely to under the crowdfunding market and hurt small businesses).

This approach is reflected in the SEC's position on the investment limits in Section 4(a)(6)B), in which there is a flat contradiction in the application of the investment limits. Subparagraph (B)(i)'s limit applies "if ***either*** the annual income or the net worth of the

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[29] *Id.* at 12.

investor is less than $100,000." Subparagraph (B)(ii)'s limit applies "if ***either*** the annual income or the net worth of the investor is equal to or more than $100,000." The provisions are clear as long as an investor's income and net worth are both below or both equal to or above $100,000. However, if one is below $100,000 and the other is equal to or above $100,000, both standards apply. Such a patent drafting error is, ironically, a reflection of the dark side of crowd psychology. Dozens of experts, perhaps hundreds, failed to detect this error during the drafting phase because we believed that the Emperor certainly could not be walking the streets with no clothes on. Nonetheless, the contradiction exists, and the Commission cannot adopt rules without resolving it.

Normally, one would resolve such a contradiction in way that furthers the goal of the particular provision. The Commission states expressly that this is an investor protection provision, yet it has interpreted it to provide less investor protection rather than more. The Commission's justification for its position is that "this clarification would give effect to the provision and would be consistent with Congressional intent in providing investment limitations."[30] However, taking the opposite position would *also* be consistent with this intent. Virtually *any* interpretation would impose investment limitations, which renders the SEC's explanation is meaningless. The question is what the limit should be when an investor has less than $100,000 in income but at least a $100,000 net worth, or vice versa.

More precisely, the primary investor protection concern is for the investor with a small income or no income who has managed to save $100,000. This person may be a retiree living exclusively or primarily on Social Security who is particularly vulnerable to investment scams and has no means of recovering from losses.[31] Thus, the Commission's interpretation would allow such a retiree with an annual income of $25,000 and $100,000 in assets to invest $10,000 in a crowdfunding offering, whereas an investor-protection

[30] *Id.* at 24.

[31] In contrast, a person who earns more than $100,000 in three consecutive years is likely to be in much better position to absorb a 100 percent loss. There is no basis, however, in interpreting Subparagraph (B) differently for income and net worth.

oriented interpretation would limit her investment to $5,000. Admittedly, Congress clearly decided that it is appropriate for a retiree living on Social Security with only $100,000 saved to make a $5,000 investment, which certainly makes the SEC's position seem benign in comparison. But that is not the rulemaking issue. What is difficult to understand is why the Commission would choose to exacerbate an already bad situation by interpreting a contradiction in an investor protection provision in a way that further ***reduces*** investor protection.[32] This is difficult to understand, in part, because the Commission provides no discussion of the potential harm to investors from its position. The more that vulnerable crowdfunding investors experience financial distress as a result of crowdfunding, the less likely it is that the crowdfunding market will succeed. The SEC's position is not doing small businesses any favors.

Congress should amend the Act to clarify that if either an investor's net worth or income is below $100,000, then the $2,000 / 5 percent investment limit applies, or communicate to the Commission that, pending clarification by Congress, the contradiction in the Act should be interpreted consistent with its investor protection purpose.

V. Investor Qualifications and Knowledge

The Commission has proposed that intermediaries be permitted to rely on the representations of investors regarding their eligibility to invest. The Commission must be mindful of imposing unnecessary burdens on crowdfunding, but in this respect it is imperative that stronger procedures be required when confirming investors' eligibility. One problem is that investors will routinely consider the value of their home in calculating their net worth, and may even neglect to reduce that amount by any outstanding mortgage. Intermediaries should be required to obtain specific confirmation regarding the investors'

[32] In a belated letter to Congress, former SEC Chairman Shapiro expressions her concerns regarding the inadequacy of investor protections under crowdfunding. If this did not include minimizing the investment amounts made by the most vulnerable Americans, it is hard to imagine to what she was referring. It appears that the SEC's position seems to have taken sharp turn since 2012.

calculation, such as an account statement that shows the value of an investor's securities account or one or more pay stubs that show their income. These documents can be sent electronically without an unreasonable burden on the investor. At minimum, investors should be asked specifically about whether they have included the value of their home in their calculation.

