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CROWDFUNDING: CONNECTING INVESTORS AND JOB CREATORS

HEARING

BEFORE THE

SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

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CROWDFUNDING: CONNECTING INVESTORS AND JOB CREATORS

THURSDAY, SEPTEMBER 15, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:34 a.m., in room 2154, Rayburn House Office Building, Hon. Patrick T. McHenry (chairman of the subcommittee) presiding.

Present: Representatives McHenry, Quigley, Cummings, and Maloney.

Staff present: Molly Boyl, parliamentarian; Drew Colliatie, staff assistant; Peter Haller, senior counsel; Ryan M. Hambleton, professional staff member; Christopher Hixon, deputy chief counsel, oversight; Rebecca Watkins, press secretary; Jaron Bourke, minority director of administration; Devon Hill, minority staff assistant; Jennifer Hoffman, minority press secretary; Carla Hultberg, minority chief clerk; Lucinda Lessley, minority policy director; Jason Powell and Steven Rangel, minority senior counsels; and Brian Quinn, minority counsel.

Mr. MCHENRY. The committee will come to order. This is the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs. This hearing is entitled, "Crowdfunding: Connecting Investors and Job Creators."

It is the practice of the Oversight and Government Reform committee to begin with a mission statement of this committee. We exist to secure two fundamental principles. First, Americans have a right to know that the money Washington takes from them is well spent. And second, Americans deserve an efficient, effective government that works for them. Our duty on the Oversight and Government Reform Committee is to protect these rights. Our solemn responsibility is to hold government accountable to taxpayers, because taxpayers have a right to know what they get from their government. We will work tirelessly in partnership with citizen watchdogs to deliver the facts to the American people and bring genuine reform to the Federal bureaucracy. This is the mission of the Oversight and Government Reform Committee.

With that, I want to thank our witnesses for being here, and I will begin by recognizing myself for 5 minutes for an opening statement.

Over 2 years into an uncertain economic recovery America's labor and capital markets continue to face unprecedented challenges.

Nearly 14 million Americans remain officially unemployed, with an additional 11 million underemployed. And small businesses continue to struggle to access capital despite an endless number of Federal initiatives.

Fixing this mess will not occur overnight, nor will it be a race by more government regulation. The purpose of today's oversight hearing is simple: In an economic environment in which lending to job creators and entrepreneurs remains dismal, we must find new and modern means for capital formation to ignite our sputtering economy.

An existing and innovative means to connect investors and job creators is crowdfunding. Many folks have not heard this terminology before, but crowdfunding is essentially the ability of individuals to pool their money in support of a common cause. Crowdfunding has traditionally taken place in the realm of charity and the arts, but also online communities and social networking where it could have a very positive implication for America's small businesses and investors.

If crowdfunding sounds familiar because politicians have been doing it for a few generations now, but it has been called something different. In the 2008 Presidential election then candidate Senator Barack Obama through small contributions alone raised over $100 million. Now that is quite advanced crowdfunding. So this makes sense, if crowdfunding can finance a candidate's campaign and really show a matter of grassroots support for what you are trying to achieve, if it could make a difference there, then certainly under the Securities and Exchange Commission we should be able it permit crowdfunding to empower citizens to invest seed money for American entrepreneurs and innovators.

During President Obama's speech last week I was happy to hear when he said, "We're also planning to cut away the red tape that prevents too many rapidly growing startup companies from raising capital and going public."

The first thing I thought of when he said that was today's hearing. I thought: Well, of course not, that is not exactly what he is going to be talking about. The next day when the White House released the details of the President's plan in bullet point form, I mean sort of the broad brush of it, he used the term "crowdfunding." And so it is very timely that we're having this hearing, and I don't think the White House coordinated with my schedule. But I applaud the President for finally recognizing that regulatory red tape has kept American startups from raising capital and hiring workers. This has never been a secret.

Unfortunately, news and information travels a bit slower over at the SEC. Despite recent efforts to relax rules on general solicitation and quiet periods, overall, the SEC has resisted calls to modernize securities regulations to meet the needs of today's economy.

For instance, recent studies show that most startups use lines of credit, such as credit cards or home equity lines, as the first step to finance their business. The difficulty with this is two-fold: Fewer people have access to credit lines or home equity sufficient to start a business. And second, small businesses using a credit card with high interest rates, it makes it tremendously difficult to finance a new business. That's exactly how my dad started his business.

But these ideas often don't make it past the dinner table for small businesses. We want to make sure that they have this access, this opportunity to get their friends and their neighbors involved in this process.

By updating regulations for today's economy, conventional barriers for raising capital could be a thing of the past. Recently as 2009, two ad executives started a crowdfunding campaign called buyabeercompany.com to buy Pabst Blue Ribbon Beer Co. Many folks call it PBR. By illustrating the true potential of crowdfunding they were able to raise over $200 million in pledges from over 5 million individuals through social networking sites such as Facebook. The average pledge was just $40, demonstrating the impact of even small donations. However, the SEC shut it down due to outdated—what I believe were outdated—regulations.

This example and thousands like it highlight the fact that America does not lack the ideas or creativity to get this economy moving again. It simply lacks access to capital. To rectify this tragedy in American innovation I introduced the Entrepreneurial Access to Capital Act, H.R. 2930, yesterday. This bill simply heeds the President's call to cut red tape for startups and allow everyday investors to connect with entrepreneurs.

In today's fast-paced world of innovation and innovators, all Americans rather than just banks and venture capitalists and so-called qualified investors, high net worth individuals, should be able to invest in the next Google, Apple, Facebook, their local coffee shop or their favorite beer company.

And I'm interested to hear from the witnesses today. I am so happy that we have such a great panel. I look forward to your testimony.

With that, I recognize the ranking member, Mr. Quigley of Illinois, for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman. Thank you for calling this hearing and for our witnesses being here today. We are in agreement: job creation must be the number one priority of Congress. But for businesses to expand and hire new workers they need resources, they need capital. Unfortunately, billions of dollars of capital are sitting on the sidelines because potential investors aren't confident enough to invest. Investors are worried of investing capital when our growth prospects are so uncertain.

As Secretary Geithner said last week, the world economy is in the midst of a second economic slowdown of this recovery from the financial crisis. This is why last month zero jobs were created and the unemployment rate remained over 9 percent.

What this means is that we have to consider any and all ideas for raising capital to invest in new businesses and hire American workers. Crowdfunding is one such idea. It is an innovative proposal for raising private capital through the power of the Internet. Crowdfunding uses small investments from often nontraditional investors to fund startup ventures. This is extremely important because these smaller startups often go unnoticed by bigger institutional investors.

To the extent that crowdfunding can match ready capital with quality investment opportunities it will be a success. I believe our witnesses will convince even the skeptics among us that there is

enormous potential here for job creation and a stronger, more vibrant economy.

Still even though most of us would use crowdfunding to jumpstart a new tech company or small neighborhood business, there are legitimate concerns that exempting crowdfunding from securities regulations would open and expand opportunities for fraud. Just as water standards keep our water safe to drink, financial regulations protect us against unsafe financial products.

According to SEC Chairman Schapiro, the SEC has a dual mandate to facilitate capital formation and protect investors. In facilitating capital formation, we must ensure that we do not leave investors vulnerable to fraudulent financial products. That's why the SEC maintains strict registration disclosure requirements for securities advertised through a general solicitation. In the words of the Supreme Court Justice Louis Brandeis, sunlight is the best disinfectant.

Exempting securities from these registration and disclosure requirements is a decision that cannot be taken lightly. The key is finding the balance between the two objectives of capital formation and investor protection.

Crowdfunding might also expose ordinary investors to a level of risk that is unacceptable when not accompanied by standard registration and disclosure. The reality is that many of these startups will fail and cause the investor to lose his or her entire investment. We have to be careful to ensure that investors fully understand the risk of investing in these financial products.

My goal today is to find answers to some of these unresolved questions. What is crowdfunding's potential for capital formation and job creation? What is the potential for fraud through crowdfunding? What common sense steps can we take to minimize fraud and protect investors? What risk will investors be exposed to through crowdfunding? And are these risks acceptable? What other steps can we take to facilitate capital formation and job creation?

I again want to thank the chairman for calling this timely hearing, and I yield back.

Mr. MCHENRY. I thank the ranking member. I'm going to keep the introductions short since we have such a substantial panel. Suffice it to say we have an academic, we have folks involved in crowdfunding, and then we have a representative from the SEC. So I will go through the introductions and then we will swear you in and we will get started with opening statements.

Ms. Meredith Cross is the Director of the Division of Corporate Finance at the Securities and Exchange Commission. Miss Dana Mauriello is cofounder and president of Profunder—ProFounder, I'm sorry. Mr. Jeff Lynn is chief executive officer of Seedrs Limited. Mr. Sherwood Neiss—Neiss, Lord, I'm sorry—is cofounder of FLAVORx. Mr. Michael Migliozzi is the managing partner of Forma Migliozzi. He can correct me on that.

Mr. MIGLIOZZI. Forza Migliozzi.

Mr. MCHENRY. Okay, I'm sorry. I have it written down wrong. But Professor Mercer Bullard is the associate professor of law at the University of Mississippi School of Law.

Thank you all for being here. It is the policy of the Oversight and Government Reform committee that all witnesses be sworn in, so if you will please stand and raise your right hands.

[Witnesses sworn.]

Mr. MCHENRY. Let the record reflect the witnesses answered in the affirmative. You may be seated.

So in order to have time for a discussion and questions if you could please keep your opening statement to 5 minutes. You'll see by the lights in front of you, green means go, yellow means whoa, and red means stop. Whoa is a technical term, I'm sorry to use that. But we will first begin with Ms. Cross, you are recognized for 5 minutes.

STATEMENTS OF MEREDITH CROSS, DIRECTOR, DIVISION OF CORPORATION FINANCE, SECURITIES AND EXCHANGE COMMISSION; DANA MAURIELLO, FOUNDER AND PRESIDENT, PROFOUNDER; JEFF LYNN, CHIEF EXECUTIVE OFFICER, SEEDRS LIMITED; SHERWOOD NEISS, COFOUNDER, FLAVORX; MICHEAL MIGLIOZZI, MANAGING PARTNER, FORZA MIGLIOZZI, LLC; AND MERCER BULLARD, ASSOCIATE PROFESSOR OF LAW, THE UNIVERSITY OF MISSISSIPPI

STATEMENT OF MEREDITH CROSS

Ms. CROSS. Chairman McHenry, Ranking Member Quigley and members of the committee. I'm pleased to testify on behalf of the Commission on the topics of crowdfunding and capital formation. The SEC's mission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.

As you know, Chairman Schapiro and I appeared before the Oversight and Government Reform committee in May to testify on the topic of capital formation. We noted that a critical goal of the SEC is to facilitate companies' access to capital while at the same time protecting investors. Companies of all sizes need cost effective access to capital to grow and develop. And the Commission recognizes that any unnecessary regulations may impede their ability to do that.

At the same time the Commission must seek to ensure that investors have the information and protections necessary to give them confidence they need to invest in our markets. Investor confidence and the fairness and honesty of our markets is critical to capital formation.

To further our goals a few months ago Chairman Schapiro instructed the staff to take a fresh look at some of our offering rules to develop ideas for the Commission to consider that may reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection. The staff is in the process of conducting that review, and in doing so, is considering the regulatory questions posed by new capital raising strategies, including crowdfunding.

Interesting crowdfunding as a capital raising strategy that could offer investors an ownership interest in developing business is growing. As you know, proponents of crowdfunding are advocating for exemptions from Securities Act registration requirements for

this type of capital raising activity in an effort to assist, early stage companies and small businesses.

The staff has been discussing crowdfunding among other capital raising strategies with business owners, representatives of small business industry organizations and State regulators. For example, the staff has met with the representatives of the Small Business and Entrepreneurship Council and from the North American Securities Administrators Association.

In addition, we anticipate that crowdfunding will be considered by the Commission's recently announced Advisory Committee on Small and Emerging Companies.

Current technology allows small businesses owners to easily reach a large number of possible investors across the country and throughout the world as a potential source of funding to help grow and develop their businesses or ideas. This source of capital and the ease with which an individual can communicate with potential investors presents an opportunity for smaller companies in need of funds. At the same time an exemption from registration and the investor protections that come from our disclosure requirements also could present an enticing opportunity for the unscrupulous to engage in fraudulent activities that could undermine investor confidence.

As a result in considering whether to provide an exemption from Securities Act registration requirements for capital raising strategies like crowdfunding, the Commission needs to be mindful of its responsibilities both to facilitate capital formation and protect investors.

In considering crowdfunding, some of the questions to consider include: Should certain minimum information be provided to investors? For example, should investors know the names of the entrepreneurs, a summary of the business plan, have a plan to use the money they raise? Should individuals or firms with a history of securities fraud violations be allowed to use the exemption? Should an SEC notice filing be required so that activities in these offerings could be observed? Should securities purchased be freely tradable? Should Web sites to facilitate crowdfunding investing be subject to regulatory oversight?

While the small amount of any potential crowdfunding investment should generally limit the extent of any individual's losses, these are issues that are among those the Commission would need to consider in connection with any future proposal.

In addition to looking at new capital raising strategies, including crowdfunding, at the chairman's request the staff is also looking at the triggers for when a company has to begin public reporting, the restrictions on general solicitation and private offerings and the rules governing communications in connection with public offering.

My written testimony provides an update on our efforts. We are committed to carefully considering these areas and developing thoughtful recommendations for the Commission consistent with the goals of facilitating capital formation and protecting investors.

Thank you for inviting me here today. I look forward to answering your questions.

[The prepared statement of Ms. Cross follows:]

Testimony on Crowdfunding and Capital Formation

by Meredith B. Cross
Director, Division of Corporation Finance
U.S. Securities and Exchange Commission

Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the U.S. House of Representatives Committee on Oversight and Government Reform

September 15, 2011

Chairman McHenry, Ranking Member Quigley, and members of the Subcommittee:

My name is Meredith Cross, and I am the Director of the Division of Corporation Finance at the Securities and Exchange Commission. I am pleased to testify on behalf of the Commission on the topics of crowdfunding and capital formation.

The mission of the Securities and Exchange Commission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. As you know, Chairman Schapiro and I appeared before the Oversight and Government Reform Committee in May to testify on the topic of capital formation. In her testimony, Chairman Schapiro noted that a critical goal of the SEC is to facilitate companies' access to capital while at the same time protecting investors. Companies of all sizes need cost-effective access to capital to grow and develop, and the Commission recognizes that any unnecessary or superfluous regulations may impede their ability to do that. At the same time, the Commission must seek to ensure that investors have the information and protections necessary to give them the confidence they need to invest in our markets. Investor confidence in the fairness and honesty of our markets is critical to the formation of capital, and the protections provided by the securities laws are critical to large and small company investors alike.

Over the years the SEC has taken significant steps, consistent with its investor protection mandate, to facilitate capital-raising by companies of all sizes and to reduce burdens on companies making offerings, be it through introducing or increasing eligibility for shelf registration or implementing small business reforms. Going forward, the Commission will continue to consider and, if appropriate, implement changes to its existing rules to reduce regulatory burdens while maintaining important investor protections provided under the securities laws.

Indeed, a few months ago, Chairman Schapiro instructed staff to take a fresh look at some of our offering rules to develop ideas for the Commission to consider that may reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection. The staff's review is focusing on a number of areas, including:

- the number of shareholders and other triggers for public reporting;
- the restriction on general solicitation in private offerings; and
- restrictions on communications in public offerings.

An additional area the staff is reviewing concerns the regulatory questions posed by new capital raising strategies, including crowdfunding. My testimony today will focus on crowdfunding, as well as the broader capital formation regulatory review we are undertaking at Chairman Schapiro's request.

Chairman Schapiro previously stated that the staff would seek input in a number of these areas from the Commission's Advisory Committee on Small and Emerging Companies, which the Commission at the time was in the process of forming. I can report that the

Commission recently announced the formation of this committee.[1] Its members represent a broad range of small and emerging companies, and investors in those types of companies, with real world experience under our rules. The advisory committee will provide a formal mechanism for the Commission to receive advice and recommendations about regulations that affect privately held and publicly traded small and emerging businesses. We look forward to working with the advisory committee and considering its views.

Crowdfunding – A New Capital Raising Strategy

A new method of capital raising that is gaining increasing interest is crowdfunding. Generally, the term "crowdfunding" is used to describe a form of capital raising whereby groups of people pool money, typically comprised of very small individual contributions, to support an effort by others to accomplish a specific goal. This funding strategy was initially developed to fund such things as films, books, music recordings, and charitable endeavors. At that time, the individuals providing the funding were more akin to contributors than "investors" and were either simply donating funds or were offered a "perk," such as a copy of the related book. As these capital raising strategies did not provide an opportunity for profit participation, initial crowdfunding efforts did not raise issues under the federal securities laws.

Interest in crowdfunding as a capital raising strategy that could offer investors an ownership interest in a developing business is growing. Proponents of crowdfunding are advocating for exemptions from the Securities Act registration requirements for this type of

[1] *See SEC Announces Formation of Advisory Committee on Small and Emerging Companies* (Sept. 13, 2011), http://www.sec.gov/news/press/2011/2011-182.htm.

capital raising activity in an effort to assist early stage companies and small businesses. For example, the Commission received a rulemaking petition requesting that the Commission create an exemption from the Securities Act registration requirements for offerings with a $100,000 maximum offering amount that would permit individuals to invest up to a maximum of $100.[2]

The staff has been discussing crowdfunding, among other capital raising strategies, with business owners, representatives of small business industry organizations, and state regulators. For example, crowdfunding was discussed at the Commission's November 2010 Forum on Small Business Capital Formation. In January, the staff met with a group from the Small Business & Entrepreneurship Council advocating an exemption from registration requirements for crowdfunding offerings meeting specific requirements. In addition, in March the staff discussed crowdfunding with representatives from the North American Securities Administrators Association, the organization of state securities regulators.

Current technology allows small business owners to easily access a large number of possible investors across the country and throughout the world as a source of funding to help grow and develop their businesses or ideas. This source of capital and the ease with which an individual can communicate with and access investors electronically presents an opportunity for smaller companies in need of funds.

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[2] Petition from Sustainable Economies Law Center to SEC (July 1, 2010), http://www.sec.gov/rules/petitions/2010/petn4-605.pdf. To date, the petition has received almost 150 comment letters, all in favor of the creation of such an exemption, with some offering different thresholds for offering size and/or individual investment limits. The comment letters are available at http://www.sec.gov/comments/4-605/4-605.shtml.

At the same time, of course, an exemption from registration and the investor protections provided thereby also would present an enticing opportunity for the unscrupulous to engage in fraudulent activities that could undermine investor confidence.[3] As a result, in considering whether to provide an exemption from the Securities Act registration requirements for capital raising strategies like crowdfunding, the Commission needs to be mindful of its responsibilities both to facilitate capital formation and protect investors.

The Commission's rules previously included an exemption, Rule 504, which allowed a public offering to investors (including non-accredited investors) for securities offerings of up to $1 million, with no prescribed disclosures and no limitations on resales of the securities sold.[4] These offerings were subject only to state blue sky regulation and the antifraud and other civil liability provisions of the federal securities laws. In 1999, that exemption was significantly revised due in part to investor protection concerns about fraud in the market in connection with offerings conducted pursuant to this exemption.[5] In assessing any possible exemption for crowdfunding, it would be important to consider this experience and build in investor protections to address the issues created under the prior exemption.

Some of the questions to consider with regard to crowdfunding include:

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[3] Note that the antifraud provisions of the federal securities laws continue to apply to any offering or sale of securities, even if an exemption from registration applies. In Fiscal Year 2010, offering frauds – cases where promoters, issuers or others defraud investors in the offer of securities – comprised 22 percent of the Commission's cases.

[4] *See* Release No. 33-6949, *Small Business Initiatives* (July 30, 1992), http://www.sec.gov/rules/final/6949.txt.

[5] *See* Release No. 33-7644, *Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption* (February 25, 1999), http://www.sec.gov/rules/final/33-7644.txt (referencing "disturbing developments" in, among other things, initial Rule 504 issuances).

- what information – for example, about the business, the planned use of funds raised, and the principals, agents, and finders involved with the business – should be required to be available to investors;
- what restrictions should there be on participation by individuals or firms that have been convicted or sanctioned in connection with prior securities fraud;
- should a Commission filing or notice be required so that activities in these offerings could be observed;
- should securities purchased be freely tradable; and
- should websites that facilitate crowdfunding investing be subject to regulatory oversight?

Although the business venture may have a well formulated plan and a committed entrepreneur, potential investors may have little information about the plan, its execution, or the entrepreneur behind the business. Investments in small businesses can be open to opportunism created by this information asymmetry. Sophisticated investors generally negotiate protections for themselves and may provide their funding over time to protect their investment, but due to the nature of crowdfunding ventures, crowdfunding investors may have limited investment experience, limited information upon which to make investment decisions, and almost no ability to negotiate for protections. While the small amount of any potential crowdfunding investment should generally limit the extent of any individual's losses, these issues are among those that would need to be considered as a part of the cost-benefit analysis that the Commission would consider in connection with any future proposal.

As mentioned, the staff is reviewing crowdfunding and other capital raising strategies at Chairman Schapiro's request. The Chairman also has stated that the Commission's recently formed Advisory Committee on Small and Emerging Companies will

be asked to assess these issues. We fully expect that the input from the advisory committee, as well as the input we receive from the public, will be helpful to the Commission as it considers these matters.

Update on Review of Certain Offering Regulations

Given the Subcommittee's interest in capital formation matters, I also would like to provide an update on the staff's review of our regulations relating to the triggers for public reporting, the restrictions on general solicitation, and communications in connection with public offerings.

Triggers for Public Reporting

Chairman Schapiro asked the staff to review the triggers for public reporting and the characteristics of companies that should be subject to public reporting obligations. Section 12(g) of the Exchange Act, which sets forth certain registration requirements for securities, was adopted in 1964 following a rigorous special study of the securities markets in the early 1960s, commissioned by Congress and conducted by the Commission.[6] The study included a survey of over 2,000 issuers that sought data from these issuers on, among other things, asset

[6] *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 88-95, pt. 3 (1963). According to the Committee Report summarizing the results of the study:

> There is no convincing reason why the comprehensive scheme of disclosure that affords effective protection to investors in the exchange markets should not also apply in the over-the-counter market. . . . [B]ecause the over-the-counter market includes not only securities of widely known and seasoned companies but also those of relatively unknown and insubstantial ones, the need of investors for accurate information is at least as great, if not greater than in the exchange markets.

S. Rep. No. 88-379, at 9 (1963).

levels, their securities offerings, shares outstanding, stockholders of record, and the number of shares held by large shareholders. The data derived from the study was critical in developing the most appropriate metrics upon which to base the triggers for public reporting given the nature of the companies and the shareholders that would be impacted.