A second problem is that investors will have an incentive to inflate their net worth or income both to establish their eligibility and to increase the amount they are permitted to invest. For example, an investor with a $90,000 net worth may represent that the investor has a $1 million net worth in order to be allowed to invest at the 10% level and invest all of it, rather than $5,000 allowed under the Act. The total reliance on self-certification ignores the fact that these are not just limits on issuers; the limits also effectively constrain investors ability to invest in certain offerings. Self-certification does not take investor eligibility because it imposes absolutely no controls on investors' ability to circumvent the limits, and it imposes no obligation on the part of issuers or intermediaries that they are not being circumvented. This approach creates a mutual incentive to require as little information as possible so as to provide the greatest freedom to both sides.

In view of the likelihood that investors will lose their entire crowdfunding investment, the Commission should implement procedures to ensure that investors can afford to lose their entire investment.

VI. Investors' Review of Investor-Education Material

The Act requires that intermediaries "ensure that each investor reviews investor-education materials," which the Commission appears to have suggested may be satisfied by having the investor check a box that they have reviewed the material. However, the investor-education provision imposes a direct requirement that investors "review" information, whereas Congress require only that investors "positively affirm" their understanding of the risk of a total loss and their ability to bear such a loss. Allowing an investor to check a box stating that the investor has reviewed investor-education materials applies a "positively affirms" that Congress chose not to apply in this case.

Anyone who uses a computer routinely checks boxes stating that they have read licensing terms and other disclosures when they know that they have not. They will do the same with respect to investor-education materials. The check-the-box approach is especially odd because an intermediary could easily determine whether the relevant document had been opened or the investor has actually scrolled past the first few lines. This would demonstrate that the investor had ***not*** reviewed the information, but the intermediary would be allowed to ignore this information. The Commission should not accept this approach as satisfying the "review" requirement.

It is impracticable, of course, to require intermediaries watch over investors to confirm that they have read investor-education materials. However, it would be practicable to require investors to take a quiz that demonstrated that they had reviewed it, a method that the Commission has suggested could be satisfactory. This quiz could be combined with the quiz that intermediaries are otherwise required to administer to confirm each investor's understanding of liquidity risk and the risk of investing in small businesses. Alternatively, the Commission could require that the investor scroll through a series of web pages that show only one or two short sentences in a large font setting forth the most important investor-education facts, with a button confirming that they have read them and a link to more information related to that web page.

VII. Meaning of "Investor" and "Investor and their Spouse"

The investment limit under the Act applies to the "aggregate amount sold to ***any investor***."[33] The same provision refers in subparagraph (B)(i) to "the annual income or the net worth of the investor." Subparagraph (B)(ii) also refers to "the annual income or the net worth of ***the investor***." In each case, the term "investor" is singular. None of the foregoing provisions refers to "investors." None of the foregoing provisions states or even implies that the term "investor" should be interpreted to mean and "investor" ***and their spouse***.

[33] Securities Act § 4(a)(6)(B).

Nonetheless, the Commission chose to interpret the singular "investor" to include the "investor's" spouse.[34] The SEC's only justification for interpreting a singular noun to represent a couple is that it:

> believe[s] that this approach is consistent with the rules for determining accredited investor status because the accredited investor definition contemplates both individual and joint income and net worth with a spouse as methods of calculating annual income and net worth.[35]

This explanation might make sense but for the fact that it is ***not*** the accredited investor standard that is being applied. It is the investment limit for investments in crowdfunding offerings, where Congress chose to use the singular term "investor."

Nor is the SEC's position consistent with its own accredited investor definition. The accredited investor definition requires at least $200,000 in income for an individual investor, but the joint income requirement is higher, at $300,000. Even assuming that it has the authority to replace Congress's crowdfunding standard for a single investor with a standard for singles and couples, which it does not have, the Commission has violated its own position that the minimum for a couple should be ***50 percent higher.***

Rather than recognizing that Congress clearly chose ***not*** to adopt this aspect of the approach to joint net worth and income that appears in the definition of accredited investor, the Commission seems to have decided that Congress ***should have*** adopted this approach.

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[34] On a related matter, the Commission asks whether the 5 percent limit should apply to the higher or lower of the investor's income or net worth. The Commission is correct that is not expressly stated in subparagraphs (B)(i) and (ii). It would be reasonable, if not necessary,§ to interpret the placement of the phrase "the greater of" immediately preceding the $2,000 and 5 percent limits to mean that the phrase also applies to "the annual income or the net worth."

[35] Proposing Release at 25

This is also despite the fact that Congress knew very well how to apply the accredited investor definition when it believed that the standard was appropriate. Congress did precisely that when the standard that it provided that crowdfunding net worth and income should be "calculated in accordance with" the calculation of net worth and income for an accredited investor. Thus, Congress specifically chose the accredited investor calculation methodology (*e.g.*, the exclusion the value of a home in calculating net worth) but not accredited investor treatment of a couple's income of net worth, yet the Commission seems to believe that this was a mere Congressional oversight that it is the SEC's prerogative to fix.

Congress should reiterate to the Commission that the singular term "investor" means a single investor and urge the Commission not to exceed its authority by amending the Act to create a crowdfunding standard for the net worth or income of couples until and unless Congress has directed it do so.

VIII. Disqualification of Crowdfunding Issuers That Are in Violation of the Act

Congress granted the Commission express authority to prohibit certain issuers from relying on the crowdfunding exemption. The Commission proposes to exclude issuers that have not provided to investors the annual reports that are required under the Act following a prior crowdfunding offering. In my view, issuers that have demonstrated an inability to comply with the ***only*** obligation that continues after a crowdfunding should not be allowed to engaged in another crowdfunding offering until they have come into compliance. The delivery of the annual report is entirely within the control of the issuer. Its inability to make this disclosure shows that it should be relied upon to make appropriate disclosures in the course of new offering.

However, the Commission has proposed to disqualify issuers only if they have not filed and delivered their ***two*** most recent reports. Under this standard, an issuer could go 23 months and 30 days without having filed a report; indeed, it might ***never*** have filed a report. There is no reason that an issuer that is currently delinquent on the filing or delivery of one report, much less two should be allowed to avail itself of the crowdfunding exemption. Permitting such issuers to participate in the same market as small businesses that do comply with the law will only degrade investor confidence in the crowdfunding market and create an unlevel playing field by imposing costs of some issuers that are not imposed on others.

Congress should endorse the SEC's exclusion of certain issuers that are delinquent on their annual reporting obligation under the Act and encourage the Commission to prohibit an issuer from relying on the crowdfunding exemption until the issuer is current on its annual reporting obligation.

IX. $500,000 Trigger for Audited Financials

The Act requires that a crowdfunding issuer provide audited financial statement if the amount of the offering exceeds $500,000. However, it also authorizes the Commission to establish some other amount. This means that the Commission could raise or *lower* this amount, yet the Commission describes this authority as permitting only an increase in the amount.[36] The Commission should acknowledge that this authority also allows for a reduction in this amount and that it will, in fact, reduce the amount if subsequent events warrant such a reduction.

Such an increase or reduction may be appropriate in the future, but the Commission does not currently have any analytical or empirical basis to do so. Debt crowdfunding, such as offered by Prosper.com and LendingClub.com, has been operational for years, may offer insight into the relevance of financial statement standards in the crowdfunding context. Gift-based crowdfunding sites have enough of an operating history they also might shed light on this question. However, the only current basis for the audited financial trigger is the specific dollar amount of $500,000 provided by Congress. In view of the current lack of

[36] Proposing Release at note 31 ("*Cf.* Securities Act Section 4A(b)(1)(D)(iii) (giving the Commission discretion to increase the aggregate target offering amount that requires audited financial statements).").

any basis for second-guessing this standard, the Commission should neither raise nor lower the $500,000 trigger. However, it should promptly establish information collection and analysis procedures in order to ensure that it has the capacity to evaluate changes in the $500,000 trigger in the future.

X. Oversubscribed Offerings

The Commission has proposed that issuers be required to disclose how they will allocate shares in oversubscribed offerings, but otherwise grants them the discretion to decide how the allocation will be done. One issue is that this is not what the proposed rule says, which is that issuers must disclose whether it:

> will accept investments in excess of the target offering amount and, if so, the maximum amount that the issuer will accept and whether oversubscriptions will be allocated on a pro-rata, first come-first served, or other basis.[37]

Read literally, this provision would permit an issuer to disclosure that it will allocate oversubscriptions on a basis other than pro rata or first-come, first-served and provide no other guidance.

This is a rather minor point relative to the more important question of whether to prohibit allocations based on a first-come, first-served basis. The Williams Act and rules thereunder specifically prohibit tender offers for public companies from being made on a first-come, first-served basis. Rule 14d-8 requires that tender offers be made on a pro rata basis because first-come, first-served offers have the potential to create a stampede effect.[38] This would be an appropriate standard to apply to crowdfunding oversubscription allocations.