Section 12(g) requires a company to register its securities with the Commission, within 120 days after the last day of its fiscal year, if, at the end of the fiscal year, the securities are "held of record" by 500 or more persons and the company has "total assets" exceeding $10 million.[7] Shortly after Congress adopted Section 12(g), the Commission adopted rules defining the terms "held of record" and "total assets."[8] The definition of "held of record" counts as holders of record only persons identified as owners on records of security holders maintained by the company, or on its behalf, in accordance with accepted practice. As such, this definition simplified the process of determining the applicability of Section 12(g).[9]

Of course, securities markets have changed significantly since the enactment of Section 12(g) and the Commission's adoption of the definition of "held of record." Today, the vast majority of securities of publicly-traded companies are held in nominee or "street name" rather than directly by the owner. This means that the brokers that purchase securities on behalf of investors typically are listed as the holders of record. One broker may own a

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[7] *See* Exchange Act § 12(g)(1); Exchange Act Rule 12g-1. When Section 12(g) was enacted, the asset threshold was set at $1 million. The asset threshold was most recently increased to $10 million in 1996. Release No. 34-37157, *Relief from Reporting by Small Issuers* (May 1, 1996), http://www.sec.gov/rules/final/34-37157.txt.

[8] *See* Release No. 34-7492, *Adoption of Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934* (January 5, 1965).

[9] *See id.*

large position in a company on behalf of thousands of beneficial owners, but because the shares are all held in street name, those shares count as being owned by one "holder of record." This change in the way securities are held means that for most publicly-traded companies, much of their individual shareholder base is not counted under the current definition of "held of record." Conversely, the shareholders of most private companies, who generally hold their shares directly, are counted as "holders of record" under the definition. This has required private companies that have more than $10 million in total assets and that cross the 500 record holder threshold – where the number of record holders is actually representative of the number of shareholders – to register and commence reporting. At the same time, it has allowed a number of public companies, many of whom likely have substantially more than 500 shareholders, to stop reporting, or "go dark," because there are fewer than 500 "holders of record" due to the fact that the public companies' shares are held in street name. In light of these issues, some have called for changes to the definition and threshold adopted pursuant to Section 12(g).

The Commission has exercised its exemptive authority in the past to adjust the application of Section 12(g).[10] For example, in 2007, the Commission adopted Rule 12h-1(f) under the Exchange Act, which provides an exemption from the held of record threshold for compensatory stock options. This exemptive rule allows private companies to provide

[10] Exchange Act Section 12(h) provides the Commission broad authority to exempt issuers from the registration requirements of Section 12(g) so long as the Commission finds that the action is not inconsistent with the public interest or protection of investors. The Commission has previously relied on Section 12(h) to raise the total assets threshold. Additionally, Congress has provided the Commission broad exemptive authority in Section 36 of the Exchange Act. The Commission has previously established exemptions from the Section 12(g) requirement and Section 12(g) provides the Commission with authority to define the terms "held of record" and "total assets." *See* Exchange Act Rule 12g3-2 and Exchange Act § 12(g)(5).

compensatory stock options to employees, officers, directors, consultants and advisors without triggering the need to register those options under the Exchange Act.[11]

A variety of proponents have advanced a wide range of proposals relating to possible amendments to Section 12(g) reporting standards. Some of these proposals seek to reduce the number of issuers required to report pursuant to the Exchange Act, for example, by raising the shareholder threshold,[12] by excluding employees, or by excluding accredited investors, qualified institutional buyers ("QIBs") or other sophisticated investors from the calculation.[13] Bills have been proposed in the House and Senate that would seek to address many of these issues, including several seeking to increase the threshold with respect to community banks.[14] Conversely, the Commission has received a rulemaking petition requesting that the Commission revise the "held of record" definition to look through record holders to the underlying beneficial owners of securities that would prevent issuers from ceasing to report in certain circumstances.[15]

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[11] Release No. 34-56887, *Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934* (December 3, 2007), http://www.sec.gov/rules/final/2007/34-56887.pdf. The staff of the Division of Corporation Finance also issued a no-action letter saying that it would not recommend an enforcement action to a company that issued restricted stock units due to the similarities between them and stock options. *See Facebook, Inc.* (October 14, 2008).

[12] In a November 12, 2008 letter, the American Bankers Association made the argument that the 500-shareholder threshold should be increased to reduce the regulatory hardship suffered by small community banks. *See* Comment Letter from American Bankers Association to SEC (November 12, 2008), http://www.sec.gov/rules/petitions/4-483/4483-21.pdf.

[13] *See 2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report* (May 2010), http://www.sec.gov/info/smallbus/gbfor28.pdf.

[14] *See* H.R. 2167, 112th Cong. (2011); S. 556, 112th Cong. (2011); H.R. 1965, 112th Cong. (2011); and H.R. 1697, 112th Cong. (2011).

[15] On February 24, 2009, the Commission received a rulemaking petition urging the Commission to count beneficial owners instead of record holders to prevent companies with large numbers of holders from exiting the reporting system. *See* Petition from Lawrence Goldstein to SEC (February 24, 2009), http://www.sec.gov/rules/petitions/2009/petn4-483-add.pdf. This followed an earlier, similar petition. *See*

As stated, the securities markets have gone through profound changes since Congress added Section 12(g) to the Exchange Act. To facilitate the Commission's review of the issues related to the thresholds for public reporting (and those for leaving the reporting system), the staff is undertaking a robust study like the one conducted when Section 12(g) was enacted. The study is seeking to determine whether the current thresholds and standards effectively implement the Exchange Act registration and reporting requirements and what it means to be a "public" company such that an issuer should be required to register its securities and file with the Commission. The staff has begun a detailed analysis of public company information – including numbers of record and beneficial owners, total assets, and public float – to assess the characteristics of public companies. The study also will seek to obtain and consider private company information to assess current reporting thresholds. To the extent that the staff develops recommendations or proposals regarding changes to the reporting thresholds for the Commission's consideration, the consequences of any such proposed change will be subject to careful assessment as to the impact on investor protection and capital formation and the other costs and benefits of any proposed change.

Restriction on General Solicitation

Chairman Schapiro also asked staff to review the restrictions our rules impose on communications in private offerings, in particular the restrictions on general solicitation.

Petition for Commission Action to Require Exchange Act Registration of Over-the-Counter Equity Securities (July 3, 2003), http://www.sec.gov/rules/petitions/petn4-483.htm.

One of the most commonly-used exemptions from the registration requirements of the Securities Act is Section 4(2), which exempts transactions by an issuer "not involving any public offering." Currently, an issuer seeking to rely on Section 4(2) is generally subject to a restriction on the use of general solicitation or advertising to attract investors for its offering.[16] The restriction was designed to protect those who would benefit from the safeguards of registration from being solicited in connection with a private offering.

The Commission and staff have acted to facilitate capital raising in private offerings by adopting safe harbor rules, such as Rule 506, and providing guidance with respect to the scope of Section 4(2) and the restriction on general solicitation and advertising. Recognizing the increased use of the Internet and other modern communication technologies in private offerings, the staff has issued no-action letters providing issuers with flexibility to use modern communication technologies without the staff recommending enforcement action regarding the general solicitation restriction.[17]

Notwithstanding these efforts, the restriction on general solicitation is cited by some as a significant impediment to capital raising.[18] We understand that some believe that the

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[16] *See* Rule 502(c) of Regulation D and Release No. 4552, *Non-Public Offering Exemption*, (November 6, 1962).

[17] *See, e.g.*, IPONET (July 26, 1996) (general solicitation is not present when previously unknown investors are invited to complete a web-based generic questionnaire and are provided access to private offerings via a password-protected website only if a broker-dealer makes a determination that the investor is accredited under Regulation D); Lamp Technologies, Inc. (May 29, 1998) (posting of information on a password-protected website about offerings by private investment pools, when access to the website is restricted to accredited investors, would not involve general solicitation or general advertising under Regulation D).

[18] *See, e.g.*, *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission* (April 23, 2006), http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf; Joseph McLaughlin, *How the SEC Stifles Investment – and Speech*, The Wall Street Journal (February 3, 2011). Concerns about the scope of the Commission's rules on general solicitation and advertising have been raised by the participants in the annual SEC Government-Business Forum on Small Business Capital Formation. *See*

restriction may be unnecessary because offerees who might be located through a general solicitation but who do not purchase the security, either because they do not qualify under the terms of the exemption or because they choose not to purchase, would not be harmed by the solicitation.[19] In addition, some have questioned the continued practical viability of the restriction in its current form given the presence of the Internet and widespread use of electronic communications. At the same time, others support the restriction on general solicitation on the grounds that it helps prevent securities fraud by, for example, making it more difficult for fraudsters to attract investors or unscrupulous issuers to condition the market.[20]

We believe it is important to consider both of these views about the need for the restriction on general solicitation in private offerings when considering possible revisions to our rules. In analyzing whether to recommend changes to the restriction, the staff is considering next steps, including a possible concept release for the Commission to seek the public's input on the advisability and the costs and benefits of retaining or relaxing the restrictions on general solicitation. The Commission could seek views from all interested parties on a number of issues related to the restriction on general solicitation, including specific protections that could be considered if the restriction is relaxed and the types of

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2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report (May 2010), http://www.sec.gov/info/smallbus/gbfor28.pdf.

[19] *See Pinter v. Dahl*, 486 U.S. 622, 644 (1988) ("The purchase requirement clearly confines §12 liability to those situations in which a sale has taken place. Thus, a prospective buyer has no recourse against a person who touts unregistered securities to him if he does not purchase the securities.").

[20] *See, e.g.*, J. William Hicks, Exempted Transactions Under the Securities Act of 1933 § 7:160 (2d ed. 2002); Comment Letter from Investment Companies Institute to SEC (October 9, 2007), http://www.sec.gov/comments/s7-18-07/s71807-37.pdf (warning that unlimited general solicitation would "make it difficult for investors to distinguish between advertisements for legitimate offerings and advertisements for fraudulent schemes").

investors who would be most vulnerable if it is relaxed. The staff also will seek input from the Advisory Committee on Small and Emerging Companies. Of course, in considering whether to recommend that the Commission make changes to the rules restricting general solicitation, we will remain cognizant of our investor protection mandate.

Communications in Public Offerings

We also are assessing our rules, and the regulatory burdens they impose, with respect to communication in public offerings. Over the years, the Commission has taken steps to facilitate continued communications around public offerings. For example, as early as 1970, the Commission adopted safe-harbor exemptions to make it clear that continued analyst research coverage does not constitute an unlawful offer.[21] In 2005, the Commission significantly reformed the registration and offering process by adopting a comprehensive set of rules and amendments to facilitate capital raising and relax restrictions on communications by issuers during the registered offering process.[22] These changes significantly liberalized the rules governing communications by the largest issuers during public offerings, thereby allowing more information to reach investors. The staff is reviewing the rules relating to communications in public offerings to consider whether any of the liberalizations adopted in 2005 should be adapted for smaller public companies, including whether more companies should be able to use free writing prospectuses before a substantially complete prospectus is

[21] *See* Release No. 33-5101, *Adoption of Rules Relating to Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Filing of a Registration Statement Under the Securities Act of 1933* (November 19, 1970).

[22] *See* Release No. 33-8591, *Securities Offering Reform* (July 19, 2005), http://www.sec.gov/rules/final/33-8591.pdf.

filed. As a result of this review, the staff may recommend proposed changes to the offering rules, or recommend that the Commission seek additional input through the issuance of a concept release.

Conclusion

In considering possible revisions to the Commission's rules, it is critically important that the staff gather data and seek input from a wide variety of sources, including small businesses, investor groups, and other members of the public. The data and input the staff receives should aid in the development of thoughtful recommendations for the Commission consistent with the goals of facilitating capital formation and protecting investors.

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.

Mr. MCHENRY. Thank you.
Ms. Mauriello.

STATEMENT OF DANA MAURIELLO

Ms. MAURIELLO. Good morning, Chairman McHenry, Ranking Member Quigley. Thank you for having me here this morning. My name is Dana Mauriello. I'm cofounder and president of ProFounder, which I started with my cofounder, Jessica Jackley, who is also the founder of Kiva, one of the first peer-to-peer microlending sites.

We started in August 2009 a platform to allow entrepreneurs to raise investment capital from their communities.

One of case studies that we saw that inspired us to start this business was two of our classmates at the Stanford Graduate School of Business that had a new technology startup that they were beginning, and they were looking to the classmates to see if those classmates wanted to contribute investment capital. We are a very tight community, about 350 students. So we know each other well after 2 years of being in class together. And within 24 hours 60 people in that class said they wanted to put in the $1,000 cap that those entrepreneurs had set to invest. This seems like a beautiful story, but unfortunately their lawyers let them know that this was impossible, in their words. And when the entrepreneurs pressed, as entrepreneurs tend to do, they found out that it was "impossible because those investors were unaccredited."

We had student debt, we did no meet the accreditation requirements. There were also more people than their lawyers felt could contribute. The entrepreneurs pushed and eventually lawyers came back with Reg D 506, which would allow 35 of those investors to contribute that $1,000 minimum.

That answer took 4 months and $20,000 to achieve. That was an incredible inefficiency that Jessica and I witnessed. And that's what really got us thinking about how could this be possible that an entrepreneur with a great idea, and a community that has the capital and wants to support them, would have something standing in the way of being able to meet each other. And looking back at my own personal history with small family businesses, none of them would have gotten off the ground if not Uncle Joe and Uncle Gene and a lot of other friends and family members contributing. So this seemed like a very logical answer.

So we started ProFounder with the vision of allowing businesses to access capital and access resources that supported their community. The solution that we came to after a year of legal research with many counsels was Regulation D 504, a Securities exemption that allows entrepreneurs to raise the capital if it is less than a million dollars. It is coming from people you have a substantial preexisting relationship with, and you follow state-by-state Blue Sky laws.

Here's how we did that. Entrepreneurs came to our platform, created a pitch, they created their term sheets. We offered two term sheet templates, either equity or revenue share. It could have been anything that was a security. And then we had a compliance calculator that allowed entrepreneurs to say here are the people who I want to invite. And we would spit out here are the laws, here are

the notice filings, here are the filing fees that you need to pay. And that was no easy task because these Blue Sky laws, which are different in every State, are completely interdependent on each other as well. You have one investor from Connecticut, you can only have 10 investors in Colorado. So that was a bear to both navigate, make a technical solution for and explain to our entrepreneurs, but we did.

We had some amazing success stories that I'm very proud to share. Bronson and the Chang family in Honolulu, they were able to open their second shaved ice store by raising $54,000 from 19 investors that included Bronson's freshman year roommate at USC, their best customers at the shop, and all of their friends and family.

Mark at Cubic Motors was able to start a motorcycle company in San Francisco with the help of his fellow motorcycle enthusiast friends to raise $50,000 from 16 investors that all got these businesses started and off the ground. They are now raising additional rounds of capital. At least two of our entrepreneurs have gone on to raise additional capital now.

We also faced challenges, we faced a lot of challenges. And the one that I'm most eager to talk about as an expert here is the challenges that these companies like ours that are facilitating crowdfunding face and how those challenges can be alleviated. We were approached by the Department of Corporations of the State of California to investigate our operations, and they came to the conclusion after months of conversation that we needed to be a broker-dealer to be facilitating these transactions on the site because we were providing form templates, because we had term sheets that people could take advantage of on the site.

Whatever regulations ultimately goes into place for crowdfunding I think it is critical to consider what can be done for companies like ours to help facilitate. If we need to be broker-dealers there is no way that we can help the small entrepreneurs like Bronson and his family's shaved ice shop in Honolulu because these due diligence requirements on us will be too high and too onerous for us to be able to serve that smaller client who has the greatest potential to really make a difference, create jobs and spur the economy.

Furthermore, another problem that we faced was definitions. There with a no clear definition for us of friends and family, of substantial preexisting relationship. There was no definition of sophisticated investor. Because of this lack of definitions it made the law extremely difficult to implement. And it made it very difficult for the counsel of the entrepreneurs that we were working with to get on board and feel comfortable with these changes.

In conclusion, thank you for having me here today and I look forward to answering your questions.

[The prepared statement of Ms. Mauriello follows:]

Written Testimony of Dana Mauriello, Co-Founder and President of ProFounder, to the Committee on Oversight and Government Reform U.S. House of Representatives, Sub-Committee on TARP and Financial Services

"Crowdfunding: Connecting Investors And Job Creators"

SEPTEMBER 15, 2011

Good afternoon Chairman McHenry, Ranking Member Quigley and members of the committee. My name is Dana Mauriello. I am the Co-founder and President of ProFounder, which is an online platform for entrepreneurs to raise investment capital from their communities. In your invitation letter, you asked me to address how crowdfunding can become a viable means of capital formation. I am grateful for the opportunity to present my views on crowdfunding this morning.

First, I will provide an overview of the current crowdfunding landscape and provide my views on why crowdfunding is a critical tool for capital formation. Second, I will describe ProFounder, including its legal framework and features as well as the challenges that we faced in creating a crowdfunding product while remaining compliant with current regulation. Finally, I will suggest regulatory changes that should be made to facilitate crowdfunding while also maintaining a high level of investor protection.

My Background and the ProFounder History

I started ProFounder with Jessica Jackley in August 2009 out of a desire to give entrepreneurs access to the resources that they need to succeed. I was first exposed to entrepreneurship through my experience with my family's businesses. My father taught me early on that there is no problem you can't solve with ingenuity and hard work--a mantra that I consider to be at the very core of the American entrepreneurial spirit. In first grade, I found that when I tried to rip pages out of my workbooks they came out torn and messy, so I invented a "Page Helper" to solve this problem and my family helped me to produce them and create a business plan. That was my start and from there, I had the opportunity to be involved with the numerous business ventures that arose from dinnertime conversation and basement tinkering -- from exercise equipment to baked goods manufacturing. The first bit of

start-up capital always came from Uncles, Aunts, and friends who believed in us and what we were doing. Our story is one that I now know is repeated across dinner tables and basements the country over.

While attending the Stanford Graduate School of Business, I met my now-co-founder, Jessica Jackley, and we started a dialogue about how to bring entrepreneurial resources to small business entrepreneurs far from Silicon Valley. Jessica also founded KIVA, the first peer- to- peer microfinance site in 2005. KIVA is widely recognized as a pioneering financial technology organization and has facilitated over $241 million in loans to entrepreneurs in 216 countries including the United States.

The idea for ProFounder came to us when we saw two classmates who were starting a business get investment interest from dozens of fellow classmates. When these entrepreneurs asked their lawyers to structure this investment deal, they were told that it is impossible for their classmates to invest even $1K each because they are unaccredited investors. When pushed, the lawyers spent months and tens of thousands of dollars to structure a deal that would include only 35 of these classmates. We were struck by the incredible inefficiency of this arrangement; available capital existed in the community, but there were tremendous legal and administrative barriers to accessing it.

Jessica and I started ProFounder to solve this market inefficiency and make it possible for entrepreneurs to unlock the capital in their communities. We called this method of financing "community funding," and created a platform that allowed entrepreneurs to utilize their social networks for investment capital in a way that is be simple, inexpensive, efficient, and legally compliant for all involved.

We chose to focus our efforts on supporting small businesses in America because we feel that these businesses have the most limited resources, but limitless ideas and potential to create innovation and economic value.

To date we have enabled 19 companies to complete 21 fundraising rounds for a total of over $612K raised from 356 investors. Our success cases include entrepreneurs like Bronson Chang who raised $56K from 19 classmates, customers, family, and friends to expand his family's candy shop in Hawaii and Raaja Nemani who raised $60K from 37 classmates, friends, and family to start a now-thriving sneaker business.

The Crowdfunding Option

a) Definitions and Landscape

Crowdfunding refers to the process of many people contributing small dollar amounts which, in aggregate, meet the financial goal of a project. In this section, I will outline the services that the most influential technology companies in this industry provide, and the legal frameworks that they employ. Note that crowdfunding also happens infrequently offline through Reg D, Reg A, and co-op structures and I am not considering those offline pathways in this overview.

KIVA, founded in 2005 by my co-founder, Jessica Jackley, was the first peer-to-peer lending site. KIVA provides an online marketplace where microfinance institutions can list businesses from their portfolios seeking loans, and individuals can contribute to the loan in $25 increments with the intention that they will be repaid their principal with no interest. Loans made on the site are not considered securities because there is no financial upside for the lender and KIVA is a non-profit that does not profit from the transactions. Prosper, also a peer-to-peer lending site, facilitates personal loans to individuals that are repaid at a fixed rate of interest. The loan products on Prosper (unlike on KIVA) are registered securities.

IndieGoGo (www.indiegogo.com), launched in 2008, provides a marketplace where donors offer capital and receive goods and services in return. An example of a typical project on IndieGoGo might be an author raising $5K to self-publish his book, asking for individuals to contribute $25 toward his goal to receive a signed copy of the book in return. Kickstarter (www.kickstarter.com) and almost 200 other sites have since launched to provide similar services. Kickstarter, IndieGoGo, and others do not facilitate investments; the capital contributed is not an investment, will not generate financial return, and will not generate a non-financial return that is dynamic depending on the success of the business. To avoid falling under the purview of state and federal securities regulators, these sites ensure that the reward for a financial contribution is limited to a good or service with a fixed value or to nothing at all.

Note that none of these crowdfunding sites allow for businesses to offer investments / transact securities. This biggest hurdle that prevents them from doing so is the prohibition of general solicitation. To a lesser degree, these sites are also thwarted by other regulatory hurdles such as: the restrictions on the involvement of unaccredited investors (Reg D 506), limits on the number of investors who can be involved in an offering (Reg D), extensive disclosure requirements (Reg A), state-by-state blue sky laws (Reg D 504), and requirements for broker dealer registration.

The last notable addition to the crowdfunding landscape is Angel List (http://angel.co/), launched in 2010 to connect accredited investors with start-ups looking for capital. They gained notoriety because of their careful curation of deals and the social validation tools that they employ to keep the network of investors and entrepreneurs very high caliber. I consider Angel List a crowdfunding innovation because it is an online platform that connects both sides of the financial marketplace. They have navigated legal barriers by only working with accredited investors, not advertising deal terms, and not charging any fees.

b) Why crowdfunding matters

It is important that crowdfunding exist because it democratizes access to start-up capital. Capital exists in people's communities and it just can't be accessed. Anyone who is bright, driven, and has a great idea can gather a supportive community around himself. Crowdfunding allows that entrepreneur to turn his community into a capital source.

Businesses that do not qualify for bank loans can get capital via crowdfunding because the crowd is using different decision making criteria than the bank. Whereas a bank looks at collateral and balance sheets, the community makes a decision based on personal knowledge of the entrepreneur's character and their affinity for her product. In addition to different decision making criteria, definitions of success are also very different for either party. Whereas banks evaluate the success of a loan solely on full, timely repayment at the market interest rate, the community may consider an investment successful if they recoup their principal, feel the pride of being a part of something, and get exclusive perks. For example, community members invest in local restaurants, not to get rich, but to be able to tell their friends that they are investors and ensure that their corner table is always waiting for them with their favorite drink on the house.

Similarly, business that can't access angel capital are often successful with the crowd. Angel investors are usually geographically focused (major metropolitan areas) and industry focused (technology). For the entrepreneur starting a vegan bakery outside of DeMoines, her options for angel capital are slim to none as neither the geography nor the industry is a typical fit. However, she is more likely to find success in raising capital from vegan neighbors in her DeMoines suburb who are eager to patronize her new establishment once it opens. This is a classic example of fan dynamics.

Crowdfunding is not a last resort, it is a strategic choice. For example, Marc raised $50K for his motorcycle business from 16 investors in his community via ProFounder and by pursuing this funding path, Mark could include motorcycle enthusiasts among his investors. These investors could provide tremendous signaling value to future investors and customers and help with marketing by using his bikes at high profile events.

Crowdfunding programs that center around community investment also have strong, inherent investor protection. If an entrepreneur's community invests in her, the repetitional consequences of her defrauding them are very strong. For example, Jared raised $41K from 17 investors via ProFounder to open Fargo Brewing Company. If Jared ran with that money, many of his relationships would be ruined and his reputation would be so decimated that he'd never be able to show his face in Fargo again. On the other hand, if Jared was unscrupulous and he obtained funding from an anonymous institution across the country, he would have relatively weak incentives to repay and absolutely no incentive to exercise generosity above what is required of him.

Crowdfunding keeps money within communities, making the entire community richer and more economically stable. This applies to physical communities and ideological communities alike. For example, if I invest in my local deli, I am very likely to also contribute to increasing their revenue by eating there more often and telling my friends to eat there as well. When the deli does well, I can use my gains to then also invest in the local nail salon. The successful deli will also spend more money in the community, hiring new employees and contracting with the local printer. Another example: I invest in another woman owned business because I want to support women entrepreneurs. When the venture succeeds, I get a financial reward and my capital gains buoy the aggregate economic success of my community of women. The entrepreneur that I invested in now has money (and inspiration) to make an investment of her own in another women-led business and continue the cycle that I began.

The ProFounder Solution

a) Legal Structure

When Jessica and I created ProFounder, our aim was to create a solution for entrepreneurs to effectively and efficiently access capital from their communities. Our biggest hurdle was navigating a very complex legal environment and we spent a year working with numerous law firms, partners, and supporters to find an appropriate legal framework to meet our goals. The first conclusion that we reached was that it is important that entrepreneurs be able to offer their investors a

financial return. We felt that this was the fairest arrangement that honored the risk that investors would be taking on the venture. We also felt that a financial return was particularly important to offer given the significant individual investment amounts that we anticipated would be necessary to meet the high ($50K+) investment goals on our platform. Offering a financial return makes the investment contract a security. Finally, we realized that entrepreneurs did not have the time or resources to register their securities offering, so finding an appropriate exemption from registration was necessary. We eliminated Regulation A because we felt that the disclosures and pre-filing were too onerous to be feasible for small businesses. We also got feedback from state regulatory bodies that Reg A offerings are so rare that the required pre-approval in each state is lengthy and onerous. We instead identified Regulation D, Rule 504 as an appropriate solution for our entrepreneurs because

- Most small businesses need less than $1M in financing
- We wanted to be able to include any potential investor; including those who are unaccredited/ unsophisticated.
- The investors who are most likely to invest in a small business are those who know the entrepreneur; in other words those who share a "substantial, pre-existing relationship" with the entrepreneur
- Blue sky laws can be easily deciphered and automated with technology

We later choose to offer a Regulation D, Rule 506 compliance structure as well.

b) Product Features

With this regulatory structure in mind, we created an online platform that had the following features for entrepreneurs:

1. Prepare for Investment
   Plan investor outreach and see relevant compliance implications for your investor pool (unaccredited investors from all 50 states). Chose between basic (504) and enhanced (506) compliance engines. Our site takes into account dynamic state-by-state interactions caused by blue sky laws.
2. Create your Pitch
   Simple, interview-style pitch creation process for a simple, clear, transparent end product that can be shared to ensure that investors are fully informed and knowledgable about the offering.
3. Create your Offer Terms
   Customize revenue- share or equity term sheet templates.
4. Publish your Fundraising Website
   Pitch and term sheet are presented together in a private fundraising website created for your business

5. Invite your Community to Invest
   Send emails to your community through the ProFounder app inviting them to view your private fundraising website, keep a record of emails sent, and see analytics on their impact. All invitations sent contain a unique link created exclusively for the recipient of the email that can not be forwarded or shared. Compliance is further ensured by requiring that all issuers confirm that they have a substantial, pre-existing relationship with the issuer before being able to view the offering.
6. Receive Pledges for Funding from Investors Directly on your Website
   Investors can pledge an investment electronically on your fundraising website
7. Manage the Collection of Funds
   Disseminate information about how to send funds and track incoming cash
8. Sign all Investment Documents Electronically
   E-signatures of term sheets and related documents for you and your investors
9. Receive Compliance Information
   Get information on necessary filling documents and fees to be submitted after you receive your funds
10. Manage Payments to Investors
    Calculate payouts due to investors per your investment contract/ term sheet

We monetized our services by (1) charging entrepreneurs a flat fee of $100 to publish their fundraising page and (2) charging entrepreneurs a flat fee of $1000 to service their contracts. Servicing a contract involved generating an investment contract that was customized by each entrepreneur, facilitating e-signatures of the term sheets, and document storage among other basic administrative services. We made the choice not to charge commissions or otherwise involve ourselves directly in the transaction to steer clear of Broker Dealer registration and responsibilities.

We began serving entrepreneurs in September of 2010 with a small, private pilot and launch publicly in December 2010. Since that time we have enabled 19 companies to complete 21 fundraising rounds for a total of over $612K raised. These companies engaged a total of 356 investors in their fundraising. The average raise size was $29K, the average investment per investor was $1,700 and the average number of investors per raise was 17.

At its peak in May 2011, our business employed 8 full time employees, 1 part time employee, and a variety of contractors.

c) Challenges Faced

- Broker Dealer Issues: We were approached by the California Department of Corporations in February 2011 to provide more information on the legal structure of our business. Conversations continued in a productive manner for a number of months, until June 2011 when the DOC determined that we needed to have a broker dealer license to continue to facilitate the transaction of securities online. This determination was based on the assertion that we were engaged in the negotiation of deals given that we provided templates for term sheets that entrepreneurs could customize and take advantage of, had at one time been involved in handling customer funds, and provided automated legal compliance support. We decided to enter into a consent agreement with the DOC, not pursue a Broker Dealer license, and remove the feature on our site that allowed for securities to be transacted (ie, publishing a private fundraising site, invite investors, and accepting pledges online). Our product still meets the same need of facilitating community-funding, the difference is that it is now a free DIY tool kit.
- Lack of Clear Definitions: Our compliance structured relied on restrictions around general solicitation, sophisticated investors, and investors with whom the entrepreneurs has a substantial pre-existing relationship. Unfortunately, none of these terms has a clear definition, so these concepts were challenging to implement in practice and we had to error on the side of excess caution in the face of ambiguity. Even at that, the entrepreneurs using our platform, and especially their lawyers, were hesitant about employing a structure that engaged these under-defined concepts and often felt more comfortable sticking to more traditional solutions (ie, accredited investors only).

Suggested Regulatory Changes

I am very cognizant of the risks involved in opening the opportunity to invest in unregistered securities offered by private companies to the general public and I respect the caution that is being exercised around this issue. Below I outline the key features of a regulatory change that would enable entrepreneurs to raise investment capital from their communities while taking precautions to protect investors and prevent fraud.

Note: While I have not yet seen the crowdfunding bill proposed by Chairman McHenry at the time of writing this testimony, I have been informed of the major provisions that he intends to include and I have structured my thoughts based on these provisions.

Points 1-2: Necessary pre-conditions for new businesses to be started that will facilitate these crowdfunding transactions

1. National Pre-Emption

Federal law should trump state law in this new regulatory area, for simplicity of compliance and so that solution can be standardized. Only once the process is standardizable, can online platforms be created to facilitate this process in a scalable way. And only once this process is scalable can these business facilitate a high volume of small deals for the mass small business market.

2. No Broker-Dealer Requirements

Currently, any platform that facilities the transaction of securities is required to obtain a Broker Dealer license. This is overly restrictive for start-ups wanting to facilitate crowdfunding. The rule change should include a clause stating that if the facilitating entity does not have a salesman stake in deals (ie, no commissions, no selective marketing of investment opportunities or endorsements), it is considered a hands-off marketplace and does not require licensing. This is a critical component of any new legislation because the broker dealer requirement creates a massive barrier to entry for new businesses looking to innovate in this industry. Furthermore, broker dealers are required to conduct extensive due diligence on issuers and purchasers and, due to this expense, it is cost prohibitive for them to facilitate the offerings of small businesses looking for minimal dollar amounts. While a $100K deal might be meaningless to a typical broker dealer, that is the size of the deals that have the ability to really jump start new business creation and growth. Lastly, if there is any general solicitation allowed in this proposed rule change, there is no longer a role for the broker dealer to play in the vetting of opportunities.

<u>Points 2-3: Critical characteristics for the bill to be usable in practice for entrepreneurs</u>

3. 500 shareholder limit

I propose allowing an unlimited number of investors into crowdfunding deals, as long as the company does not exceed the 500 shareholder limit. I understand that bills are pending to increase this shareholder limit, as primarily motivated by ensuring that employee stock issues and secondary trades are not limited, and I am fully in favor of that change, however I don't feel that it is necessary to implement that increase solely for crowdfunding to be successful. In fact, we have found that there is a natural limit to the number of investors that an entrepreneur can include based on the sheer human effort required to make the sales (effort which we have found that technology cannot eliminate). This natural limit also arises because many entrepreneurs are cognizant about not including so many shareholders that future investors are turned off from participating. Since, as we learned, people want to invest personally meaningful amounts ($1700 on average per investor via ProFounder), thousands of investors are not necessary to achieve financial goals.

4. "General solicitation"

General solicitation is currently defined as seeking interest from the general public for an offering through mass communication and this is prohibited for all unregistered securities offerings. The spirit of this law is to ensure that false claims about an offering can not be spread to unknowing potential investors. However, given its current definition, general solicitation serves to create unreasonable barriers for businesses to share information about an offering with even a close community of potential purchasers. A more balanced definition of general solicitation would state that issuers can publicly advertise offerings with appropriate disclosures, given that the opportunity to purchase the securities is only open to qualified purchasers (described below).

Points 5-9: Investor protection clauses.

5. Qualified Purchasers

While I am proposing that issuers be able to general solicit by sharing offering information, I would like to balance that with investors protection pertaining to who is qualified to purchase said securities. Specifically, I can identify three groups of individuals who should be able to purchase because they will be most well informed and able to make an educated decision about the opportunity: those who are sophisticated, those who know the entrepreneur, and those who are local to the (bricks and mortar) business.

a) "Sophistication" - Sophisticated investors are defined as those individuals who are sufficiently knowledgeable with respect to financial matters such that they can fend for themselves in the purchase of securities and do not require the full protection of securities law (http://www.sec.gov/info/smallbus/qasbsec.htm). This definition currently comes into play in Regulation D, Rule 506, which states that up to 35 "sophisticated" investors can participate in a fundraising event. The spirit of this law is to acknowledge that some investors are educated/ experienced enough to make their own investment decision regardless of their personal wealth level. Unfortunately, the definition is very vague and difficult to use in practice. As a result, lawyers frequently choose to ignore the sophisticated investor exemption of Regulation D, Rule 506 and insist that their clients only include accredited investors when fundraising. A more effective alternative would be a standard questionnaire to determine that someone is a sophisticated investor. Once defined more clearly, any sophisticated investor should be able to participate in an offering through this proposed crowdfunding exemption. One potential use case for this provision is young alumni who are educated, but not yet wealthy, investing in student businesses from their alma mater.

b) Personal Relationship - Anyone who has a personal relationship with the business owner should be allowed to invest in the offering. Under Regulation D,

Rule 504, business owners can engage unaccredited/ unsophisticated investors to invest so long as they share a "substantial, pre-existing relationship." The spirit of this law is that people who have an intimate, personal knowledge of your finances, and you of theirs, should be able to invest based on this knowledge regardless of their wealth or financial expertise. An updated version of this "personal relationship" provision would state that anyone who can certify that they have a personal relationship with the entrepreneur and can confidently speak to his or her character and business acumen can invest and the "pre-existing" portion of the definition would be eliminated. This is adequately broad such to allow entrepreneurs to tap into their online social networks and request introductions to friends-of-friends.

c) Local Investors - Anyone who lives within 100 miles of the business (bricks and mortar location) should also be able to invest based on the premise that they can do appropriate due diligence by visiting the business, verifying that it exists, testing its product, and seeing its traffic. This provision is inspired by Rule 147, an intra-state offering exemption available to local businesses that do nearly all of their trade within the state and are looking to include only investors within the state.

6. Limit Investment Amounts

The amount that any individual investors can invest in securities organized through this exemption annually should be limited to 5% or less of his or her liquid investable assets. I understand that the proposed legislation contemplates setting this limit as the lesser of 10% of net income or $10K. While this would be sufficient for the majority of cases, I see no reason to limit the specific dollar amount as it is meaningless if not stated in relative terms to an individual's net worth.

7. Limit Total Raise Amounts

The dollar amount that an entrepreneur can raise annually using this exemption should be limited to $1M and it should be permissible to combine this exemption simultaneously with any combination of others (for example, with Reg D, Rule 506 which is most commonly used in angel investing) for an unlimited aggregate dollar amount. I understand that Chairman McHenry's bill proposes a $5M limit and while I certainly would not be opposed to this higher ceiling, I also don't see a pressing need for it. As a point of reference, the average dollar amount that a business wants to raise on ProFounder is $30K. SBA- backed small business micro-loans center around $75K and the average start-up capital invested in Inc 500 companies is around $75K as well. The crowdfunding exemption is most useful in providing the first capital in the door for a business and I believe that it will serve as a gateway for businesses to raise larger rounds of growth capital from traditional sources down the road.

8. Disclosures

It is appropriate and necessary to require a limited, concise set of disclosures to be shared with potential purchasers. Specially, I see a place for an abridged balance sheet of historical and forward looking financials, risk factors, and an explanation of forecasts. Striking a balance is imperative here; if disclosures are too extensive, time consuming, or confusing to new businesses, then this exemption will never be utilized.

9. Notice Filings

I feel that it is appropriate for the issuer to submit a notice filling (in the fashion of Form D for all Reg D offerings) to so that all securities are properly documented and accounted for in case of fraud. If nominal fees are necessary to support governmental administrative costs, this would be a minimal hurdle and is not something that I would object to.

Conclusion

I want to thank Chairman McHenry, Ranking Member Quigley and members of the committee for the opportunity to participate in this Hearing. I applaud the Committee for turning its attention to crowdfunding and working so quickly to draft a bill that addresses the key issues. My experience starting and running ProFounder has left me with a deep respect for the small business entrepreneur and her potential to create real economic change for herself and others. Without capital from their communities, Bronson would not have been able to open his second candy shop, Raaja would never have started his sneaker company, and Marc would not be producing high performance electric motorcycles. Each of these businesses engaged in community-fund via ProFounder and went on to create jobs and infuse more capital into their local economies. I look forward to a time soon when these success stories can be replicated more widely; a time when entrepreneurs can seek investments from their community at-large in a way that is simple and efficient.

Thank you.

Mr. MCHENRY. Thank you.
Mr. Lynn.

STATEMENT OF JEFF LYNN

Mr. LYNN. Chairman McHenry, Ranking Member Quigley, honorable members of the subcommittee. My name is Jeff Lynn and I am CEO and cofounder of Seedrs, a forthcoming equity crowdfunding platform based in London. I'm also a U.S. securities and corporate lawyer by background, having practiced with the international firm of Sullivan & Cromwell in both New York and London. I want to thank you for inviting me to testify today on this very important and timely topic.

Seedrs will allow entrepreneurs to raise up 100,000 pounds in equity capital from the crowds through an online platform. We like to think of it as kickstarter with returns instead of donations or lending club with equity instead of debt. Details of how the platform works are set forth in my written testimony.

We have applied for Seedrs to be authorized by Britain's Financial Services Authority, and assuming we are successful it will be the first equity crowdfunding platform anywhere in the world to be expressly approved by a major securities regulator. We will launch initially in Britain only, with the aim of rolling out through the rest of the European Union shortly thereafter.

When my cofounder and I designed this model, we examined both the United States and Britain as our potential first target market. Both had positives and negatives, but the overriding consideration was the current U.S. securities laws would present an insurmountable obstacle, where securities regulation in Britain is significantly better suited for this financial innovation.

We are very excited about making crowdfunded equity finance available in Britain and eventually across Europe. Nevertheless, it is highly encouraging to see that some lawmakers want to consider rule changes that would allow equity crowdfunding platforms like Seedrs to operate in the United States as well.

I believe this is a very positive development, as it will open a powerful tool to American entrepreneurs and investors alike, and could prove to be a key factor in boosting the economy and creating jobs throughout the country.

At the same time it is important that any rule changes be considered carefully, and in particular that a balance be struck between keeping administrative burdens low enough for these platforms to be viable while still maintaining sufficient investor protections.

I've laid out in my written testimony a few thoughts on how best to strike that balance based on our experience on building Seedrs. I would like to briefly summarize the three main ones here.

First, we think it is important that equity crowdfunding platforms be subject to some degree of regulation. This does not need to be highly burdensome. There are categories of regulation currently in existence that small businesses have been able to comply with, such as broker-dealer registration and SEC investment adviser registration, and those could be used as a starting point, albeit they would need significant adaptation.

In the absence of any form of supervision though, there's too much scope for crowdfunding platforms that lack sufficient systems

and controls to cause harm to investors. And as importantly, many investors simply will not use platforms that lack a regulatory seal of approval. We have been told repeatedly about potential Seedrs investors that the fact that we will launch only after becoming FSA authorized is absolutely crucial to their decision to use us.

Second, we would be against imposing a limit on how much an investor can invest in a particular startup. These platforms can only function if larger investors are able to participate alongside smaller ones. And a per investment cap risks unnecessarily excluding larger investors.

At the same time, there are better ways of making sure that investors understand the risks involved and do not get in over their heads, such as capping aggregate investment based on the investor's declared net worth, and requiring investors to complete a questionnaire showing their understanding of the risks. Seedrs will do both of these.

Finally, we think that equity crowdfunding platforms will be most effective when they are actively involved in executing the investment transaction and managing the investment after completion.

The greatest risk to investors when investing in a startup comes not when the startup fails but rather when it succeeds. Any sensible investor knows and accepts that the odds are significant that the business will not work out and there will be no return of capital. However, if the startup succeeds but due to a flaw in the way the investment was structured or managed the investor does not get the benefit of that success, that is a much bigger problem. This is why Seedrs will provide a substantial level of intermediation as part of its service, including legal due diligence, subscription agreement negotiation, and post completion management. We expect that other successful platforms are likely to do the same.

We do not think that these services need to be required by law, but it is important that whatever set of rules is adopted for crowdfunding they at least allow for and perhaps even explicitly authorize a meaningful level of intermediation.

To conclude, Mr. Chairman, I am both encouraged and excited by the prospect of equity crowdfunding becoming a reality in the United States. I hope the thoughts and insights I have shared from our experience will prove helpful as consideration of rule changes moves forward.

Thank you for the opportunity to appear before you today, and I would welcome the chance to respond to your questions or to amplify or clarify these statements at any time.

[The prepared statement of Mr. Lynn follows:]

Written Testimony of
Jeff Lynn
Chief Executive Officer, Seedrs Limited

Before the
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs
Committee on Oversight & Government Reform
United States House of Representatives

September 15, 2011

Chairman McHenry, Ranking Member Quigley, honorable Members of this Subcommittee, my name is Jeff Lynn, and I am the Chief Executive Officer and a co-founder of Seedrs, a forthcoming equity crowdfunding platform based in London. I want to thank the Subcommittee for inviting me to testify today on this very important and timely topic.

By way of background, I am a U.S. securities and corporate lawyer by training. I received my J.D. from the University of Virginia School of Law, I am a member of the New York Bar, and I practiced with the international law firm of Sullivan & Cromwell LLP from 2004 to 2008 in New York and London. During my time at Sullivan & Cromwell, I represented industrial, financial services and private equity firms on a range of securities, finance, corporate and governance matters. I also worked closely with the SEC and Britain's Financial Services Authority (FSA) on a range of matters, and I oversaw the periodic editing and updating process for *The Sarbanes-Oxley Deskbook* by Jack Bostelman.

I left the active practice of law in 2008 in order to pursue a career working with early-stage businesses, which I firmly believe will be the greatest source of wealth and job creation, as well as innovation, in the years to come. As part of my career transition, I enrolled in the MBA program at Saïd Business School at the University of Oxford, where I met my co-founder, Carlos Silva, and began working on what has become Seedrs.

Today I would like to tell you a bit about the Seedrs model, why we chose to start it in Britain rather than the U.S., and some of the lessons we have learned and thoughts we have developed around the regulatory framework for platforms like ours.

Seedrs is an equity crowdfunding platform that will allow entrepreneurs to raise up to £100,000 in equity capital from the "crowds". In short, the Seedrs process operates as follows:

- Entrepreneurs disclose information about their businesses, which we review and approve, as well as the amount of money the businesses are seeking to raise in exchange for how much equity, all via our website.

- Investors review businesses' information, decide which ones they want to invest in and how much, and purchase equity interests in the businesses they choose by transferring funds and signing electronic documentation, all via our website.

- We aggregate multiple small investments in each business into one large one, and once a business has received the full amount it is seeking, conduct legal due diligence and execute the share purchase through a special-purpose vehicle.

- Entrepreneurs access a powerful network of mentors and other support once they've been funded, all while limiting their administrative burdens by allowing them to interact with only one legal shareholder.

- Investors stay informed about and involved in the businesses as they develop following investment, and they receive payment of dividends and proceeds from sale.

In many ways the Seedrs user experience is similar to that of Kickstarter and other donation-based crowdfunding platforms, but with two crucial differences: first, people who use Seedrs will get genuine equity exposure—just as an angel or venture capitalist would—rather than non-monetary rewards; and second, in order to ensure that investors' interests are adequately protected, we provide significantly more intermediation—including disclosure review, legal due diligence and execution and post-completion management—than a donation-based platform would.

We have applied for authorisation by the FSA, which is a necessary precursor to launching the platform. We hope to be authorised within the next few months, and assuming that we are, we plan to launch Seedrs in the UK in early 2012, with the aim of rolling out through the rest of the European Union in 2013. We are backed by a group of angel investors from both Britain and the U.S.

When Mr. Silva and I first designed this model, we examined both the U.S. market and the British market as potential initial targets. Both had positives and negatives, but the overriding consideration was that current U.S. securities laws would present a major—and probably insurmountable—obstacle, whereas securities regulation in Britain (and the rest of the European Union, which has very similar rules) is significantly better-suited for this type of financial innovation. To briefly summarize the difference, and with the caveat that I am not a UK-qualified lawyer:

- The U.S. and British approaches to the regulation of public offers of securities are relatively similar. The Prospectus Directive—which is an EU-wide piece of legislation that has been implemented in each of the EU's 27 member states, including Britain—requires that any public offering that is not the subject of an exception must be made pursuant to a prospectus that has been approved by a relevant regulator, which is the FSA in the UK. This requirement is very similar to that contained in Section 5 of the Securities Act of 1933, and the effect of both is that raising money through a public offering requires a significant amount of administrative and legal work—more than any startup or other very small business could realistically be expected to perform.