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[37] Proposed Rule 201(h).

[38] *See* San Francisco Real Estate Investors v. Real Estate Invest. Trust of Am., 692 F.2d 814, 817 (1st Cir. 1982) ("When Congress enacted the Williams Act in 1968, it recognized that an offeror who hoped to gain control of a target firm might well rely on a 'stampede' effect. The offeror would encourage shareholders to decide in its favor by offering a high price for only a portion of the outstanding shares and making that price available."). There are other anti-stampede provisions under the Williams Act, including minimum offer period and withdrawal rights.

The stampede effect is, of course, a reflection of a less appealing form of crowd dynamics. As Senator Merkley has stated, the Act's provisions "are designed to allow investors the chance to carefully consider offerings, permitting the 'wisdom of the crowd' to develop, rather than perhaps just the 'excitement of the crowd.'" The Senator was referring here to withdrawal rights, which are also important in mitigating the stampede effect (the Commission has proposed a withdrawal right up to 48 hours before the deadline for an offering[39]). However, issuers will have an incentive to use a first-come, first-served approach to allocating oversubscribed offering to pressure investors to act quickly without thinking. This could be mitigated by requiring pro rata allocations.

Congress should encourage the Commission to require that oversubscribed offerings be allocated on a pro rata basis, as is required under the Williams Act, in order to prevent the stampede effect that allocation on a first-come, first-served basis may create.

XI. Stale Financial Statements

The Act requires that crowdfunding issuers provide financial statements to investors. This information will be critical in helping the crowd evaluate issuers, but it will not be helpful if the information is stale. Stale information is of particular concern here because many issuers will have a very short operating history. For example, if an issuer with a calendar fiscal year begins operations in December and makes an offering the following June, then the financial statement from its most recent fiscal year would cover only one month, *i.e.*, one-seventh of the lifespan of the business.

The Act does not indicate how current the financial statements must be. The Commission has proposed that financial statements need only be as recent as the end of the issuer's

[39] Proposed Rule 304(a). The Act requires that issuers provide a "reasonable opportunity" to cancel their orders prior to sale, Securities Act § 4A(b)(1)(G), and 48 hours prior to the deadline meets this requirement.

most recent fiscal year. During the first 120 days of an issuer's fiscal year, the financial statements need only be as recent as the end of *preceding* fiscal year. In the latter scenario, the issuer with a calendar fiscal year that began operations in December in Year 1 could submit financials covering only that month for a crowdfunding offering beginning as late as April of Year 3. The financials would be 16-months stale and cover only one month in the issuer's 17-month lifespan.

The SEC's proposal will substantially dilute the value of crowdfunding financials. The requirements permit extremely stale information relative to the life of a firm to be the basis for an investment decision by nonaccredited investors. It is unclear how the wisdom of the crowd will be able to evaluate a firm based on financial information that may be effectively irrelevant to an issuer's current financial condition.

The Commission correctly notes that an issuer must disclose any material changes that have occurred since the date of the financials. For example, issuers must disclose material changes in reported revenue and net income. However, requiring such disclosure without also requiring that the information be provided in the format of a financial statement undermines the purpose of using financial statements in the first place. A financial statement is, in effect, a standardized way of organizing information that facilitates interpretation and comparison. A generalized disclosure about changes in revenues and net income does not satisfy this standard. It promotes the dissemination of financial information in obtuse, inconsistent formats. Enforcement of the requirement to correct of material changes would be far more difficult than enforcement of a clear financial statement standard.

If changes in financial information were unlikely, this might not be a significant problem, but early stage businesses are very likely to experience changes in their financial information over short periods. These changes will be critical information because they will be both current and reflect the possible direction of the business. This SEC's approach is also problematic because it leaves substantial discretion to issuers to update financial information when the changes are positive, while not disclosing information when it is negative.

The Commission should require that crowdfunding issuers provide truly ***current*** financials. These need not necessarily meet the same degree of formality. For large offerings, the Commission could require that issuer provide their audited financial statements for the two most recently ended fiscal years plus non-audited (*e.g.*, CEO-certified) financial statements[40] through the end of the month that ends no more two months before the month in which the offering begins (*e.g.*, an offering any day in March would require financials ending in January). It should not be burden for an issuer what is otherwise providing audited financial statements.