- Recognizing that very small businesses often need to raise capital but cannot do so under the normal public offering rules, both the U.S. and Britain have adopted a series of exceptions for small offerings. In the U.S., these are contained primarily in Regulation D under the 1933 Act, while in Britain they form part of the Prospectus Directive and are also spread across several pieces of domestic legislation and regulation.

- Many of the small offering exceptions focus on what we call "accredited" investors in the U.S. and are referred to as "self-certified high-net-worth" investors and "self-certified sophisticated" investors in Britain. Rules 505 and 506 of Regulation D allow small offerings to be made relatively freely to accredited investors in the U.S., and there is a similar degree of latitude for high-net-worth and sophisticated investors in Britain. These exceptions, while important, are insufficient to allow for equity crowdfunding, because the power of crowdfunding is based on ordinary investors—and not just the super-rich—being able to participate.

- There are other small offering exceptions that are not just limited to accredited investors or their equivalent, and these are the exceptions that are relevant to equity crowdfunding. This is also where U.S. and British regulation diverge. In the U.S., Rule 504 of Regulation D allows small businesses to offer their securities to non-accredited investors so long as, among other things, they do not engage in general solicitation or general advertising. In Britain, by contrast, the business may reach out to potential investors much more widely, but an FSA-authorised firm must review and approve the offering materials that the business uses. The effect of this difference can be summarized as follows:

    - In the U.S., an entrepreneur can say essentially whatever it wants (subject to fraud and misrepresentation rules), but she can only say it to people with whom she has a pre-existing connection.

    - In Britain, an entrepreneur can only say things that a professional financial firm has signed off on, but he can say those things to pretty much anyone.

- The foregoing distinction is a slight over-simplification, but it gets to the heart of why crowdfunding can work in Britain (and, by extension, the rest of the European Union) but not in the U.S. today. As an FSA-authorised firm—which we are required to be anyway—Seedrs will be able to review and sign off on each startup's disclosures, thereby allowing them to be posted on the platform and communicated in a way that would constitute general solicitation and advertising in the U.S.

Given this key difference in rules, we decided to build Seedrs for the British and, ultimately, European market, and we are very excited about providing this innovative and potentially very effective method of finance to entrepreneurs and investors across Europe.

Nevertheless, it is highly encouraging to see that some members of Congress—and, as of last week, possibly the White House—want to consider rule changes that would allow equity crowdfunding platforms like Seedrs to operate in the U.S. I see this as a very positive development, as it will open up a very powerful tool to American entrepreneurs and investors alike and could prove to be a key factor in boosting the economy and creating jobs throughout the country.

At the same time, it is important that any rule changes be considered carefully, and in particular that a balance be struck between keeping administrative burdens low enough for these platforms to be viable, on the one hand, and maintaining adequate investor protection, on the other. The investor protection point is a particularly important one: not only is it essential from a policy perspective, but in the absence of adequate protections investors will shy away from using these platforms, and therefore their potential to get job-creating businesses off the ground will never be tapped.

I'd like to take this opportunity to share with the Committee our thoughts on how best to strike that balance. These thoughts come from over two years of work that we have done, including discussions and interviews with hundreds of potential users of the platform (both investors and entrepreneurs) as well as our own deep analysis of the level of protections that can be put in place while still allowing the platform to function economically:

1. *Equity crowdfunding platforms should be subject to some degree of regulation and supervision.*

    a. Equity crowdfunding platforms are fundamentally financial services businesses, and allowing them to operate in too much of a "Wild West" environment would be bad policy and bad for the market. It is bad policy because there is simply too much scope for a

crowdfunding platform that lacks sufficient systems and controls to cause harm to investors through maladministration of their funds or, more importantly, failing to properly structure the investment or manage it following completion. And it is bad for the market because most investors simply will not use platforms that lack some sort of regulatory "seal of approval": we have been told repeatedly by potential Seedrs investors that the fact that we will launch only after becoming FSA authorised is absolutely crucial to their decision to use us.

b. It is, of course, vital that the regulation not be so burdensome as to make it uneconomical to operate the platform. This is an especially serious concern in an area, like crowdfunding, where the individual transaction sizes are so small. Because most crowdfunding platforms, including Seedrs, make their money by charging a percentage of each transaction, the per-transaction revenues are relatively low and could easily be overwhelmed by per-transaction costs of compliance.

c. We do not have a view on exactly what regulation structure would be most appropriate in the U.S., and we are conscious that the structure of the U.S. and British regulatory systems are sufficiently different that it would be difficult simply to "borrow" the British model. However, we think that a good starting point would be one of the types of regulation that is currently in existence and with which small businesses are able to comply. FINRA broker-dealer registration or SEC investment advisor registration both come to mind as examples of this, and while neither is precisely suitable for crowdfunding platforms, perhaps they could be adapted into—or serve as inspiration for—the appropriate form of regulation.

2. *There should be no across-the-board limits on how much can be invested through an equity crowdfunding platform, but there are other ways to ensure that investors understand the risks and do not invest more than they can afford to lose.*

a. In order for equity crowdfunding platforms to function and actually see investments completed, it will be essential that some larger investors join alongside the small investors. While a £10 or $10 investment minimum is important for a number of reasons—including allowing investors to "test the waters" with a relatively small sum, ensuring that investors do not feel pressured to invest more than they can afford, and creating a viral marketing effect—very few $50,000 or $100,000 capital raises are likely to be completed solely on the back of $10 or even $100 investments. It is therefore crucial that platforms be open to larger investors who invest $500, $5,000 or even, potentially, $50,000 in a given business, and any across-the-board limit risks excluding these investors and undermining the efficacy and economics of the platform.

b. We also think that across-the-board maximums are not particularly effective for investor protection purposes. Different amounts of money mean different things to different investors: even a $100 maximum would be more than many people can afford to invest in a high-risk asset, whereas a $10,000 maximum would unnecessarily restrict many larger investors.

c. However, there is an argument that some type of limit may need to be in place in order to ensure that investors understand the risks and considerations of investing in startups, and to protect them from investing more than they can afford to lose. While we think that much of this can be addressed through clear, plain-English risk warnings that lay out the

high-risk, illiquid nature of the asset class, Seedrs has also implemented two comprehensive screens on investors:

i. The first is a questionnaire that every investor must complete before investing: some questions ask about the potential investor's professional and educational background, while the others are multiple-choice questions about the risks and considerations of investing in startups. We then use an algorithm to score each questionnaire, and only those individuals whose score indicates that they have the experience, expertise and knowledge to understand the investment risks are allowed to invest. As a practical matter, we think this questionnaire will effectively screen out the more vulnerable individuals while allowing in the sort of ordinary investors who should be able to invest in startups.

ii. Second, once an investor has passed the questionnaire, she must declare her net worth to us within a range, and she is then limited to investing no more than 20% of the bottom end of that range through the platform in aggregate. She may then change the number later on as her circumstances change. This net worth restriction ensures that each investor is investing in this asset class no more that what is reasonable to her, while allowing her to choose how she wishes to spread it across the asset class.

d. There are no doubt a number of other viable approaches to the goal of ensuring that investors do not invest too much relative to their individual positions, and it would be well worth having an open discussion in the interest of adopting a consensus standard. We would be happy to explain our screening process in more detail at anytime, and we would also be grateful to hear others' thoughts on how we might be able to improve it.

3. *Equity crowdfunding platforms will be most effective where they are actively involved in executing the investment transaction and managing the investment after completion.*

a. The greatest risk to investors when investing in a startup comes not when the startup fails but rather when it succeeds. Startups are a very high-risk asset class, and any sensible investor knows and accepts that the odds are significant that he will never see his money again. However, if the startup succeeds, but due to a problem in the way the investment was structured or managed the investor does not get the benefit of that success, that is a much bigger problem. No investor will tolerate the prospect of having picked and allocated money to the "next Facebook" only to find that his investment was not what he thought it was, and that he is not entitled to the rewards he expected.

b. The scenario described above can occur for any of a number of reasons, but they fall into two basic categories:

i. *Problems with investment structure*. Investments in startups (and other private companies) are usually made pursuant to a subscription, or shareholders, agreement that is executed following a legal due diligence process. The legal due diligence process ensures that the company is what it says it is, and in particular that the company actually represents the underlying business, rather than key assets or operations of the business being held in a separate, undisclosed entity. Meanwhile, the terms of the subscription agreement have a substantial effect on the investor's rights: if the agreement fails to include appropriate provisions with respect to, for example, "tag-along" rights or anti-dilution measures, the investor

may find that even though the company has succeeded, she is not able to realize value on her shares.

ii. *Failure to take necessary shareholder action*. After an investment has been completed, there are often actions that need to be taken by investors. Many of these, such as casting procedural votes at shareholder meetings, are unlikely to be of consequence to the investor's ultimate realization of value, but in some cases the failure to take an action can cause a significant problem. This is particularly true in the case of executing documents when a subsequent financing or sale of the business occurs: if investors do not sign the papers they need to sign, the transaction may fall through, potentially causing great detriment to the business. There may also be times when the collective action of shareholders is needed to enforce minority shareholder rights and protections.

c. Given these types of risk, and the difficulties involved in a large number of small individual investors avoiding them on their own, we think crowdfunding platforms have an important intermediary role to play. At Seedrs, we will conduct legal due diligence on, and enter into a subscription agreement based on our standard form with, every company before an investment is completed. Then, following completion, we will act on behalf of all investors as the manager, using our discretion to take shareholder actions and make decisions (other than voluntary sale decisions). We believe that this approach ensures that when an investment is successful, there is as little risk as possible that investors fail to derive the value they expect from it.

d. While we believe the type of intermediation Seedrs plans to provide is tremendously important, we do not think that it necessarily needs to be required by law or regulation. This would seem to be a matter on which people can vote with their feet: those who want the crowdfunding platform they use to provide this intermediation will use one that does, and those that are happy going it alone will use a platform with less intermediation. It is nevertheless important that whatever set of regulations is adopted for crowdfunding, they be drafted so as to allow for a meaningful level of intermediation. Equity crowdfunding platforms must be permitted—and perhaps even receive explicit authorisation—to act in more than a pure execution-only capacity and thereby have the opportunity to provide the protections that come from legal due diligence, a well-drafted subscription agreement and post-completion management.

e. Closely related to permitting crowdfunding platforms to provide this intermediation is the issue of protecting them from vexatious litigation in doing so. By virtue of the volume of businesses with which crowdfunding platforms are likely to be involved, along with the inevitably high failure rate of many of those businesses, there is a meaningful risk that plaintiffs' lawyers and even competitors who want to clear out the market will launch baseless strike suits. This is less of a risk in Britain, where the loser-pays court system means that a culture of spurious litigation has not yet developed. But given the long history of these types of lawsuit in the U.S., combined with the particular vulnerability of crowdfunding platforms, it will be important that they be protected to the extent possible. To be clear, I would not advocate protecting platforms against any form of legitimate litigation, and in particular I think that if a platform holds itself out as providing certain protections to investors, as Seedrs will, it is reasonable that the courts be available to enforce that commitment where necessary. That is very different, though, from the strike suits that many businesses have been subject to through the years, and it is this latter type

of litigation that needs to be addressed as part of opening the doors to equity crowdfunding.

Finally, as a broader thought, I hope that consideration will be given to allowing cross-border crowdfunding, so that foreign investors can invest in U.S. startups (to the extent that foreign laws allow), and American investors can invest in foreign startups. I would expect the former of these to be non-controversial, but I appreciate that facilitating investment abroad may not seem, at first glance, to be helpful in the creation of American jobs. I disagree with this view, and I firmly believe that if American investors can invest in foreign startups, that will make it substantially more likely that those startups set up operations in the U.S., both because they now have the money to do so, and because they have the connections and support of an American investor base. Those operations will, in turn, be just as valuable creators of jobs for Americans as are the startups that began here. I have full confidence in the ability of American entrepreneurial talent to continue to build some of the most innovative and successful new businesses, but my years living in London have shown me than Brits, Europeans and others around the world also have the ability and desire to build great companies. Rather than wall off the U.S. market to these companies, the best thing the U.S. can do is give them a reason to bring their success here, and having a base of investors located here is just such a reason.

To conclude, I am both encouraged and excited by the prospect of equity crowdfunding becoming a reality in the U.S. Seedrs has worked very hard to build a model that works in Britain and Europe, and we have no doubt that, once legal, a number of very strong models will develop here as well. I hope the thoughts and insights I have provided from our experience are helpful as consideration of rule changes moves forward, and I would be happy to amplify or clarify these statements, or to provide additional detail about the Seedrs approach and our views on crowdfunding, both now and at anytime in the future.

Mr. Chairman and members of the Subcommittee, thank you for the opportunity to appear before you today.

Mr. MCHENRY. Thank you, Mr. Lynn. Mr. Neiss.

STATEMENT OF SHERWOOD NEISS

Mr. NEISS. Chairman McHenry, Ranking Member Quigley, and members of the committee, thank you for holding this hearing today and allowing me to share an entrepreneur's perspective on how crowdfunding investing will spur innovation among your constituents, create jobs and help our economy grow. This framework was just endorsed by President Obama in the American Jobs Act.

My name is Sherwood Neiss, and I'm a entrepreneur who started and sold the 3-time Inc 500 company and is trying to raise capital for two more. This is my third time I have given congressional testimony on the hurdles related to capital formation for entrepreneurs and small businesses. This testimony was written in conjunction with my cofounders at the startup exemption, Jason Best, a 2-time Inc 500 entrepreneur, Zachary Cassidy-Dorion, and Karen Kerrigan of the Small Business and Entrepreneurship Council.

I'm going to discuss three things: First, how crowdfund investing solves a problem of connecting entrepreneurs to capital; second, the framework under which we suggested this should take place; and, third, provide two examples.

As someone who has tried to raise capital in the past few years I know how hard it is. Try going into a bank to get a loan or a line of credit. Try finding a credit card company that will give you a decent interest rate or try peddling your idea to venture or private equity. They aren't focused on who will create the majority of net new jobs, but who has the greatest chance for a 10X return in the shortest period of time.

So the point is there is no capital out there for the majority of businesses. We need to hire Americans and get us out of this recession.

A solution is crowdfunding investing. Crowdfund investing is using equity to pool small amounts of capital from a large number of Americans to start and expand at businesses. Crowdfunding is nothing new to America. The Statue of Liberty was even built thanks to thousands of small donations from Americans. On crowdfunding investing sites entrepreneurs will their pitch ideas, and investors decide which ideas they think are worthy of backing. If a startup doesn't hit its funding target, no money is exchanged.

The funding rounds will occur via SEC regulated Web sites where entrepreneurs will be vetted and their ideas discussed freely with other investors. Anyone with deceptive practices and false moves will be documented and discussed by the thousands on Facebook, Twitter and other platforms. Time and again we see if you make a false move on the Internet it will only take hours before millions of people know about it.

Successfully funded businesses will not only benefit from the capital but the collective knowledge, experience and marketing power of the people who have a vested interest in making sure the entrepreneur succeeds. Successful businesses will also create jobs.

The complete rules of our framework are in my written testimony, but here are six main points. First, we propose the creation of a funding window of up to $1 million for entrepreneurs and small businesses.

Second, investors would have to acknowledge the risk involved in this type of investment and that there is no guarantee of return.

Third, once they acknowledge the above they can choose to invest. However, investments via this window would be limited to $10,000.

Fourth, because of the size of the crowd and the anticipated small dollar amounts invested, we propose eliminating the 500 investor rule, as well as broker-dealer license requirements.

Fifth, due to the limited size these offerings should be exempt from costly State registration.

And sixth, general solicitation should be allowed only on registered Internet platforms where entrepreneurs and investors can meet and people and ideas can be vetted by the crowd.

Standardized base reporting will be used to submit information to the SEC about small businesses utilizing these platforms.

CFI is being using in other countries successfully, including the U.K., France, Hong Kong, and China. Over the last 5 years over $300 million has been donated on U.S. crowdfunding sites for art related projects or entrepreneurs in the developing world. Just think what could have been accomplished if we used the same dollars to fund jobs and innovation in the United States.

Here are two examples of where people have donated money to support an entrepreneur. Imagine how many more companies we could fund if the same investors were given potential for a return on their investment. Three engineers created a product that greatly improved mobile video cameras. They were turned down by 43 vc's and banks. So they created a short video on a Web site and solicited money via their Twitter, LinkedIn and Facebook communities. They raised over $24,000 and announced selling the products, creating jobs and have gained investor interest from vc's.

And Brooke from Lancaster, Pennsylvania wanted to expand from a small T-shirt kiosk to a larger store, but was unable to raise capital through traditional means. So she created a video and raised $15,000. Now she has a stand alone store and has hired more employees.

These are just two stories but thousands are waiting based on estimates from the SBA and the Kauffman Foundation. We believe CFI can generate over 500,000 companies and over 1.5 million net new jobs over the next 5 years.

Americans should be allowed to invest in their communities. Today technology makes this a possibility. The Internet with its transparency and accountability will make this concept thrive. In turn, the crowd will fund ideas they believe in and these ideas will be the launching pad for thousands of worthwhile businesses. Both parties agree on the importance of getting capital to our entrepreneurs; our framework is at zero government cost proposal to accomplish this.

Thank you for your time. I look forward to your questions.

[The prepared statement of Mr. Neiss follows:]

INTRODUCTION

Chairman McHenry, Ranking Member Quigley, and members of the Subcommittee, thank you for holding this hearing today and allowing me to share with you a framework to allow a limited amount of critical seed capital to flow to entrepreneurs in a new form of investing called Crowdfund Investing. Over the next 5 years, this framework has the potential to create 500,000 companies and 1.5M net new jobs at zero cost to our government. My intention is to explain why securities laws -- put in place before the Internet age -- need to be modernized and overhauled, and how these reforms can boost our struggling economy. By revamping the Security and Exchange Commission's (SEC's) position on solicitation and accreditation, we can open the doors to small business growth and prosperity. Allowing for an exemption for Crowdfund Investing, which includes prudent protections for investors, will spur innovation among your constituents, create jobs, increase consumer spending, and reinvigorate our economy. This framework enjoys bipartisan support with President Obama quoting from it in the 2011 American Jobs Act.

My Name is Sherwood Neiss and I am an Entrepreneur. This is my third time partaking in hearings before the U.S. Congress. I was most recently part of a hearing related to issues of capital formation in May 2011. Prior to that, I was here in 2006 testifying on the unintended consequences of Sarbanes-Oxley on small businesses. I pointed out that the regulatory burdens under Section 404 were the reasons why the audit at our '3-time Inc 500, Entrepreneur of the Year award winning' company tripled in time and cost, ate up 14% of our net income and made us decide that we were better off selling the company than raising capital in the public markets to grow, hire and expand. I am delighted that my and others' testimonies helped convince Congress to pass the small business exemption from 404(b) audit requirements, and I am hopeful that my testimony today will convince you to consider other adjustments to existing rules that hinder capital formation.

My co-founders at The Startup Exemption, Jason Best and Zachary Cassady-Dorion along with Karen Kerrigan of the Small Business & Entrepreneurship Council and I have been the main advocates behind the push for this Crowdfunding Exemption in Washington. We crafted the following Crowd Fund Investing framework and we are backed by thousands of entrepreneurs and Americans who have signed our Petition to make Crowdfund Investing legal.

THE REALITY OF HOW PEOPLE VIEW MONEY TODAY

First, I would like to point out the obvious: people don't easily part with their money. It isn't easy to come by and it isn't easy to let go. We have an attachment to money that is at times even more personal than our closest relationships. This is cited as one of the main reasons why so many marriages end in divorce. Granted the more money you have the more flexibility you have with it. So I think it is fair to say that people with a limited amount of money are more limited with what they can do with it and more cautious on how they spend it.

Now rather than hit you over the head with facts, let's just assume that everyone here is aware of the dire economic situation that surrounds us; the recession, high unemployment, low confidence and political stalemate. Because of this the stock markets are volatile and people are pulling their money out of them. On the flip side, according to an August 25th story in USA Today, Americans are saving more money than ever. So personal savings are going up as fear and skepticism increases. Not, what we would call, a healthy environment for liberal spending.

BUSINESS, THE JOBS ENGINE OF THE USA

Now let's jump to a couple other facts. Businesses create jobs. Jobs employ Americans. Americans spend their income on housing, food and travel in such a way that stimulates our economy. And both Americans and businesses provide tax revenue so our government can operate and pay its obligations.

And finally, businesses need capital to grow and hire. Prior to the 2008 financial meltdown, traditional capital for startups or small businesses either came from personal savings, credit cards, loans or, if you were in the lucky 2%, private money (venture capital, private equity or angels). Today, try going into a bank to get a loan or a line of credit. Try finding a credit card company that will give you a line of credit with what used to be considered a decent interest rate of 9%. And try peddling your idea to Venture, Private Equity or Angel people as they are all focused on the same deals. None of which are providing capital to those that collectively will create the vast number of net new jobs but those that have the greatest chance for a 10x return in the shortest period of time. So the point is, there's no capital out there for the majority of businesses that we need to hire Americans and get us out of this recession.

Hopefully we can all agree on those facts. Now I might be wrong with the following line of reasoning however I doubt it.

HOW MANY PEOPLE WOULD GIVE A PANHANDLER $100?

First, if I asked each of you to give me $100 for a business idea I have, having no relation to me or the idea, I'd bet 100% of you would tell me to take a hike.

Second, let's assume 10% of you in this room knew me. Even with that connection, I'm fairly certain that none of you would give me $100 without answering a few questions namely:

1) Why do you need the money?
2) What is the idea?
3) What problem does it solve?
4) Who is going to buy your product?
5) How does your business make money?
6) What will the money allow you to do?

7) What's in it for me? and
8) Tell me why I should trust you with my $100 and why you are the right person to do this?

So those that know me and understand what I'm trying to do might just give me $100. It won't be everyone because everyone's financial circumstances are different. e.g., I just don't have $100 right now, I'm hesitant about investing in anything, I just don't think it is something I'd use and hence not sure it is the right investment for me, all my money is tied up, I'm saving for a vacation, etc.

Then again, some of you might be thinking this is a great way to take advantage of innocent people. While you might ask such questions because you are rational, there are plenty of irrational people out there that wouldn't. We see them on the news. Exuberant folks who hear a good idea and just jump in. For that, we need to understand what makes them irrational. There are 2 main drivers: trust and greed.

So how do we address this? Make them acknowledge that what they are doing means they can lose all their money. Using today's technology we can make people listen to the following disclosure thru their web browser and then require them to type it into a disclosure form.

> *"I understand that my investment in this idea may lead to no return. That any money I invest may disappear and I am making this decision of my own choice."*

That's a pretty long phrase and they'd have to listen to it a few times to make sure they enter it correctly or the system will not let them proceed.

Now if I made you repeat that sentence to me before I took your $100, I bet the majority of you that have no relation to me would say, "You want me to give you $100 for some idea you have, I have no clue who you are AND you have the audacity to ask me to type into a form a sentence that acknowledges I might never see this $100 again? Take a hike!"

A REAL LIFE EXAMPLE – TODAY'S UNFORTUNATE REALITY

Now let's put this into a real life example. Most people understand that if you are sick, medicine can help you get better. Adults take this logic for granted, however children don't quite understand it. Pharmaceutical companies have done a great job over the years developing pediatric forms of medicine so that it is easier to administer. However, if any of you have children you know that getting them to take nasty tasting medicines can be a 10-day battle. First, you can't reason with an infant that spits up a medicine because it is bitter. And second, you can't use logic on a sick, fussy toddler.

Let's say I'm a pharmacist and have worked with a flavoring company to come up with liquid flavors that can be added to liquid medicines without interfering with the basic properties of the medicine. I want to sell this flavoring system to pharmacies around the

country and they will pay me a fee to use the system. The money I raise will be used to buy inventory, some office supplies, hire an assistant, and pay my rent. I envision I'll need $500,000 to really get things going but for this first stage (inventory & packaging) I need $50,000. That in exchange for the $50,000, I'm willing to give up 20% equity in my company.

Now how many of you would give me $100? Guess what? Probably not many of you for many of the same reasons I gave above. Welcome to the reality of raising capital. It isn't easy! It takes a lot of time, energy and connections to get the backing you need to launch a business. There's no guarantee that the people I speak with will be interested in my idea and hence there's no guarantee that I will raise the capital I need to grow my idea. However it can happen and it does.

Now what if I told you that this company turned into a three-time, Inc. 500 company that had 50 employees, with paid healthcare and retirement benefits. That these employees had families, bought homes and used their hard-earned dollars to keep our economy chugging along. That other than payroll taxes we paid corporate taxes and bought countless products and services from a multitude of vendors that accounted for further economic spending. Well guess what, we did. That was, FLAVORx, the company that I cofounded.

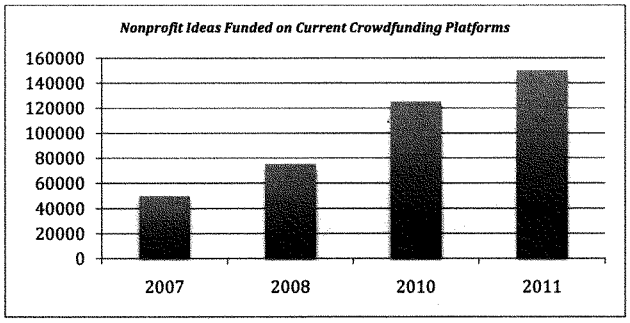
We were lucky because we were able to use all traditional means of financing available prior to the 2008 meltdown (credit cards, loans, lines of credit, and private money). Today, I'm confident in telling you based on my personal experience of trying to raise capital for two other startups of mine since we sold FLAVORx, that if we tried to start FLAVORx today, under the current environment, that we would have failed, no jobs would have been created, no products or supplies from third party vendors would have been purchased, no taxes would have been paid to our government and no investors would benefit from our eventual sale.

The fact of the matter is today, unlike 12 years ago when we were financing FLAVORx, there's a way for us to do this online where our friends, family and broader social network can vet us, our idea and our business model and decide if the 20% equity stake in the idea is worth their many $100 investments. It is called Crowdfund Investing and this is how it can work:

CROWFUNDING AND ITS HURDLE ... THE SEC

If you go online today there are websites like Indiegogo, Kickstarter, and Kiva that allow a person with an idea (mainly art-related) or an entrepreneur in the developing world to seek funds from the crowd in order to make their idea a reality. These people pitch their ideas to their social network via these platforms. On the platform they talk about the idea, who they are, the need for the idea, and how much money they need to make it a reality. The crowd decides which projects they want to fund and with how much money they are going to **give**. The losing ideas don't get funded. All the money is just a donation and the only perks an investor gets ranges from a thank you card, to a mention, to a t-shirt or in

some cases samples or thank you dinners. Over the past 5 years, on websites like the ones mentioned above over 500,000 ideas have been funded.



*Data related to this chart is an aggregate from the top 10 crowdfunding sites over the past 4 years.

Pretty cool, right? People helping people. Sort of the American way. What if we wanted to tie a return to those same dollars? Well at that point you enter the domain of the SEC, and its rules that were initially crafted 80 years ago, which still dictate how we can fund companies using these antiquated rules.

Do you realize that as an American you are free to spend $100 however you see fit but if you wanted to take $100 and invest in my medicine flavoring business idea, I might end up in jail? The fact that we micromanage what Americans can do with a few dollars almost seems un-American and anti-business. Americans today are more sophisticated than they were 80 years ago.

In 1933 when the framework of our current securities laws was established, 4% of Americans invested in the markets. Today that number is over 50%, clearly showing that the majority of individuals understand the basics of investing.

Almost 80 years ago when the telephone was a luxury item, and television and the Internet didn't exist, we crafted rules to hold companies accountable and transparent. Today, we have 24-hour eyewitness news, the Internet and a wide array of social media where deceptive practices and false moves are documented and discussed by thousands on Facebook, Twitter, and other platforms.

So even though we live in an age where we encounter risk and manage it and we have tools at our fingertips to give us more information than ever before, we still act as if it were 1933.

These thoughts are shared by experts as well. The following are some of the many academic reports written about the SEC rules and how they prohibit access to capital for small businesses and entrepreneurs:

Proceed at Your Peril: Crowdfunding and the Securities Act of 1933, Tennessee Law Review. Joan MacLeod Heminway & Shelden Ryan Hoffman, August, 2011

Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption, University of Pennsylvania Journal of Business Law. Nikki D. Pope, August, 2011

Petition for Rulemaking: Exempt Securities Offerings up to $100,000 with $100 Maximum per Investor from Registration. Sustainable Economies Law Center. Jenny Kassan, July, 2010

SEC Regulations Barricade The Crowdfunding Floodgates, The Crowdfunding Revolution. Kevin Lawton, November, 2010

Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns, New York University Journal of Law and Business. Stuart R. Cohn & Gregory C. Yadley – Fall, 2007

Security Regulations and Their Effects on Small Businesses, California Research Bureau. Rosa Maria Moller, Ph.D. - April, 2000

The general consensus of each of these articles is that except for those that can afford it, the rules as they are written are costly and burdensome, and stymie the flow of capital. For larger businesses looking to seek capital in excess of $5M, these rules and associated costs are indeed beneficial to the investor. However, for smaller businesses seeking less than $5M they are counterproductive. Most of these articles go on to say that while the cost of regulation might be offset by the benefit of disclosure that in small companies where transparency is just a fact of life, they are indeed a barrier to growth. Because of this people are deterred from raising capital and many would be successful ideas never go anywhere.

WHY THE RULE CHANGE IS NECESSARY, AND WHY IT WILL BE EFFECTIVE:

Why is that we allow anyone to invest their hard earned money in the regulated and "disclosed" markets where people have made and lost billions of dollars under the mindful watch of the SEC yet we can't let those same people invest modest amounts in local community startups and small businesses where they know the players with the same potential outcome? There are few rules in life about what you can spend your money on until it comes to investing.

Current security laws presume that Americans are not responsible and are incapable of understanding that life is full of risk. And yet our everyday lives are full of examples. We don't expect a new restaurant to go through elaborate taste tests, even though people who spend $50 to $100 may wind up with a bad meal. Imagine if every seller on eBay had to be vetted with SEC rigor – commerce on the site would come crashing down. Or buy something on sale and then find out two weeks later, the same item is now 50% cheaper. People casually spend hundreds of dollars on iPads, tickets to concerts and sporting events, and even on products on the Internet from sellers that they might never have even heard of before. Why should we treat an investment of $100 as riskier than $100 of consumption? When it comes to security laws there is a different standard. One in which we must protect the interests of the investors because they are not "wealthy," "smart" or "responsible" enough to make their own decisions.

The current rules make it seem that in order to take money from the general public we need to make investing in startups the most secure investment possible. It isn't, and it never will be. But people still *want* to invest in entrepreneurs because they believe in people with ideas. It is a shame that instead of encouraging this activity, we throw pessimism in the face of entrepreneurs. This is not American. This was not the intention of our forefathers and this is NOT the America who will be competitive in the future.

Crowdfunding offers something unique with its strong elements of social networking. Opening the funding process to the general public adds transparency and trust signaling. It's much harder for fraud to occur when the whole world is watching on an open and transparent platform, especially with credibility and performance ratings that are visible to the community. Raising money nearly always requires using a first-level network as a trust signal to drive the network effect. No trust circle equals no funding.

In addition, there is a disparity that exists in between the funding world and gender. Women run only 8% of companies that receive money from venture capitalists. Compare this to the 41% of small businesses that are run by women. If getting capital to women under the old methods was challenging, ask them today. As you well know, women make great entrepreneurs and investors, and they continue to start businesses at a greater rate than men. Opening up other avenues for capital will help women-owned enterprises grow more rapidly -- a distinct challenge for women entrepreneurs as they continue to lag behind men in business growth.

It is ironic that thousands of people were able to invest money into scams like that perpetrated by Bernie Madoff (predominately through experienced and licensed financial advisors) yet they are prevented from making their own decisions about putting a fraction of that same money to use in a community startup. Never mind that Crowdfund Investing requires that "the investor" sit down, look at a deal, and analyze rather than trust the judgment of an advisor who makes their commission the instant the investment is made.

Our nation's small businesses have suffered disproportionately during the downturn and continue to struggle more than their larger counterparts. Many existing businesses, with their credit lines tapped out and their revenues battered, have struggled to remain afloat, much less expand. Businesses wanting to grow have often found themselves stymied by the reluctance of banks to lend again after the crisis. New start-ups, which have fueled job creation after previous recessions, have not taken root at the same pace as in the past.

Crowdfunding is like being part of a college team. You are only as strong as your weakest link. You aren't in the majors, and it takes both a good team and a great fan base to propel you to the championship. In crowdfunding the fans are the investors that more likely than not will know the players and rally around them, providing strategy, experience and money, not so they can pay their way to the BIG game but so they can launch a company that will benefit the entire community.

Believe it or not, crowdfunded companies will be the vetting ground for both public and private financing of winning companies. The ones the crowd gets behind and helps succeed will be the ones the VC's will line up to help grow. And you know what? In the end, everyone will benefit – the entrepreneur, the crowd that supported them and the VC that took them to the next level.

INVESTOR PROTECTION:

When discussing the current crowd funding taking place, the question is raised: "Why are people doing this?" If only 43% of projects on Kickstarter succeed, why aren't people crying foul but instead pledging more than ever before? ($7M in March on Kickstarter compared to $4M in January). The answer is simple. They want to help someone they know. They want to support an idea. They want to be part of a community and they want some recognition for it. People are drawn to crowd funding because they are capitalists. They admire entrepreneurs, and they know that sooner or later they may be entrepreneurs as well.

What are they basing it on? It comes down to trust and transparency. On the Internet, when your "wares are out there," it is on the line for everyone to see. By being transparent, you build trust. Users check out the reviews, read what other people are writing and make careful and informed decisions. All of this is recorded and becomes part of a larger "self-policing community" of profiles for both parties and a greater community rating system. These reputations today are carrying across the web from eBay to Tripadvisor to Rate-a-VC.

Other companies like TrustCloud aim to become a portable reputation system where their algorithm collects your online "data exhaust" – the trail you leave as you engage with others on Facebook, LinkedIn, Twitter, commentary-filled sites like TripAdvisor and beyond – and calculate your reliability, consistency and responsiveness. The result is a contextual badge you carry to any website, a trust rating similar to the credit rating you have in the offline world. These are tools that can and will be incorporated into any online Crowdfund Investing (CFI) platform to help foster transparency and accountability.

I think any of you would find it hard to disagree with this statement, "the Internet today has made the world a more transparent place. Your actions are followed and the opinions flow freely."

According to the Sustainable Economies Law Center, "The success of crowd funding sites demonstrates the desire of the public to support projects that they believe in. Enabling the additional motivation of possible financial return would only reinforce this economically healthy impulse."

So let's address all the naysayers. What if we carve out an exemption and it all comes tumbling down? What if we open the doors to defrauding thousands of people out of $80? Are these protectionists right? Will crowdfunding bring down the entire economy? To them we say, recall what happened in the Ireland Banking crisis of the late 1970's when the

bankers went on strike and warned the public that the economy would collapse without a banking system. What happened instead was a peer-to-peer banking system where the local pubs became de facto banks, lending money to their customers. It worked so well that some people even joked that there is no better judge of character than a bartender.

Opening the doors to a limited exemption will not cause the fraud that WorldCom and Enron did to their employees and investors, or that Wall Street and Bernie Madoff perpetrated on the American people. It will create a peer-to-peer system where communities become the de facto seed and early-stage funders to entrepreneurs. And if you think about it, there is no better judge of character in the United States than your neighbor, friends, and family.

But there are more reasons to trust the crowd. First, they are massively diverse. Fundamentally the collective IQ of the crowd works like this. Every time a new member joins who has one or more superior facets of IQ, the collective IQ is raised by those unique facets. Second, the values that VC's claim to provide will be disrupted by the crowd. A VC's Rolodex is easily replaced by social networks (i.e. LinkedIn). And the Rolodex of a few thousand crowd investors is much stronger than that of a few VCs. Third, expertise – it is disputable that the people who manage money bring more operational experience to the table than an interconnected crowd of people, many of whom are investing in you because they understand your business. And finally, valuation sophistication – the crowd has been putting their value on things since the beginning of time. Price anything too high and no one will buy it.

Naysayers act as if crowdfund investing were made legal, then every American will dump their savings into this. So either that makes us think they REALLY think we have the solution to kick starting our economy and are afraid of money not being invested traditionally OR they think that everyone for some reason will see Crowdfund Investing as lower risk than any other choice they make in their daily lives when in fact we all know this isn't true.

Crowdfund Investing is more than just money – it is facilitation, diligence, team building, and valuation. Most importantly, it is the engine that will create much needed jobs.

That being said, we shouldn't assume that "everyone" will bring expertise. Some will be a marketing engine for the entrepreneur and others will just bring a few dollars. Collectively, they will gather behind entrepreneurs they believe in, they will fund only those they are willing to risk their investment in and they will invest only if they think what they are being offered is fair. Trying to circumvent the crowd to bilk them out of a lot of little dollars isn't going to be worth the time or energy of a shyster.

There seems to be a general understanding in Washington that government spending stimulates the economy, but that when it comes to letting the average American decide how he or she wants to spend and/or invest his or her own money, then we need government oversight.

We stand at a moment in time when we can use crowdfund investing to start an education process. Where the average American who wants to be part of the process (mind you there's no forcing here) can be taught to think like an investor and ask questions of entrepreneurs like, "How does your idea generate cash? Do you offer a product or service I would buy? What skills/experience do you have to be accountable with my money and why should I trust you?"

In doing so, entrepreneurs will learn how to communicate, be accountable and transparent, and investors will provide critical seed and early stage capital. Jobs will be created, innovation will be spurred and our economy will continue to grow.

We do not believe it is the role of government to limit how we can spend our money. Nonetheless, we appreciate your desire to protect our savings and so I want to have the discussion, "if you believe that $10,000 is too much for an American to risk, what is the smallest amount you believe I should be able to invest in my entrepreneurial friend without SEC scrutiny? If you are fine with $1, at what point are you uncomfortable?" That is the point whereby we should set the limit. I wouldn't be surprised though, if we put it to a vote, the crowd would tell you "I'm an adult, I can make my own financial decisions."

If the dollar amount isn't what concerns you but the potential for fraud, even at $1, then we need to have a frank discussion about that.

As Kevin Lawton, author of *The Crowdfunding Revolution* says, "Fraud isn't really the issue, 'Failure' occurs much more frequently in startups." According to a Kauffman Foundation survey, approximately half the time you will lose all or some of your investment. Just as you diversify in the public markets to reduce exposure, having a portfolio of varied investments solves failure in the crowd funding space. As we have seen from over $300 million donated to projects and ideas through crowd funding already, while people are concerned about losing their money, they are more interested in helping someone bridge the gap, bring an idea to fruition, succeed, and in the end being able to tell their friends and family they had a part in the creative and entrepreneurial essence of what it is to be American. It's like paying for a brick in a new park or baseball stadium to be engraved with your name.

As Kevin Lawton said, "Fraud is just some noisy component of failure, and at that, it's going to be pretty hard to get away with much of it when there are millions of eyeballs worth of visibility and mechanisms which social networking enables to further vet entrepreneurs."

And thus, the biggest problem we need to solve is education. Running a portfolio and understanding the risk-vs-reward dynamics of investing in early phase companies is essentially an education problem. One way to solve the problem of unaccredited investors making investments, if you think of it as a "problem," could be to make people "educationally accredited." This can be done with a simple document, which explains the basics of the risk-vs-reward curve of risk startups and the basic principles of a portfolio. It can be done in a few pages and can be sent out in paper form, transmitted via email as a pdf, or done online in a more scalable way via a platform. Before being allowed to invest,

people would have to answer a series of questions that test their comprehension of the document.

Instead of pushing people down with a relentless assault on their intelligence, perhaps we should contemplate that people are adults and will make their own decisions. Our job should be to educate: education helps to create prosperity.

Education will teach the participants about analyzing and understanding risk. Nearly every company has a level of opacity. Even a brick-and-mortar restaurant business probably doesn't give you their recipes. Tech startups don't give you their 'IP', often not even to VCs. That's how it is. Lack of complete transparency creates a level of risk, which is why we have varied portfolios. And within an open market, if an investor has access to two similar deals, one of which is more transparent, which do you think he'll invest in? Concerns should be focused on the basics of investing, such as disclosures of the principal people in the company, details of the business model, use of funds and the securities offered.

The solution is simple. It doesn't require deregulation but reregulation -- a new regulatory framework. It doesn't require new thinking but rethinking the current rules to account for transparency and accountability.

CROWFUND INVESTING ... THE FRAMEWORK

Crowd Fund Investing (CFI) is not permitted by securities laws today but it stands to be a powerful method of financing, where groups of people will come together to invest in startups and provide valuable knowledge and experience to help an entrepreneur succeed. It will provide a way for unaccredited investors to pool their individual small contributions (likely between $50 and $500 each), and invest in companies and entrepreneurs they believe in. The funding rounds will occur on Internet platforms, which provide an added level of transparency and communication between the investors and the entrepreneurs. And "Micro-Angel Investors" will support people and businesses they believe in and in turn, help to grow the economy.

In order to make this a reality, we support creating common sense modifications to existing regulations to enable small businesses to raise capital. These reforms are modest, follow the spirit of the Securities Act of 1933 and the Exchange Act of 1934 and include:

1. Strong anti-fraud provisions
2. Limited risk and exposure for unaccredited investors
3. Transparency
4. Standards-based reporting and
5. Limit to the amount of seed capital a company can raise

This Framework is a proposal to the SEC for creating an exemption to enable entrepreneurs and small businesses to utilize their personal networks to raise small amounts of capital to start or grow their businesses. It would provide a framework for how much capital they can raise and restrict who can participate. This model was vetted by the

Small Business & Entrepreneurship Council (SBE Council) and again at a Crowdfunding Thought-Leaders Symposium held in San Francisco on August 1, 2011.

The goal of calling the industry participants together was to gain buy-in for the rules under which equity-based crowdfunding should be allowed. In addition, they believe having the group draft the rules better serves the foundational principles of limiting investor risk, optimizing fraud protection, enhancing informational transparency, and standardizing disclosure and enforcement.

This framework is meant to be a guide for any and all crowdfunding platforms on the Internet. Any entrepreneur/business that does not meet the criteria outlined below or "graduates" from the framework would have to comply with existing SEC rules. As with all security-related instruments U.S. anti-fraud provisions prevail.

1. **Amount and Class of Shares**: We propose the creation of a "funding window of up to $1M" for entrepreneurs and small businesses. "Small Business" is defined as one with average annual gross revenue of less than $5M during each of the last three years or since incorporation if the business has existed for less than three years. This definition is consistent with definitions utilized by the Small Business Administration. Straight common shares along with their standard rights could only be used. This is on par with similarly used shares in early stage rounds of family and friends financing.
2. **Limit**: We believe that investments from unaccredited investors should be capped at $10,000. The $10,000 limit is in line with other established financial disclosure limits like those on banking transfer reporting requirements. Accredited investors will not be subject to any limits. *Note*: The vast majority of individuals who choose to make Crowdfund Investments will most likely invest below $500. The current average is approximately $80 on existing crowd funding platforms.
3. **Risk Disclosure**: Given that 60% of Americans now own stocks or mutual funds, there is a certain level of investor sophistication that is greater today than ever before. (In the 1930s, only 5% of the population invested their money). In addition, unlike investing in the public markets where individuals rely upon the experience/advice of advisors, people choosing to invest via crowd funding will often be investing in their social networks with people they know and trust. Hence, accreditation should be attached to investors understanding of the risks inherent in this type of investment. Prior to using these platforms, investors will have to agree using current standard verification technology that they understand there is no guarantee of return, that they could lose their entire investment and that their liquidity/return is limited to any dividends, sale, public offering or a merger of the company.
4. **500-Investor Rule**: Eliminate the 500-investor limit for Crowdfund Investing via this window.
5. **State Law**: Exempt these offerings from state law registration requirements based on the limited size of the amount that can be raised, but leave intact applicable state law notice filing requirements, similar to the way SEC Rule 506 currently works.

6. **General Solicitation**: Allow for general solicitation on registered platforms where individuals, companies and investors can meet virtually, ideas can be vetted by the community as a sort of peer review and individuals can make informed decisions regarding whether or not to invest their money.
7. **Filing and Reporting**: Standardized forms (generic term sheets & subscription agreements) based on industry best practices will be used to maintain transparency and reduce time and expense for all parties. They will be electronically maintained using standardized procedures. Post funding standardized and automated reporting for use of proceeds will be required on a quarterly basis by entrepreneurs. Platforms will provide the SEC monthly offering reports that include information on: deals funded, entrepreneurs' names, social security numbers, addresses, date of births, amount of capital raised, list of investors and individual dollar amount contributed.
8. **Platform broker/dealer exemption**: Due the small nature of the dollar amount, and the high volume of automated activity, allow facilitation of funding for securities without need for a (FINRA) broker/dealer license by the facilitator, where deals facilitated fall within the constraints of this framework.
9. **Availability:** This exemption shall not be available to foreign issuers, investment companies, and public companies.

A similar framework is already in place in the U.K., France, Holland, India and China. Now is the time to make this happen in the U.S. so our economy is not left behind. We believe our framework is one that will allow for transparency, accountability, limited risk and exposure and the flow of capital.

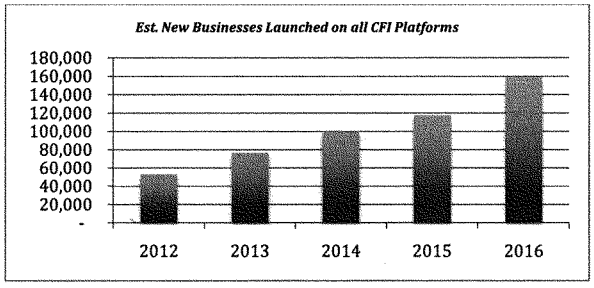
WHAT CROWFUND INVESTING CAN ACCOMPLISH

Crowdfunding goes beyond money, experience or trust. Michael Shuman, author of *The Small Mart Revolution: How Local Businesses Are Beating the Global Competition*, states "Crowdfunding has the potential to deliver the jobs Americans have been longing for. We know that small businesses, especially locally owned ones, are key for expanding the nation's employment, and these businesses comprise (by output and jobs) more than half the private economy. And yet almost none of the $30 trillion we have in our long-term investments (stocks, bonds, pension funds, mutual funds, insurance funds) touches these businesses. This is a colossal market failure, driven by obsolete securities laws. Moving even a few percentage points of our capital into local, small business could effect a stimulus home run."