For smaller offerings that have less burdensome financial statement requirements under the Act, a modified standard for providing current information might be appropriate. However, permitting issuers to sell shares off of financial statements that may be 16-months stale, especially where that 16-month period may represent almost the entire lifespan of the business, will not facilitate the development of an efficient market. Issuers will exploit the opportunity to make offerings based on stale information and thereby dilute investor confidence in crowdfunding.

Congress should inform the Commission that requiring only financial information as of the end of the most recent fiscal year, which may be 16-months stale at the time of the offering, will provide investors with inadequate information to evaluate investments and undermine confidence in the crowdfunding marketplace. Congress should encourage the Commission to require that issuers provide the most current financial information practicable, even if the most current information complies with a lower standard.

[40] The Act's financial statement requirement could be read to require current financial statements or only the most recent financial statements. In light of this lack of clarity, the Commission should be viewed as having the authority to impose a reduced requirement for current financials or to require that current financials be provided that meet the Act's standard.

XII. Extension of Time to File Taxes

The Act requires that issuers raising $100,000 or less in a 12-month period file a copy of their most recently "filed" tax return. The Commission interprets this requirement literally, which means that issuers that have obtained an extension to file their returns would not be subject to this requirement. The Commission asks whether issuers should be allowed circumvent this requirement simply by obtaining an extension of time to file.

In my view, it is reasonable to interpret the date a tax return is "filed" as a date not later than the deadline for the filing. The Commission should adopt this interpretation in order to prevent issuers from improperly evading the tax return filing requirement. Alternatively, the Commission could impose this interpretation when the issuer has never filed a tax return in order to ensure that at least one tax return is available.

On a related issue, the Commission asks whether issuers should be permitted to redact personal identifying information. The purpose of filing tax returns is to provide investors with useable information on which to base an investment decision. To the extent consistent with this purpose, the Commission should permit the redaction of personal information.

Congressional Testimony of

David J. Paul

Co-Chair and Co-Founder of CfIRA

(Crowdfunding Intermediary Regulatory Advocates)

Chief Strategy Officer of Gate Global Impact

before the United States House of Representatives

Committee on Small Business

Subcommittee on Investigations, Oversight and Regulations

For the Hearing:

"SEC's Crowdfunding Proposal: Will it work for small business?"

January 16, 2014

To Chairman Schweikert, Ranking Member Clarke, and other honorable members of the Committee:

As all of you are aware, Congress passed the Jumpstart Our Business Startups Act (the JOBS act) on March 27, 2012 which was signed into law on April 5, 2012.

Very shortly thereafter, on April 20, 2012, I organized what may have been the first meeting between representatives of the crowdfunding industry and the Security and Exchange Commission. Since that first meeting, CfIRA has enjoyed an ongoing and productive dialog with both the SEC staff and the commissioners up to, and subsequent to, the release by the SEC of the proposed Title 3 crowdfunding regulations on October 23, 2013.

While it would be difficult to say that the crowdfunding industry speaks with a singular voice, it is fair to say that the overall consensus among the industry is that the SEC has done a diligent and thoughtful job creating the proposed regulations. In general, we remain hopeful that Title 3 crowdfunding, when it comes online later this year, will prove to be an effective and robust new asset class, matching small businesses with individual investors in a safe and productive marketplace.

With that said, there are certain aspects of the proposed regulations which may be amiss and which we hope to address and modify. Some of these concerns will be the subject of my testimony.

Given the limited time for testimony, I will confine my comments to four salient issues. These four issues are certainly representative of the kinds of concerns which the industry has with respect to the proposed regulation, but these are by no means exhaustive: **Audit Requirements, Pooled Investment Restrictions, Intermediary Participation Restrictions, and Funding Portal Liability.**

Audit Requirements

As currently proposed, there are three tiers of financial disclosure requirements for Title 3 offerings, corresponding to the amount raised:

First Tier: $0 - $100,000
Second Tier: $100,000 - $500,000
Third Tier: $500,000 - $1 million

The First Tier requires disclosure of financial statements certified by an executive officer of the company. The Second Tier requires financial statements reviewed by an accountant.

However, the Third Tier requires CPA audited financials. Furthermore, the requirement for such CPA audited financials is on an ongoing basis, with such audited financials to be provided to investors every year following a Title 3 raise of over $500,000.

It is worth noting that these disclosure requirements for the Third Tier are actually more onerous and exhaustive than the current requirement for Regulation D offerings which does not mandate audited financial statements for issuers, nor ongoing annual audited disclosures.