In my May 2011 testimony I write, "Over the past 5 years, more than 500,000 people with ideas for films, albums and art projects, and entrepreneurs in developing countries, have used crowdfunding sites to raise money." Since then numerous crowdfunding sites have not only launched here in the USA but around the world as well, and the amount of ideas funded has far exceeded 500,000.

According to the SBA about 500,000 companies incorporate each year. While our belief that is that Crowdfund Investing will help stimulate ideas and businesses we do not believe

that we can create 500,000 companies overnight. However we do believe that following typical crowdfunding trends, we can create 500,000 companies over the next 5 years.



Based on SBA statistics on normal business attrition[1] (closure, merger, sale) times a trending growth curve by the US Census Bureau Statistics[2] about Business Size we estimate that the 500,000 companies created on CFI platforms over the next 5 years have the ability to create the 1.5M net new jobs.

BIPARTISAN SUPPORT FOR CROWDFUND INVESTING

Perhaps it is for this reason that President Obama during his September 9, 2011 speech to a joint session of Congress said, "Everyone here knows that small businesses are where most new jobs begin. And while corporate profits have come roaring back smaller companies haven't." "Ultimately our recovery will be driven not by Washington but our businesses and our workers. We can help." "I agree there are some rules and regulations that do put an unnecessary burden on businesses at a time when they can least afford it." So "we are ... planning to cut away the red tape that prevents too many rapidly growing startup companies from raising capital and going public." "We should have no more regulation than the health, safety and security of the American people required. And every rule should meet that commonsense test." "We should be in a race to the top and I believe we can win that race." "And it has been the drive and initiative of our workers and entrepreneurs that has made this economy the engine and envy of the world." "Members of congress it is time for us to meet our responsibilities."

Pursuant to his speech the American Jobs Act was released with the following paragraph:

Reducing Regulatory Burdens on Small Business Capital Formation: As part of the President's Startup America initiative, the Administration will pursue efforts to reduce the regulatory burdens on small business capital formation in ways that are consistent with investor protection. This includes working with the SEC to explore ways to address the

[1] http://web.sba.gov/faqs/faqindex.cfm?areaID=24
[2] http://www.census.gov/econ/smallbus.html

costs that small and new firms face in complying with Sarbanes-Oxley disclosure and auditing requirements. **The administration also supports establishing a "crowdfunding" exemption from SEC registration requirements for firms raising less than $1 million (with individual investments limited to $10,000 or 10% of investors' annual income)** .... This will make it easier for entrepreneurs to raise capital and create jobs.

CONCLUSION:

Crowdfund Investing has bipartisan support. Hopefully by now we have explained to you how Crowd Fund Investing really isn't something new. That with the proper framework and education we can allow the average American to take a few low risk dollars and use them in a powerful way to crowdfund entrepreneurs. That in doing so not only will we be solving the capital formation problem but we will be creating thousands of companies and employing thousands of Americans.

The good news is the SEC has the authority to make these changes. According to Section 3(b) of the Securities Act, the SEC grants the commission the power to:

> "Add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering ..."

At the end of the day, both the President and Republican members of Congress agree that it isn't in the government's interest to regulate investments in startups when the exposure to risk is limited to modest amounts. Hence we need to advance the framework presented here so that the government's interest in ensuring the success of our nation's entrepreneurs is also met. The scope of current securities laws is too broad, so broad that such laws stifle new forms of capital formation where the interests of entrepreneurs are already underserved.

We are in favor of a balanced approach. One that does not require excessive government oversight but allows Americans to invest in startups and small businesses in a limited way. When it comes to the economy, it is important to remember that be it government, investment or entrepreneur, we are all on the same team.

Thank you and I look forward to your questions.

Mr. MCHENRY. Thank you. Mr. Migliozzi.

STATEMENT OF MICHEAL MIGLIOZZI

Mr. MIGLIOZZI. Good morning and thank you, Chairman McHenry, Ranking Member Quigley, and members of the committee. My name is Micheal Migliozzi. I am the creative director and managing partner of Forza Migliozzi, an advertising and brand content agency. I am honored to have my presence requested by this body for any assistance regardless of how small that I am able to contribute with ideas to unleash our economy, leading to job creation and financial recovery. I am without question absolutely humbled to contribute what experience I have.

From my earliest memories my father told me that America is the land of opportunity, or that you can become whatever you want to become, through hard work you will succeed. I'm passing this on to my two little girls. I chose advertising.

I have had the unique opportunity to work with some of the smartest pioneering dream chasers and passionate people in business. As an ad man, it is though I am part psychologist, part bartender, and part clergy. It is my work to sell their work. My career path has taken me all around this great Nation, northwest, east and south, working for some of the best advertising agencies in the world from New York City to Portland, OR, creating campaigns for sneakers, sodas, sports teams, credit cards, casinos, hotels, beer and many other categories.

For an ad man the struggle and battle was to get to the reward of the big idea, the 24/7 quest to solve the problem at hand is never ending.

I came to realize that this is the struggle of the entrepreneur as well, a 24/7 cycle of commitment to your dream, the risk that might never see a reward, the fight to battle, or maybe to look failure in the face and fail it to take a hike. A few years back I took my own advice and became an entrepreneur by opening my own advertising agency.

I'm going to get on to crowd sourcing. What is crowd sourcing? The best definition I have ever found—excuse me, give me a moment.

Mr. MCHENRY. Sure.

Mr. MIGLIOZZI. What is crowd sourcing, the best definition I've ever found—I'm going to have to pass for a moment.

Mr. MCHENRY. We will come back to you to finish up, if that's all right. If you need some more water——

Mr. MIGLIOZZI. Thank you.

Mr. MCHENRY. Mr. Bullard.

STATEMENT OF MERCER BULLARD

Mr. BULLARD. Chairman McHenry, Ranking Member Quigley, members of the subcommittee, thank you for the opportunity to appear today to discuss the regulation of crowdfunding.

I would like to start by laying out the structure of securities regulation in order to put crowdfunding regulation in context. Securities transactions are generally regulated on three levels. On the first level securities transactions are subject to the same general commercial anti-fraud provisions that apply to all businesses.

On the second level securities transactions are subject to security specific anti-fraud provisions that provide increased investor protection.

There is some general agreement that crowdfunding triggers the first two levels of regulation which provides some degree of investor protection. On the third level, securities transactions are subject to public registration or reporting requirements, and this is where crowdfunding runs into trouble. Public registration, reporting requirements are generally impracticable for crowdfunding. In fact many issuers find them to be impracticable.

Congress and the SEC have created a variety of exemptions from public registration and primary public registration requirements, but these exemptions are also impracticable for many forms of crowdfunding. And the most significant problems are generally that some form of disclosure document is required and there is a general prohibition against solicitations and advertising in connection with the sale of securities. So the regulatory question as to crowdfunding is whether it would be appropriate to liberalize one or more existing exemptions or create a new exemption to accommodate crowdfunding.

I think the answer should be yes for the archetypal crowdfunding program. This would be offerings in which investors, individual investments were limited to a small amount, $100 or $250. The total amount of the offering did not exceed for example $100,000. For such de minimis investment amounts registration and reporting requirements should not apply. Other requirements should be imposed, including enhanced requirements for crowdfunding broker-dealers to combat the heightened risk of fraud.

Other types of crowdfunding, macro crowdfunding finance,—macro finance crowdfunding if you will, raise very different concerns. A $10,000 investment, for example, is not a de minimis amount, it is a significant amount for many investors and should be subject to some degree of registration and reporting. Making it much easier for scam artists to sell unregistered securities to families living below the poverty line or seniors barely surviving on Social Security is usually not good public policy.

Any macro finance crowdfunding exemption should be subject to the regulatory cost-benefit analysis traditionally used to evaluate registration and reporting requirements. This cost-benefit analysis generally considers the increased risk of fraud and the benefits to capital markets and to investors. It also considers the relationship of any new exemption to existing exemptions and the interest of all issuers, not solely those of crowd funders.

The areas where reform is needed in macro finance grant funding would be easier. Increasing the Reg A limit to $50 million is an example of why I don't believe there would be that much dispute. But let's not do that to make crowdfunding easier, let's do that to make Reg A work better for all types of capital raising.

Similarly, the 500 investor trigger for reporting obligations, the ban on general solicitation in advertising, and the qualifications for accredited investors all need to be reformed, but not to accommodate macro finance crowdfunding. They need to be reformed to accommodate the full range of issuers. The 500 investor trigger is routinely honored in the breach. Firms with thousands of beneficial

owners are often permitted to cease public reporting. At the same time other firms with thousands of beneficial owners are never required to file public reports in the first place.

The ban on general solicitation and advertising is fundamentally inconsistent with the Information Age. The frenzied and very public trading of Facebook's 2½ billion shares makes a mockery of this prohibition, as did the failure of the U.S. segment of a Facebook private offering earlier this year.

The wealth and income test for accredited investors have not been adjusted for 20 years, and they are structurally nonsensical. A young investor with $900,000 cannot put 10 of it in a hedge fund, but a retired auto workers with a million dollar portfolio living on say $40,000 a year that the portfolio generates can drop the whole million in a hedge fund. The investor who can afford to lose his shirt cannot invest, but the investor who cannot afford to lose his shirt can.

In conclusion, there is micro finance crowdfunding that simply does not implicate the public policy concerns underlying the third level of securities regulation, registration and reporting. The exemptions for other small issuers where investors are risking more than de minimis amounts are appropriate only to the extent of the cost of increased fraud, if any, is outweighed by the benefits.

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

[The prepared statement of Mr. Bullard follows:]

Chairman McHenry, Ranking Member Quigley, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the regulation of crowdfunding. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit investor advocacy group, and a Jessie D. Puckett, Jr., Lecturer and Associate Professor of Law 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 CFP Board's Public Policy Council; and a co-founder of and faculty advisor to the Self-Regulatory Organization for Independent Investment Advisers. 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 reglation issues from every perspective and attempt to provide testimony that reflects the interests of all parties as well as the practical exigencies of real-world compliance. My testimony is intended primarily to set forth a structure for how to think about a crowdfunding exemption, which I support for microfinancing (*e.g.*, a maximum contribution of $100 and maximum funding of $100,000) and conditionally support for larger fundraising efforts. However, I strongly oppose the latter exemption to the extent that it would allow $10,000 investments by individuals without regard to their financial sophistication or wealth.

Legal Context for Crowdfunding

There are essentially three levels of regulation that apply to crowdfunding. The first level comprises basic commercial antifraud law, much of which is state law. This law is not specific to the securities markets, but is applicable to business disputes generally and provides the foundation on which securities-specific regulation is built. Commercial antifraud law provides some degree of protection to investors, but the structure and substance of securities regulation reflects a shared, longstanding state and federal policy that commercial antifraud law provides inadequate protection to investors.

The second level of investor protection is securities-specific. It comprises the general state and federal antifraud laws that apply to transactions in securities. These laws are securities-specific in the sense that they are triggered when a transaction involves an interest in a business that is a "security." The definition of "security" include "investment contracts," as well as stocks, bonds, notes and other types of interests in businesses. Whether an interest is a security is usually clear, but there are situations in which judicial interpretation has played an important role. For example, the U.S. Supreme Court's *Howey* test interprets the meaning of "investment contract" under the federal securities laws, and its *Reves* test interprets the meaning of "note." Where an interest in a business involves a security, persons who act as intermediaries in transactions involving the security (*e.g.*, broker-dealers and investment advisers) are subject to extensive conduct regulation.

There are forms of crowdfunding that do not involve the issuance of securities. Forms of crowdfunding in which contributions are essentially donations with no expectation of any financial return do not involve securities. Other forms of crowdfunding in which contributions entitle the contributor to a discounted or free

item (*e.g.*, a copy of an album created with the contributions[1]) generally have been treated by regulators as also not involving securities.

However, some forms of crowdfunding offer an opportunity to participate in the financial experience of the funding's recipient. Regulators have taken the position that these interests are securities based on investors' expectations of a return on their investment. To date, this position has not been formally challenged. Any challenge under current law would likely fail because regulators' position falls well-within established law regarding the definition of "security." The status of this kind of crowdfunding does not appear to be a contentious issue or the subject of calls for regulatory reform.[2]

This means that current proposals to reform the regulation of crowdfunding (used here to refer to activities involving the issuance of securities) should be viewed in the context of general commercial and securities antifraud laws. These laws provide a fairly expansive foundation for both public enforcement and private claims as mechanisms to minimize fraud and engender the level of confidence in financial markets that is necessary for modern economies to function. There are many

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[1] Crowdfunding may involved a combination of donative and investment options. SellABand.com allow for donations to bands as well as a share of revenues from album sales. See www.SellABand.com. 33needs offers a share of revenues as well. *See* www.33needs.com. Cameesa, Inc., offered investors the opportunity to finance the production of selected t-shirts and share in the profits from sales from those t-shirts, but it did not register the securities and shut down in 2010. *See* Niki Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, 13 U. Pa. J. Bus. Law 101, 107 - 8 (2011) (*Crowdfunding Microstartups*). In contrast, IndieGoGo and Kickstarter appear to offer only merchandise and other non-investment perqs. See www.indiegogo.com and www.kickstarter.com.

[2] *See Crowdfunding Microstartups* at 109; Joan MacLeod Heminway and Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933* (Sep. 2011) (*Proceed at Your Peril*) *available at* http://ssrn.com/abstract=1875584. Some have suggested that a solicitation via social networks such as Facebook or an online community organized based on a common interest in the issuer might not constitute a general solicitation. *Id.* at 118; Rulemaking Petition of Sustainable Economies Law Center at n.22 (July 1, 2010) (*Rulemaking Petition*) *available at* http://www.sec.gov/rules/petitions/2010/petn4-605.pdf. It is unlikely that such a solicitation to the number of potential investors that many businesses would expect crowdfunding to reach would be consistent with the general solicitation prohibition.

instances in the securities laws where these laws, and nothing more, provide the level of protection that legislators and regulators have deemed to be adequate.

However, there are also many instances in which legislators and regulators have deemed antifraud rules alone to be inadequate to protect investors. In this situation, a third level of regulation has been built on the first two levels that imposes registration and reporting obligations on issuers of securities and related conduct rules for intermediaries. For example, large public offerings of securities generally trigger requirements to file a registration statement and regular reports (*e.g.*, the annual report, or 10-K) with the SEC. Such "public" companies are also subject to a host of substantive and procedural rules, such as federal proxy regulations.

This third level of regulation is not simply a matter of disclosure; it is disclosure with heightened consequences. Registration and reporting requirements are attended by public enforcement actions and private claims that are not available under general antifraud claims. For example, if a firm conducts an unregistered offering in reliance on a registration exemption, and that reliance later turns out to have been mistaken, purchasers of the firm's securities are entitled to the return of the purchase price without needing to prove virtually any other element such as the firm's intent. This private right of action makes compliance with registration exemptions – which are at the heart of current regulatory reform proposals involving crowdfunding – a make-or-break matter for firms engaged in raising capital.

Crowdfunding necessitates reliance on registration and reporting exemptions because the small amount of capital raised cannot cover the fixed costs associated with public registration and reporting. This is true whether crowdfunding involves $100 maximum investments in $100,000 maximum offerings,[3] or investments limited to $10,000/10 percent of the investor's annual income in offerings of less of

[3] *See Rulemaking Petition.*

less than $1 million.[4] And the securities laws have, for decades, been responsive to firms that face similar financial constraints while ensuring a minimum level of investor protection. Current proposals for reducing regulatory burdens on crowdfunding represent the kind of proposals that the SEC has addressed, if not always acceded to for years.

The exemptions that are most relevant to crowdfunding are: private offerings under Sections 4(2) and 4(5) of the Securities Act and Rule 506 under Regulation D; Regulation A and Rules 504, 505 and 1001; and intrastate offerings under Securities Act Section 3(a)(11) and Rule 147 thereunder. A detailed discussion of these exemptions is beyond the scope of this testimony other than to note that they variously impose three requirements that present difficulties for crowdfunding offerings: (1) the production and filing of some form of detailed registration statement, (2) the prohibition of any general solicitation or advertising,[5] and/or (3)

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[4] American Jobs Act Fact Sheet and Overview, White House (Sep. 8, 2011) *available at* http://www.whitehouse.gov/the-press-office/2011/09/08/fact-sheet-and-overview.

[5] Crowdfunding at low investment levels is simply incompatible with the general solicitation/advertising prohibition, both in principle and practice. The concept of crowdfunding derives from the idea that distributive, participatory collaboration can create benefits that targeted, exclusive collaboration cannot. These benefits are created, for example by the very dispersion of participation that only a general solicitation can achieve. Crowdfunding is ideally suited to exploit technologies that facilitate both wide dispersion of participation opportunities and the coordination of participation.

This aspect of crowdfunding is an element of the development of online auctions in conventional public offerings and a broader democratization of finance. *See generally* Brian Rubinton, *Crowdfunding: Distintermediated Investment Banking* (Apr. 11, 2011) *available at* http://ssrn.com/abstract=1807204. Google, an early adopter of the online auction IPO in 2002, *see also Crowdfunding Microstartups*, at 106 (discussing Spring Street Brewing Company's $2 million Regulation A Internet offering in 1996, which raised an average of $570 from approximately 3,500 investors), viewed its public offering structure as an expression of its corporate culture and business model, in much the same way that the participatory nature of crowdfunding reflects its origins in crowdsourcing as a means drawing on widely dispersed pockets of expertise in a cooperative project. The online auction IPO is itself a form of large-scale crowdfunding. One difference from smaller crowdfunding is that IPOs offer the scale of investment that attracts large investors with respect to whom there are well-established networks that also enable private offerings without the necessity of resorting to general solicitation. *See Crowdfunding Microstartups* at 112 (describing "closed community" of investors). At very small fundraising levels, only retail investors are likely to be interested, it is not possible to form a network of these investors without running afoul of the general solicitation/advertising prohibition. It is precisely through generalized communications that crowdfunding achieves the scale necessary to find support. Investment Banking at 5; *Proceed at Your*

the geographic limitation to a single state. These requirements generally render existing exemptions impracticable or prohibitively costly for crowdfunding.[6]

Thus, the current crowdfunding issue is whether current exemptions from public registration and reporting requirements should be relaxed in certain circumstances. This issue must be considered, as noted above, in the context of the antifraud regime that applies to commercial and securities transactions under federal and state laws. This antifraud regime provides a certain level of investor protection that, as supplemented with an appropriate level of registration and reporting pursuant to crowdfunding-friendly legislation or exemptive rulemaking, could reflect a reasonable accommodation of the conflicting policy concerns underlying the regulation of U.S. securities markets.

Microfinance and Macrofinance Public Policy Concerns

The idea of investment crowdfunding arose in connection with small fundraising efforts in which individuals contribute very small amounts. Exemptive proposals

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Peril at 45; Paul Bellaflamme, Thomas Lambert and Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd* at 2 (Feb. 13, 2011) (*Tapping the Right Crowd*) *available at* http://ssrn.com/abstract=1578175. Profounder acts as an intermediary for crowdfunding under Rule 504, which prohibits general solicitation and advertising, by limiting access "to friends, family members, and preexisting acquaintances of each entrepreneur—in other words, those with whom the issuer has a preexisting relationship." C. Steven Bradford, *Crowdfunding and the Federal Securities Laws* at 32 (Aug. 24, 2011) (*Federal Securities Laws*) ("registration is not a viable option for early-stage small businesses seeking relatively small amounts of capital") *available at* http://ssrn.com/abstract=1916184. To the extent that this approach actually complies with the general solicitation/advertising prohibition, it is not truly crowdfunding; the group with access is the opposite of the distributive "crowd" that crowdfunding is intended to access. *See generally* Ajay Agrawal, Christian Catalini and Avi Goldfarb, *The Geography of Crowdfunding* (Jan. 6, 2011) *available at* http://ssrn.com/abstract=1692661 (discussing geographic dispersion of investors as characteristic of crowdfunding). Existing exemptions are reasonably well-designed to accommodate precisely the kind small-scale fundraising that Profounder appears to facilitate.

[6] *Federal Securities Laws* at 29 - 30 ("registration is not a viable option for early-stage small businesses seeking relatively small amounts of capital") *See generally* Small Business & Entrepreneurship Council (Dec. 21, 2010) *available at* http://www.sec.gov/info/smallbus/2010gbforum/2010gbforum-sbe.pdf; *Proceed at Your Peril* at 29.

that reflect this model generally would limit individual contributions to $100,[7] $250[8] or $1,000[9] and the total capital raised to $100,000.[10] From a public policy perspective, that is, public policy as embedded in the existing structure of securities registration and reporting requirements, these microfinance crowdfunding proposals make a strong case that the amount invested and the context of the investment justifies a complete crowdfunding exemption for issuers (if not intermediaries, as discussed below) on the ground that the size of investors' potential losses do not trigger the concerns on which the third level of securities regulation – registration and reporting – is based.[11]

I agree. While one might question whether the loss of a *$1,000* investment could still be considered a *de minimis* loss, the principle that the registration/reporting level of securities regulation should not be implicated by *de minimis* investments is consistent with the structure and purpose of the securities laws and the typical expectations of microfinance crowdfunding investors. The SEC has the authority under Securities Act Section 3(b) to create such an exemption and should proceed forthwith to request comment on a range of specific proposals. Its rulemaking must entail, of course, a cost-benefit analysis that would meet any challenge, for example, from investor advocates that questioned whether the cost of fraud that may occur under the exemption justified the somewhat uncertain capital formation and investor opportunity benefits created.

Exemptive proposals that go beyond the core, microfinance concept most closely associated with the concept of crowdfunding are a different matter. One proposal

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[7] *See Rulemaking Petition* at 7.

[8] *See Proceed at Your Peril* at 60.

[9] *See Crowdfunding Microstartups* at 121.

[10] *See Rulemaking Petition* at 7.

[11] *See Crowdfunding Microstartups* at 113 (discussing minimal impact of small losses).

would permit investments of $10,000, which cannot reasonably be viewed as falling within the *de minimis* exception described immediately above. Unless the core structure and logic of the securities laws are to be wholly abandoned, macrofinance exemptive proposals necessitate a traditional securities law analysis. There are good reasons for the existing structure of securities law exemptions – a flexible structure that has for decades helped establish the U.S. as the leading securities market in the world and for which the SEC should be given credit, not criticized. Concerns regarding macrofinance crowdfunding apply to capital raising not only by small firms, but also by large firms, as illustrated by Facebook's failed U.S. private offering earlier this year.[12]

For example, the federal securities laws generally prohibit general solicitations in connection with offerings to individuals who do not meet minimum financial sophistication and/or wealth requirements. Even *institutional* investors are often subject to such requirements as a condition of their making certain high-risk investments. These restrictions have significant logical shortcomings, but they have functioned reasonably well. In contrast, the White House proposal to create an exemption for "individual investments limited to $10,000 or 10% of investors' annual income" is inconsistent with longstanding securities law principles and should not be permitted. The use of the term "or" in this standard means that an individual with a very small income and $10,000 in savings – even a retired person living on Social Security -- would be permitted to invest all of his savings in a single crowdfunding venture.

The use of "or" in the White House proposal may be an error. It would be a reasonable approach if investments were instead limited to the "lesser of" $10,000 or 10% of an investor's annual income. This revision would mean that a person who

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[12] *See* Mercer Bullard, *Facebook Fiasco Reveals Flaws in Private Offerings*, Morningstar.com (Feb. 2, 2011) (*Facebook Fiasco*) *available at* http://news.morningstar.com/articlenet/article.aspx?id=369342 (this article is attached at the Appendix to this testimony).

earned, for example, $15,000 annually would be limited to investing $1,500 in an offering, rather than $10,000 permitted under the White House proposal. This version of the exemption would actually cure one of the longstanding logical problems with the SEC's existing accredited investor standard. The accredited investor standard permits a person with $1 million in investments to invest in a private offering even if the entire $1 million is invested, which contradicts the idea that the $1 million in investments enables the investor to bear the loss. Similarly, the accredited investor $250,000 income test has no bearing on the amount of the risk taken in connection with the investment. A person who earns $240,000 annually cannot invest $10,000 in a private offering while a person who invests $250,000 can invest their entire net worth. Although these logical problems are, to some extent accommodations to the exigencies of compliance (the more finely tuned the rule, the higher the compliance cost), they could be modified to provide a more rational relationship between the income/assets test and the investor's actual capacity to bear a loss.

There are similar, broader problems with the reporting triggers under the Exchange Act and the general solicitation prohibition under the Securities Act. Private markets have become so well-developed as to make a mockery of the 500-investor limit, as illustrated by the level of activity in the secondary market in Facebook's *2.5 billion* shares.[13]

As a general matter, the restrictions on general solicitation and advertising have become increasingly outdated.[14] The concept of *delivering* information is giving way to the concept of the universal availability of information, even information that is intended to avoid violating the general solicitation/advertising prohibition. Again, Facebook illustrates this problem. The recent failure of the U.S. component of a Facebook private offering illustrated how even communications that are reasonably

[13] *See id. infra*, at Appendix.

[14] *See Proceed at Your Peril* at 62.

designed to be private may end up online in the Wall Street Journal.[15] These are significant problems in the regulation of capitalraising, but they need to be given fuller and different consideration from the treatment afforded to microfinance crowdfunding.

In summary, a microfinance crowdfunding exemption would be appropriate and consistent with the protection of investors on the ground that the amount of the investment was *de minimis* and did not trigger the policy concerns underlying registration and reporting requirements under the securities laws. Although the articulation of a complete exemption is beyond the scope of this testimony, its core feature could include the following:

- $100,000 aggregate offering limit,
- Limit of one offering each year *or* maximum of one offering open at any time,
- Offerings only by natural persons,
- $250 maximum investment per investor (as specifically authorized by an amendmdent to Securities Act Section 4, with SEC authority to increase the amount),
- Inclusion as a covered security under Securities Act Section 18 with no restriction on state enforcement authority,
- Exclusion of crowdfunding investors from counting toward the 500-investor reporting trigger under the Exchange Act,[16] and
- Offering conducted through a crowdfunding broker-dealer (*ie.*, subject to crowdfunding-specific intermediary regulation pursuant to SEC rulemaking).

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[15] *See Facebook Fiasco infra*, at Appendix.

[16] The purpose of the 500 investor registration trigger would not be served if investors who had invested $100 or less were included in that total. The same *de minimis* reasoning that would support the registration exemption would support excluding those investors when considering whether the number of shareholders is large enough to implicate the public policy concerns underlying reporting requirements under the Exchange Act. As noted above, this is not an issue for debt crowdfunding because reporting requirements are triggered by the issuance of equity, not debt.

In contrast, a macrofinance crowdfunding exemption should be placed on a separate track. A macrofinance exemption raises far broader and more complex issues than a microfinance exemption and will affect many more issuers that just crowdfunders. Combining microfinance and macrofinance exemptive proposals will unnecessarily impede the adoption of a microfinance exemption. Microfinance crowdfunding should not be held hostage to the interests of larger firms that seek much broader, and fundamentally different relief from the securities laws.

Intermediary Regulation

The regulation of intermediaries has, over time, expanded as an indirect means of regulating the conduct of issuers of securities. For example, the regulation of municipal securities, which are substantially exempt from issuer regulation under the securities laws, is conducted primarily through the regulation of intermediaries who distribute them. The nature of crowdfunding may lend itself to a primarily intermediary-based approach to regulation. To the extent that responsibility for crowdfunding compliance (*e.g.*, investor eligibility) is placed on the intermediary, the fixed costs of crowdfunding compliance can be achieved at lower cost and will be implemented by repeat-player, securities professionals, rather than one-time-participant ventures or marketplace web-sites.

Without intermediary regulation through the existing broker-dealer regulatory regime, crowdfunding would create a significant likelihood of an unacceptably high level of fraud in the crowdfunding marketplace.[17] Many crowdfunding activities are conducted through the Internet, which offers an ideal vehicle for perpetrating investment scams.[18] This would undermine investor confidence and ultimately may result in the evisceration, if not elimination, of crowdfunding markets altogether.

[17] In 1992, the SEC liberalized Rule 504's requirements to permit, essentially, offerings under which crowdfuding could be conducted. Seven years later, it concluded that the actual increase in fraud was not worth the benefits and substantially tightened Rule 504's requirements.

[18] *See Proceed at Your Peril* at 49 - 50.

Crowdfunding is a fundraising mechanism that relies more heavily on public trust than do public markets; it would not survive if it became generally associated with fraud. A crowdfunding exemption assumes the stripping away of issuer regulation; broker-dealer regulation would provide an essential backstop to protect the integrity of the crowdfunding market.

Intermediary regulation reduces the likelihood that crowdfunding will facilitate pure fraud, that is, scams designed simply to extract money from investors based on misrepresentations, as opposed to enterprises that are, by any objective measure, imprudent investments, but that represent a good faith effort that is at least consistent with what investors expect the issuer to *attempt* to do, if not succeed at doing. The distinction between scams and objectively bad investments is an important one because the total, social cost of fraud depends partly on the investor's actual expectations. When an investor loses $100 to a venture that is akin to a charitable, notprofit enterprise, the total loss of utility to the investor will be less than when the venture is a strictly profit-making enterprise (just as some investors who engage in social investing understand that they are accepting a lower return for which they are being compensated in nonmonetary utilities).[19] In a sense, the loss of $100 under a crowdfunding exemption should be "less" than a $100 loss in a regulated offering.[20] However, this will not be the case if loss is to a scam artist using crowdfunding as a front for plain vanilla theft. Indeed, the cost of the $100 loss may be *greater* when the investor enters the transaction with higher social expectations and ends up financing the lifestyle of criminals. It is intermediary regulation that would best minimize losses to scams as opposed to losses to hopeless, but well-meaning, good faith pipedreams.

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[19] *See* Armin Schwienbacher and Benjamin Larralde, *Crowdfunding of Small Entrepreneurial Ventures*, Handbook of Entrepreneurial Finance at 16 (Sep. 28, 2010) (discussing crowdfunding investors' nonmonetary values) *available at* http://ssrn.com/abstract=1699183.

[20] This is analogous to the theory of crowdfunding as a form of price discrimination. *See Tapping the Right Crowd* at 3 - 4.

As a general matter, a person who provides a marketplace for crowdfunding is required to register as broker-dealer. However, it is not clear this applies to someone participating in a single distribution of crowdfunding interests.[21] Nor is it clear that the operator of a crowdfunding site that facilitates occasional, but not "regular" crowdfunding offerings would be a broker-dealer.[22] The SEC has not provided adequate guidance in this area.[23] It should do so and clarify that crowdfunding marketplace operators must register as broker-dealers (as appears to be its current position). If operators of crowdfunding markets are not regulated as broker-dealers, investors would be denied the kind of regulation that would provide a significant level of protection and materially reduce any increased incidence of fraud that accompanies the introduction of a crowdfunding exemption.

Although the full panoply of broker-dealer regulation is clearly not warranted for firms whose securities-related business is limited to non-custodial crowdfunding operations, there is currently no applicable mechanism for broker-dealer "lite" status under the Exchange Act. In contrast, the definition of "exchange" includes a complete exemption for securities markets that facilitate only the sale of securities by a single seller (the issuer). Similar relief (but not complete exemption) from broker-dealer regulation may be appropriate for crowdfunding-only operators. Until that happens, however, operators of crowdfunding sites should be required to register as broker-dealers.

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[21] They would not be required to register as "exchanges" because sites that facilitate the distribution of an issuer's securities, where there is only one seller and no "bringing together of orders among multiple buyers and sellers," are exempt from the definition of "exchange" under the federal securities laws. *See Federal Securities Laws* at 34. However, sites that facilitated a secondary market in crowdfunding securities generally would be exchanges. Crowdfunding operators also would not be investment advisers in reliance on the broker-dealer exclusion in Section of the Investment Advisers Act. If they were not broker-dealers, there is a good chance that they would be regulated as investment advisers. *See generally id.* at 45 - 54.

[22] *See generally Guide to Broker-Dealer Regulation*, Division of Trading and Markets, SEC (April 2008) *available at* http://www.sec.gov/divisions/marketreg/bdguide.htm.

[23] *See generally Federal Securities Laws* at 34 - 45.

Debt Crowdfunding

The crowdfunding discussion has generally focused on equity investments, yet the issuance of interests in the form of debt generally triggers the same public registration issues that apply to equity. (In contrast, reporting obligations are not triggered by the issuance of debt because they are based on the issuance of equity.) There are already significant crowdfunding markets in the fixed income arena, known as "peer-to-peer lending," and the SEC has negotiated accommodations with issuers of notes that it deems to be securities. Reforms intended to address equity crowdfunding should be coordinated with existing and future regulation of debt crowdfunding.

Current crowdfunding proposals are not consistent with the approach that the SEC has taken in the peer-to-peer lending context.[24] Microlenders file full-blown registration statements and make daily, if not hourly SEC filings, apparently pursuant to SEC-imposed requirements. Although it is not clear whether the SEC required that microlenders act as issuers as a condition of their continuing in business, microlenders do, in fact, act as issuers. This is not a viable alternative for crowdfunding in the equity context, and regulating debt and equity crowdfunding different will make it difficult for crowdfunders to offer both debt and equity alternatives to investors. Along with donative options, debt and equity investment options comprise what might be considered the logical triumvirate of financing for true crowdfunding ventures.[25] The registration requirements for crowdfunding debt and equity should be rationalized.

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[24] *See generally id.* at 14 - 16.

[25] *See Disintermediated Investment Banking, passim* (discussing interdependency of donative and investment forms of participation).

State Regulation and Preemption

The states play a key role in the regulation and policing of the securities markets. For example, it was state regulators that brought major cases involving analyst fraud and mutual fund market-timing in the early part of the last decade at a time when the SEC allowed these practices to develop. Some crowdfunding proposals contemplate substantial preemption of state authority. Any crowdfunding proposal should consider carefully the loss of investor protection that a partial or complete preemption of state regulation would cause. At a minimum, state enforcement authority as to antifraud conduct in the crowdfunding market should be preserved, although it would be appropriate to provide that securities sold under a microfinance crowdfunding exemption were covered securities that were exempt from state registration regulation.

Appendix

Facebook Fiasco Reveals Flaws in Private Offerings

By Mercer Bullard | 02-10-11 | 06:00 AM |

Last month, Goldman Sachs (GS) rescinded its private offering of Facebook shares to its U.S. clients, while proceeding to sell $1 billion in shares to its non-U.S. clients. Goldman pulled the U.S. offer because, in its own words, it:
concluded that the level of media attention might not be consistent with the proper completion of a U.S. private placement under U.S. law.

The withdrawal of the U.S. Facebook offering was an embarrassment to Goldman Sachs and U.S. markets. Regulators should use it as a catalyst for reforming fundamental aspects of the current regulation of private offerings.

General Advertising

Private companies can avoid the high cost and administrative burdens of registering the sale of new shares under the federal Securities Act by selling them under the Act's exemption for "nonpublic" offerings. Courts have interpreted the "nonpublic" requirement to mean that public dissemination of information must be limited. To make a long story short, issuers found that courts' case-by-case, *ex post* decisions on permissible communications during an offering were too unpredictable for efficient planning, so the SEC created a somewhat more predictable safe harbor. Regulation D (known as Reg D) requires that issuers and their agents not "offer or sell the securities by any form of general solicitation or general advertising."

The Facebook fiasco demonstrates the outdated nature of this rule. To illustrate, consider Goldman's message to its prospective Facebook investors:

When you have a chance, I wanted to find a time to discuss a highly confidential and time sensitive investment opportunity in a private company that is considering a transaction to raise additional capital.

It is a bit comical that Goldman must pretend that its clients will not know that the unnamed company is Facebook. It is downright absurd, considering the prohibition against general advertising, that this private communication soon appeared in the*Wall Street Journal*. It is this kind of exposure that probably led Goldman to "conclude that the level of media attention might not be consistent with the proper completion of a U.S. private placement under U.S. law."

There is more. Directly above the *Wall Street Journal* excerpt appeared a link to a*SmartMoney* article: "How to Buy Shares of Facebook." The article describes sales of hundreds of millions of shares of Facebook, Twitter, and other hot-but-private firms through private exchange SecondMarket (the Walmart of private offerings)--and how you can get access to this market.
The Jan. 29 homepage for SecondShare, a private offering information website (apparently unaffiliated with SecondMarket), graphed the rise of Facebook's valuation from well under $7 billion in August 2009 to over $70 billion today, based on trading in its shares. More precisely, that's *private* trading in its 2.5 *billion* shares outstanding.

How private is this "private" market? Bono's private-equity fund Elevation (named after his song) reportedly bought a $250 million stake from Facebook employees. Business Insider reports that he gained access to Facebook through Roger who met Mark through Sheryl who is married to Marc (who is now severing ties with Roger).

The private markets are not private or markets. They are social networks. Offerings by the most successful private issuers, especially sexy tech issuers, have been and will always be accompanied by general advertising. Whether or not the advertising is legally attributable to the issuer (Facebook) or its agents (Goldman) is immaterial. The idea of non-public dissemination of information no longer has practicably definable boundaries.

Eligible Investors

Courts also have interpreted the "nonpublic" requirement for private offerings to mean that offers can be made only to certain types of investors. Again, *ex post*judicial decisions regarding investor eligibility have provided a poor model for prospective planning, so the SEC issued clearer guidance in Reg D.

Reg D sets forth objective, easily measured criteria for determining investor eligibility. For example, any person with a net worth of at least $1 million or steady annual income of at least $200,000 ($300,000 for a couple) qualifies. The net worth and income tests act as general proxies for an investor's financial sophistication and ability to bear a loss. Issuers found that these proxies were easy to apply. The deepest and most liquid private markets in the world were born.

Goldman's U.S. offering assuredly did not get hung up on the investor eligibility issue--the minimum investment reportedly was $2 million--but the issue is overdue for closer scrutiny. One reason is that minimum net worth and income standards are weak proxies for sophistication and the ability to bear a loss. One might question the assumption, for example, that a retiree with $1 million in investments--suggesting an annual income of $40,000 at a typical 4% drawdown rate--is financially sophisticated and/or able to bear a substantial loss

The current test can produce skewed outcomes. Compare a 65-year-old millionaire who invests 100% of his assets in a single hedge fund that is wiped out, with a semi-millionaire of the same age with only $100,000 invested in the same fund. The first, a "sophisticated" investor under the law, is left destitute. The unsophisticated investor still has $400,000 in investments. Investor eligibility rules therefore might work better if they turned on an investor's actual exposure to private-offering-like risk However, evaluating investors' eligibility in this manner would be far more burdensome for issuers than establishing compliance with the existing net worth/income test.

An alternative approach might be to require a minimum investment in a low-risk asset. For example, purchasers could be required to prove that they have at least $500,000 invested in a globally diversified mutual fund. This test theoretically would ensure a minimum retirement income (*e.g.*, $20,000 annually at a 4% withdrawal rate) if the private investments made with additional funds were wiped out, while providing an even simpler compliance test than the current one. The test would potentially increase the number of individuals who could access private investment vehicles, while excluding excessive risk-takers.
The low-risk investment minimum could be tailored to the age and/or employment status of the investor. The minimum for a still-working 50-year-old could be lower--$300,000, perhaps--on the theory that a complete loss on the private investment would still allow time to catch up. The minimum for the working 25-year-old could be zero (better that the harsh lesson of private investment risk be learned at age 25 than 65[1]).

The idea of requiring a minimum low-risk investment could create social benefits. Just as we all pay the medical expenses of the uninsured, helmetless motorcyclist who ends up in the emergency room, we all pay for the risks taken by persons who make risky investments. Investment risk-taking is being indirectly subsidized by taxpayers who will pick up the tab for those who lose their shirts and therefore depend more heavily on taxpayers in their old age.

We should not be surprised to see the concept of minimum low-risk investments begin to appear in other regulatory contexts. The Department of Labor is considering regulatory reforms regarding the use of annuities in self-directed, defined contribution plans. The DOL could require that plans offer (or even that participants purchase) a fixed annuity that would pay a minimum annual retirement income, in part to reduce reliance on Social Security as a source of retirement income.

The Logic of Private Offering Regulation

The Facebook U.S. offering fiasco raises serious questions about the logic of the eligibility criteria for investors in private offerings. One might argue that no test can credibly certify as financially sophisticated a buyer of shares of a company run by a 28-year-old at 100 to 125 times earnings. Certainly there should no debate that a test that allows a retiree with a million-dollar portfolio to bet it all on Facebook is incoherent.

As discussed above, the Facebook fiasco also exposes the fundamental incongruity of private offering regulation and the dynamics of the Information Age. The law's capacity to restrict the dissemination of information is becoming more limited daily. Continuing to pretend otherwise will serve only to further shrink our private offering market and send more private U.S. firms overseas in search of capital.

Mercer Bullard is president and founder of Fund Democracy, a mutual fund shareholder advocacy organization, an associate professor of law at the University of Mississippi School of Law, a senior adviser for financial planning firm Plancorp Inc , and a former assistant chief counsel at the Securities and Exchange Commission. He has testified frequently before Congress on regulatory issues. He can be reached at bullardm@funddemocracy.com.

Mr. MCHENRY. Thank you, Mr. Bullard.

Mr. Migliozzi, we will return to you, if you can summarize. I think 4 minutes left.

Mr. MIGLIOZZI. I will pick up if I may with regards to the entrepreneur.

So a few years back I did, I took my own advice and became an entrepreneur by opening my own advertising agency. I now share the same challenges and same roadblocks that many entrepreneurs face regardless of size, purpose or industry. My business is wholly dependent on other businesses who need to sell their products or services. They are dependent on an end consumer to sell to, the consumer a paycheck to spend with. As we have seen, the cycle or the gears of this cycle have locked up.

Crowd sourcing and advertising. What is crowd sourcing? The best definition I ever found goes something like this. It is a neologistic compound of crowd and outsourcing for the act of taking tasks traditionally performed by an employer contractor and outsourcing them through a group of people or community through an open call to a large group of people, a crowd asking for contributions.

Apparently I've been doing this for quite some time. We will go on to buy a beer. This is fun.

In the fall of 2009 I read a——

Mr. MCHENRY. Just take your time, it is okay.

Mr. MIGLIOZZI. All right. I'm having an allergic reaction to medication.

Mr. MCHENRY. I'm sorry, I know that's very convenient for the day you are having.

Mr. MIGLIOZZI. Huh?

Mr. MCHENRY. So sorry. I know having an allergic reaction is very convenient for testifying before Congress.

Mr. MIGLIOZZI. Yes, I'll finish it.

Mr. MCHENRY. I say that with sarcasm but just take your time. It is fine.

Mr. MIGLIOZZI. Okay. In the fall of 2009 I read a New York Post article about Pabst Brewing Co. was up for sale, and the asking price was $300 million. In jest via a corporate Twitter account I tweeted maybe we can crowd source this. And before I could even hit the "send" button I knew this would be at the very least a great case study to evaluate crowd sourcing, its behavior, its magnitude.

My expertise is not finance, economics or law. My expertise is in effective branding, marketing consumer behavior and possibly a little side show regardless of medium.

I'm not here to confirm nor deny any of the findings of the Securities and Exchange Commission's cease and desist order. I was asked to be here to recount the important aspects of my experiment as it relates to funding companies without traditional financial outlets and to highlight the success it had not in theory but in actuality.

Crowd sourcing means crowdfunding. This experiment was to answer my questions about crowd sourcing. With such a large amount, a $300 million asking price it would require the crowd sourcing vehicle to be easily partaken by all, exclusively online.

Excuse me. The goal was to stay as the focal point, a countdown starting at a mind boggling $300 million may not be so mind boggling as we're hearing about trillions of dollars every day, but a very large amount just the same. What was being asked of them, their interest to join in the largest ever crowd sourced audience, that was their interest, came in the form of pledging their name, email address and an unbinding amount they were pledging and in caps "send no money."

It is important for me to state here that at no time was any money ever received, nor was there any way for users to send the money nor any way for us to collect money. How to create enough buzz to get this into the hands of others would be required, how long could the buzz be sustained, how would the user take control of the conversation to generate buzz. Transparency, any questions and their answers needed to be anticipated and answered by viewing the site.

Of course at the onset of the experiment there was simply no way to predict a positive outcome, far too many variables. A one page Web site is created with full disclosure, a Twitter account created, a press release circulated, this on or about November 10, 2009. By December 1, 2009, over $14.75 million was pledged.

I'm getting into the red, if I may ask for additional time.

The amount of press, press about the concept, the ease of understanding, the genius of the experiment generated buzz traffic sharing that by the end of 2009, the amount of pledges had exceeded $100 million. Christmas, New Year's passed. I was certain with the new year this would be old news. By February 22, 2010, over $200 million was pledged. What was just an experiment was now taking up far too much of my time with press requests, some 150 articles written, radio interviews by that point. There was an interest by media users, etc., that this could happen. Could it? How? What steps would need to be taken? Pledges were still coming in. Press was still writing about this. This experiment was turning into a solid case study and an award winning one at that as it won for most innovative in the crowd sourcing competition at South By Southwest in 2010.

On March 24, 2010, I received a FedEx from the SEC which led to the shuttering of buyabeercompany.com. Those proceedings concluded on June 8, 2011. Pabst Brewing was purchased on May 26th purchased 2010 for about $250 million, according to the Wall Street Journal, by investor C. Dean Metropoulos. At the time of closing buyabeercompany.com, over $282 million was pledged by over 7 million users, averaging $38 per pledge.

My conclusion is coming. I believe this illustrates the power of crowd sourcing or rather as it is referred here specifically as crowdfunding. What a powerful tool whereby the investor now becomes purchaser, brand steward, evangelist where the brand must answer to them and live up to their every expectation, not as a simple financial tool but as their expansion of buying into the brand. This process could have been easily used for the sale of Hummer GM, as seeking to shed their division was selling this American icon to China. While that $150 million fell through, I can't help but imagine if crowdfunding could not have only saved this brand but the jobs, the dealerships and the money spent on

R&D, the equity built into the marketing brand loyalty by simply opening this up to the general public.