These overly onerous requirements for the Third Tier of security crowdfunding offerings may have the unintended effect of pushing potential issuers away from doing Title 3 crowdfunding offerings above $500,000 entirely, and instead will make Regulation D offerings more attractive to potential issuers.

This seems clearly inconsistent with the spirit of the original legislation. In effect, this may create a 'donut hole' between $500,000 and $1 million where offerors do not utilize Title 3 at all.

In addition to creating an artificial market irregularity, this will also have the unfortunate effect of making these offerings unavailable to unaccredited investors, since Regulation D offerings utilizing Title 2 are not available for investment by unaccredited individuals.

Pooled Investments Restrictions

The proposed regulations exclude funds from utilizing Title 3 to raise capital, in effect, requiring all crowdfunding investments to be direct investments. This rule would restrict pooled investments, or hedge funds and private equity funds from raising money through crowdfunding.

While we may agree that most funds may not be suitable issuers for crowdfunding, we believe that this restriction is overbroad as it appears to restrict the fundraising of Special Purpose Vehicles or Single Purpose Entities (SPE's) investing only in a single operating company that would otherwise qualify as an eligible Title 3 issuer.

This restriction does not serve to protect investors, but rather this restriction actually succeeds in denying crowdfunding investors some of the advantages and protections afforded to other investors and institutions in other asset classes, particularly those utilized in Regulation D offerings.

Intermediary Participation Restrictions

Current proposed regulations would restrict intermediaries from holding interests in the companies conducting Title 3 offerings on their platforms. This serves to restrict intermediaries from participating alongside their investors in these offerings.

Rather than diminishing a theoretical 'conflict of interest' between intermediaries and investors, as a practical matter this restriction effectively forbids alignment of interests between investors and intermediaries.

This concept is often described as "skin in the game." We believe that intermediaries who invest in issuers make for better alignment of interests. We believe that allowing such co-investment by intermediaries would have two very desirable benefits for investors. First, an investor may take comfort in knowing that the intermediary facilitating the transaction is invested in the same deal and on the same terms in the investment they are considering. Second, when an intermediary has such "skin in the game" that fact itself will encourage intermediaries to take more seriously their assigned role in the marketplace.

While we are aware that an intermediary's investing in a deal may be perceived by an investor as a tacit endorsement of that deal (perhaps to the exclusion of others in which the intermediary has not committed its firm's capital) and that this tacit endorsement may itself be construed as "investment advice", we do not believe that this is necessarily the case.

But even if such a determination were to be made, we believe that this "investment advice" restriction should not be applied to all intermediaries. At most, this restriction should be limited to Funding Portals and not to Broker-Dealers conducting Title 3 crowdfunding offerings, as Broker-Dealers are not restricted from offering investment advice in Title 3 crowdfunding offerings.

It is also worth noting that Broker-Dealers are not restricted from owning positions in other types of offerings in which they support, including Title 2 Regulation D offerings. So the restriction on Broker-Dealer financial participation triggered by Title 3 offerings may have the undesired effect of disencouraging Broker-Dealers from bringing Title 3 offerings at all.

Funding Portal Liability

Section 4A(c)(2) of the Securities Act provides that an "issuer" will be subject to liability if it fails in either of the following two criteria: (1) if an issuer makes an untrue statement of material fact or omits to state a material fact; (2) if an issuer does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.

While this may seem reasonable and proper for *companies* issuing securities, as written, the regulations suggest that funding portals themselves can be broadly included in the definition of issuers.

If this interpretation proves accurate, then a funding portal as well as each of its directors, principal executive officers and other employees involved in an offering, may potentially have personal liability for every transaction conducted on its platform.

The proposed consequence for a violation under this provision is to allow an investor to recover the amount of his or her investment, even if he or she no longer holds the security.

To put a fine point on this, this would mean that if the platform does one hundred $1 million deals, then each of a portal's affiliated persons would have $100 million in personal exposure. A portal effectively becomes a guarantor for every single statement in every offering document of every offering on its platform.

To say that this liability issue may have a chilling effect on anyone considering creating a portal may be something of an understatement. Indeed, each employee of a funding portal will have to make a decision as to whether they are comfortable exposing themselves, and potentially their families, because of the personal liability involved.

It is not hard to imagine this liability potential resulting in an adverse selection, where conservative market players are scared away and only aggressive players are willing to take on this risk. Clearly, this would not be in the best interests of the market as a whole.

Respectfully submitted,

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