What started out as an experiment to test for hypothesis or the power of social media and the propelling of a crowd toward a common goal had become a concrete and plausible way to do business in a landscape which moves rapidly and without harness. For my purposes it gave me invaluable information on consumer behavior. Hopefully other aspects of this can provide light on how we can utilize this to fund, build, expand businesses, the economy, leading to job creation. The possibilities of crowdfunding for starting expanding and purchasing companies are never ending.

Thank you.

[The prepared statement of Mr. Migliozzi follows:]

Introduction

Good morning and thank you to Chairman McHenry, Ranking Member Quigley and members of this committee.

My name is Michael Migliozzi. I am the Creative Director and Managing Partner of Forza Migliozzi, an advertising and brand content agency.

I am honored to have my presence requested by this body. Any assistance, regardless of how small that I am able to contribute with ideas to unleash our economy leading to job creation and financial recovery, I am, without question, absolutely humbled to contribute what experience I have.

My journey to this point, if I might share, starts with a 4 year old boy in the hills of Naples, Italy. One of eleven children, whose mother scattered them across the landscape in the hope that their chances of survival would be greater. The setting is World War II.

This small boy and his brother, just a few years older, hid from the Nazi soldiers. In their retreat they were killing everything they came upon, animals, elderly men and women, children. As these two small boys saw Nazi soldiers coming their way, the elder of the two, able to climb a tree, needed to protect his brother.

Around them was the bloody carnage of war.

The elder brother, beyond his 9 years of age, took the blood of a fallen Nazi solider and smeared it onto the 4 year old. He told him to lie below the tree and not to move. Not to breathe. Not until he told him to.

The 9 year old climbed the tree, with a rifle found on the ground, kept his eye on the approaching Nazis.

A Nazi solider came upon the 4 year old and looked down at him, he then moved his body around with the bayonet attached to his rifle. Unknowingly he was in the crosshairs of a 9 year old who had his finger on a trigger.

What stopped this 9 year old from pulling the trigger?

The United States military on the horizon.

The 9 year old was my uncle. The 4 year old my Father.

15 years later, my father, flew to America, to meet his elder brother. What he met was the greatest country created.

He sought citizenship. He was sponsored. He learned the nation's language. He learned of George Washington. He became a citizen of the United States.

From my earliest memories, my father told me that America is the land of opportunity. That you can become whatever you want to become. Through hard work you will succeed.

I chose advertising.

I have had the unique opportunity to work with some of the smartest, pioneering, dream chasers and passionate people in business. As an ad man, it as though I am part psychologist, part bartender, part clergy. It is my work to sell their work.

My career path has taken me all around this great nation. North. West. East and south. Working for some of the best advertising agencies in the world. From New York City to Portland, Oregon. Creating campaigns for sneakers, soda, sports teams, credit cards, casinos, hotels, beer and many other categories.

For an ad man, the struggle and battle is to get to the reward of the big idea. The 24/7 quest to solve the problem at hand is never ending.

I came to realize that this is the struggle of the entrepreneur as well. The 24/7 cycle of commitment to your dream. The risk that might never see a reward. The fight to battle off fear of failure or maybe to look failure in the face and tell it to take a hike.

So a few years back I took my own advice and became an entrepreneur by opening my own advertising agency.

I now share the same challenges, the same roadblocks that many entrepreneurs face, regardless of size, purpose or industry. My business is wholly dependent on other businesses need to sell their product or services. They, dependent on an end consumer to sell to. The consumer, a pay check to spend with.

As we have seen, this cycle or the gears of this cycle have locked up.

Crowdsourcing in Advertising.

What is crowdsourcing? The best definition I have ever found goes something like this:

It is a "neologistic compound of Crowd and Outsourcing for the act of taking tasks traditionally performed by an employee or contractor, and outsourcing them to a group of people or community, through an "open call" to a large group of people (a crowd) asking for contributions."

Apparently, I have been doing this for quite some time.

Early in my career, I was tasked with creating a solution to benefit a children's AIDS foundation. This was still the days when this disease was something no one wanted to talk about, let alone acknowledge it existed. With no budget to

achieve their goals, the struggle became how to create an ad. No budget for media. No budget for production.

What I had was these children were receiving AIDS in ways no one expected.

It came down to a fax. While this might sound simplistic, the medium became the message and those receiving the fax had no idea they would be getting this fax much in the same way children were contracting AIDS. While its call to action was to donate, it also asked for this to be shared with others. And it was done so in droves. It won many advertising awards and accolades, but what it taught me was the truth is extremely powerful and a huge motivator for the crowd. Person to person. Mouth to ear.

Since that time, I've used crowdsourcing many times over the years, from launching a music single onto the charts for an artist to pitching the first ever crowdsourced Super Bowl spot.

BuyABeerCompany.com

In the fall of 2009, I read a New York Post article that Pabst Brewing Company was up for sale and the asking price was $300 Million. In jest, via our corporate twitter account, I tweeted maybe we can crowdsource this and before I could even hit the send button, I knew this would be, at the very least, a great case study to evaluate crowdsourcing, its behavior, its magnitude.

My expertise is not in finance, economics nor law. My expertise is in effective branding, marketing, consumer behavior and possibly a little sideshow. Regardless of medium.

I am not here to confirm nor deny any of the findings of the Securities and Exchange Commission's cease & desist order. I was asked to be here to recount the important aspects of my experiment as it relates to funding companies, without traditional financial outlets and to highlight the success it had, not in theory, but in actuality.

Crowdsourcing meets crowdfunding.

This experiment was to answer many questions about crowdsourcing.

With such a large amount, a $300 million asking price it would require the crowdsourcing vehicle to be easily partaken by all. Exclusively online.

The goal was to be stated as the focal point. A countdown starting at a mind boggling $300 million, maybe not so mind boggling as we are hearing about trillions of dollars every day, but a very large amount just the same.

What was being asked of them? Their interest to join in the largest ever crowdsourced audience. That was all. Their interest came in the form of

providing their name, email address and a non-binding amount they were "pledging." And in caps "SEND NO MONEY."

It is important for me to state here, that at no time was any money ever received nor was there anyway for users to send money nor anyway for us to collect money.

How to create enough buzz to get this into the hands of others would be required? How long could the buzz be sustained? How would the user take control of the conversation to generate buzz.

Transparency. Any questions and their answers needed to be anticipated and answered by viewing the site.

Of course, at the onset of this experiment, there was simply no way to predict a positive outcome. Far too many variables.

A one page website is created, with full disclosure. A twitter account created. A press release circulated. This is on or about November 10, 2009.

By December 1, 2009 over $14.75 million was pledged.

The amount of press, press about the concept, the ease of understanding, the "genius" of the experiment generated buzz, traffic, sharing that by the end of 2009 the amount of pledges had exceeded $100 Million.

Christmas, New Year's passed. I was certain with the New Year, this would be old news.

By February 22, 2010 over $200 million was pledged.

What was just an experiment was now taking up far too much of my time with press requests, some 150 articles written, radio interviews, by that point. There was an interest by media, users, etc. that this could happen. Could it? How? What steps would need to be taken?

Pledges were still coming in. Press was still writing about this. This experiment was turning into a solid case study and award winning one at that as it won for most innovative in the crowdsourcing competition at SXSW in 2010.

On March 24, 2010 I received a FedEx from the SEC, which led to the shuttering of BuyABeerCompany.com, those proceedings concluded on June 8, 2011.

Pabst Brewing Company was purchased on May 26, 2010 for about $250 million according to the Wall Street Journal by investor C. Dean Metropoulos.

At the time of closing BuyABeerCompany.com over $282 Million was pledged by over 7 million users, averaging $38 per pledge.

Conclusion

I believe this illustrates the power of crowdsourcing, or as it is referred here specifically as crowdfunding.

What a powerful tool whereby the investor now becomes purchaser, brand steward, evangelist. Where the brand must answer to them and live up to their every expectation. Not as a simple financial tool, but as their expansion of buying into the brand.

This process could have been easily used for the sale of Hummer. GM, seeking to shed this division, was selling this American icon to China. While that $150 Million deal fell through. I can't help but imagine if crowdfunding couldn't have not only saved this brand, but the jobs, the dealerships, the monies spent on R&D, the equity built into the marketing and brand loyalty by simply opening this up to the general public.

What had started as an experiment to test a hypothesis of the power of social media and the propelling of a crowd toward a common goal, had become a concrete and plausible way to do business in a landscape which moves rapidly and without harness.

For my purposes it gave me invaluable information on consumer behavior. Hopefully other aspects of this can provide light on how we can utilize this to fund, build, expand businesses, the economy leading to job creation.

The possibilities of crowdfunding for starting, expanding, and purchasing companies are never ending.

Thank you.

Mr. MCHENRY. Thank you. I understand the pressure of testifying and at the same time having a health issue as well. So we certainly understand that.

I will begin my questions and recognize myself for 5 minutes. Votes are called on the floor, so we're going to try to get through our first round of questions and come back for more.

Ms. Cross, the President outlined in his speech and then the administration issued the following: Reducing regulatory burdens on small business capital formation. The administration also supports "crowdfunding" exemption from SEC registration requirements for firms raising less than $1 million with individual investments limited to $10,000, or 10 percent of the investor's annual income, and raising the cap on many offerings Reg A, that Mr. Bullard testified about from $5 million to $50 million. This will make it easier for entrepreneurs to raise capital and create jobs.

Can you describe the SEC's perspective on the President's recommendation in terms of the crowdfunding portion, not the Reg A, but if you could describe the SEC's perspective on this.

Ms. CROSS. Thank you for your question. I have to say first the Commission hasn't taken a position yet. These statements were just made. So we're discussing the matter internally at the Commission. I'm sure we will be having more discussions in light of the interest in the topic.

From my personal perspective I think that the key to such an exemption would be whether it could be crafted so that there could be cost effective crowdfunding exemption that could be—that wouldn't present significant concerns of fraud. If so, then I could see real benefits.

The issue you've got to watch out for is that if it becomes viewed as a tainted market where people go to fraudulently steal money, then that won't help anyone. So there needs to be some sort of balancing happening on a cost effective basis where some level of requirements, what kind of information might be required, are there notice filings, things of that nature, what the caps are, how much money for any individual, all of those issues would be important so this isn't a place where just bad actors go to steal money from people.

Mr. MCHENRY. Okay. And so would an annual audit be one of those?

Ms. CROSS. That's an interesting question. I don't know if an audit is what I would be thinking of. I was thinking more in terms of oversight of those operating the site so that at least someone is keeping track that these companies actually exist, that the money is coming from investors to these companies, those sorts of things that would give you pause. If somebody just opened up a Web site and took money and then disappeared that would be pretty awful. So what——

Mr. MCHENRY. Which—not to use sarcasm, which never happens today?

Ms. CROSS. Well, I can't say whether it happens today or not.

Mr. MCHENRY. Really? So I would just propose this. So based on this the SEC would think that the eBay exchange where I offer my used pickup truck for sale, that that transaction would never happen without the SEC preserving and protecting against fraud.

I'm not asking you to answer, but what's the timeframe for the SEC to review this recommendation and how long would that take to implement?

Ms. CROSS. We're currently discussing it internally. I don't have a timeframe, but I would expect we would want to consider it deliberately in the near future.

Mr. MCHENRY. Is that 2 years, 1 year, is it 6 months?

Ms. CROSS. As I said, I can't commit the Commission to a timeframe but I would expect that it would be in the near future.

Mr. MCHENRY. Back in May I asked a similar question about accredited investors, the 500 investor cap. Any update there?

Ms. CROSS. Yes. We're deep into the various work streams that we discussed back in May. One of them is the 500 shareholder cap. We have a study underway at the Commission now to get all the data that we need in order to be able to determine what revisions to the cap there should be. So that's deep underway right now.

We also are working on concept release on how to address the issues with regard to a ban on general solicitation and looking at targeted offering reforms around these issues and in addition we just announced this week the formation of our Small and Emerging Co. Advisory Committee so we can get their input there as well.

Mr. MCHENRY. What was the impetus for creating that group?

Ms. CROSS. For the committee? We've been working on forming a committee. It is complicated to form committees under the advisory committee rules. The purpose of it is to get—to be able to try out ideas.

Mr. MCHENRY. I understand the purpose. What was the impetus for creating it?

Ms. CROSS. In order to be able to get—I'm sorry, we've been in the process of forming it since many months ago.

Mr. MCHENRY. Okay, okay. Do you have a timeframe for when this 500 investor cap will—there will be some resolution to it?

Ms. CROSS. I would say because we have to do the study to get the data that we need to do an appropriate analysis it would take a significant period of time. It would be sometime in 2012.

Mr. MCHENRY. Mr. Quigley is recognized for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Mr. Lynn, make sure I get this right, you talked about allowing a dual set of investors, high end as well as the low. Are you talking about the high end ones being under the normal rules or also under crowdfunding?

Mr. LYNN. No, on our platform they will all be under the exact same set of rules. Everybody will come in through the platform whether they are investing 10 pounds or 10,000 pounds or 100,000 pounds, directly to the platform.

The key point, just to try to elucidate slightly why it is important that we have the big investors alongside the smaller ones, is that platforms like this will not succeed if it is only $10 or $100 investments being made through them. What will happen is the business that is seeking capital, we will get a lot of interest, there will be a high volume of investors, but to try to raise $50,000 or $100,000 on the back of $10 or similar size investments the deals simply won't get closed.

So for these platforms to function for a marketplace to exist, we think that we need to be able to go after both the smaller investors, but also people who might traditionally be angels but see a value proposition in investing through a platform like ours alongside the smaller investor.

Mr. QUIGLEY. Why can't you do this in a system, a dual system for the same sort of investment? The whole point of the high end investors having so much more regulation and control is because you are dealing with a lot more money. At least it is one of the elements of this. Don't you now run the risk, why would anybody go under the normal rules if the big one could go under crowdfunding?

Mr. LYNN. Two answers. Yes, first of all, you could do two separate systems, absolutely. You could do a system where the smaller investors receive an additional level of protection and the larger investors do something on a different track, different plane. It just adds administrative complexity, and there is no particular reason when you could have everything under the same system where effectively, as I've said in my testimony, we're looking at a platform where all investors get a much more significant level of protection than they would if they went off and bought shares in their friend's company.

The second point is investing through a platform like ours has both advantages and disadvantages to high net worth investors. The advantage is it is simple, it is easy and straightforward and they don't have to do a lot of administrative work. Many angels prefer to be able to invest in a hands-on way, to be able to interact directly with the entrepreneurs, to be able to go on the board, provide advice. And we think that many angels will continue to want to use the traditional off-line method of investing as well. We want the choice to be there for them.

Mr. QUIGLEY. Ms. Cross, we're on limited time because we're due on the floor a few minutes ago. How do you begin to balance this? You talk about the notion of at least having some rules about this, you ticked off quite a few points. But at what point are we right back to where we are now anyway with all the rules and regulations that the President sort of referred to that we want to pull away so that we encourage this kind of investment at the small level?

Ms. CROSS. That's a very important question, and I think any rulemaking would have an appropriate balancing of the cost and benefits. I think that the smaller the amount of money that people could risk losing, the less regulation you would need, the less impact it could have across the markets.

Mr. QUIGLEY. Let me interrupt you again because we are short. I guess the crux of my concern is that the smaller investor—doesn't it seem like that is the less sophisticated, less knowledge, less ability perhaps; perhaps the very person who needs the most protection? I mean, is that a glimmer in your mind or is that just wrong.

Ms. CROSS. That's certainly a concern and you would need to think about that. I think the notion of crowdfunding, which again the Commission has not taken a position on, but the notion of it is at some de minimis level, one would argue that there isn't a need for the full panoply of regulations that comes from securities registration, even though the particular people may be on the less

sophisticated range because they have less to lose. And the question really is a cost-benefit analysis.

I think it's important, though, that if it turns out all the unsophisticated investors who don't get the information registration would require end up defrauded, then it's going to be an unsuccessful experiment. If, instead, it's a success, and—then I think it does provide an opportunity for—and this is my personal view—for another avenue to raise money cost effectively, but it's—it's an interesting experiment that we would need to at least keep a close eye on.

Mr. QUIGLEY. Mr. Chairman, these are thoughts that I'd like to get the thoughts of all the participants unfortunately, we are now heading to the floor.

Mr. MCHENRY. And the chair would announce that we have votes on the floor. It's the intention of the chair to go cast the first vote, return back here, try to get a few more rounds of questioning in, at which point we'll have two additional votes thereafter.

There are Members that will be sworn in between the first and second vote here. So we should be able to get back and have an additional 30 minutes.

Mrs. MALONEY. Point of information, Mr. Chairman. May I ask my question and make a bolt to the floor because I don't think I can come back?

Mr. MCHENRY. Yeah, I would just ask indulgence of the Member to come back after this first series of votes because the——

Mrs. MALONEY. It is really hard for me. I can just do it really quick right now.

Mr. MCHENRY. I have to go get to the floor and vote so I can get back here. Go ahead, I will give the gentlelady a minute.

Mrs. MALONEY. First, I want to thank you for holding this hearing. It is tremendously important, looking at the crowdfunding exemption and how it is implemented.

An offer, a startup mentor and angel investor in the district that I represent by the name of Marty Zwilling wrote an interesting blog calling into question some of the virtues of crowdfunding, and I would like to quote what he said, "He warns that crowdfunding places the focus on the product, not the business model. When pitching to consumers online or off line, the feedback will likely be on features and design. The key success factors of the business model, meaning how you make money, management expertise, and financial projections, will likely get overlooked."

And I would just like to know how the panel would respond to what he said. He also warns that investors are not prepared for the high risk of startups and he has—he believes that it will be marketing to the riskiest, most speculative investments to some of the least sophisticated. So I would like to hear your response.

Mr. MCHENRY. The gentlelady's time has expired. We have just enough time for me to get to the floor—for us to get to the floor to vote. When we return, I will let the panel answer that question. The committee is in recess.

[Recess.]

Mr. MCHENRY. The committee will come back to order. We do have two new Members that won special elections on Tuesday being sworn in on the floor today, right now at this moment. So we

have some time to have additional rounds of questions, and so I will recognize myself.

Well, actually, I will let the panel answer my colleague Mrs. Maloney's question, which pertains to fraud. If you could begin with that, if you can recall her question from 15 minutes ago, Ms. Cross, and we will just go right down the panel.

Ms. CROSS. Yeah, I will just quickly respond. I think that her question points out the point about whether investors will have access to the kind of information that they need, whether it is focused on the idea or the company in which they would be investing, and so whether that is through the rules of the platform or any other regulations, what kind of information would be needed at a minimum is an important issue.

Mr. MCHENRY. How would the SEC deal with that?

Ms. CROSS. I think it depends on the costs and benefits. I think at the lower levels of investing, fewer requirements may make sense. Higher levels, you would think perhaps you would need more robust disclosure requirements.

Mr. MCHENRY. All right.

Ms. MAURIELLO. So just to address the general issue of fraud, the idea has come up from numerous people about broker dealership or the responsibilities of the facilitating party to do something. And, Chairman McHenry, I think you brought up a good analogy with eBay that if I am going to buy a car on eBay, I am not going to ask eBay to verify that the seller of that is legitimate. I am going to look at the reviews. I am perhaps going to call, get references on his reputation.

So this issue of fraud is certainly not a new one that we are facing with the idea of crowdfunding. It is a very old idea, and while it is been well tested and well proven what the solutions can be online, improvement of those solutions are more based on reputation and based on crowdsourcing information than on the facilitating party.

So, for example, if we had been a broker/dealer at the time that some of these deals had gone through on our site and had to do due diligence, for example, I would have had to call to do reference checks the very same people who are doing investments in the deal in the first place. They had more much more information than I did at that particular time.

Mr. LYNN. I mean, I think I agree with Dana and I think an important point as well about fraud, generally, is it is in the interest of every one of these platforms like ours to do everything we can to minimize the levels of fraud that occur. Is it bad for the market? If this becomes, as Ms. Cross said, if this becomes an environment in which sort of bad or fraudulent companies see this as a way to raise money, I am out of business. So there is—whatever the regulation may be, we have a tremendous incentive and we have with Seedrs put in place a number of very significant protections to try to limit that.

Also, just quickly to address Congresswoman Maloney's point about investors not being sufficiently sophisticated or not understanding what they are getting into, I firmly disagree with that. I think that while we do have a level of screening on the test to make sure that truly vulnerable people do not invest through the

platform, it is not that hard to understand that investing in startups is a very high-risk, highly illiquid form of asset, and we think that a wide range of people are capable of and qualify to do so.

Mr. NEISS. I concur with that. I think Congresswoman Maloney was talking about people focusing on the product and the business model. I just don't get why we have to keep on pushing people down with the relentless assaults on their intelligence. I mean, we are pretty smart people. I am going to be partaking in these platforms. I have money tied up in an investment group. I know how to ask questions and I know how to educate other people that will be investing as well.

So by people like me partaking in this, we are just going to be educating more people, which is going to raise the bar and make it even safer for everyone.

Mr. MIGLIOZZI. I come from the same position as yourself as far as eBay is concerned. I look at State lotteries. A dollar and a dream is probably one of the best tag lines in New York State in many, many years, and most of those people funding the lottery are not exactly sophisticated investors, nor are they sophisticated investors in casinos. Now they are all hoping to gain.

What we are doing, at least from what I an understanding here, is we are preventing people from the possibility of huge opportunities to either elevate themselves up, whether it is a small amount of money or a large amount of money, and preventing them making this—what we have, the land of opportunity, is now protecting you from fraud and therefore curtailing any possibility of getting yourself involved in a crowdfunding or a startup or riding it all the way up.

Mr. MCHENRY. Mr. Bullard.

Mr. BULLARD. The answer to the eBay question, which is a good question, is really a structural one. The answer is that for going on 100 years legislators and regulators have treated securities transactions differently from other transactions. If they are not different, we should repeal the Federal securities laws, but this isn't a matter of crowdfunding regulation. That is fundamentally a matter of whether securities transactions are different, and I think they are.

As to whether, for example, private offering requirements—you know, unaccredited investors are an assault on the intelligence of Americans—again, it is so deeply embedded in the structure of the Federal securities laws to make paternalistic judgments about who is going to be allowed to invest in unregistered offerings. The idea that that is somehow just fundamentally questionable is not a crowdfunding issue. That is an attack on the very structure of the Federal securities laws, and maybe that is the way Congress wants to go, but let's not pretend it is anything other than what it is.

It also shows I think, you know, the ignorance of people who, you know, I think have good-faith businesses and want to raise capital with respect to the amount of fraud that goes on on the Internet, and specifically with respect to securities. And there is no question that any liberalization of the exemption rules will result in some incremental increase in fraud. And you know, no one likes to say it except for someone who is somewhat of a free agent, but the big-

ger issue is about figuring what the optimum level of fraud is, and you are going to get a lot of fraud.

And if the bill, which I appreciate, you know, starts the conversation, is as written made into law, you'll have a massive amount of fraud. And I can tell you, your crowdfunding market will cease to exist because the level of fraud will simply destroy any confidence in anyone, other than an unsophisticated investor would be willing to participate in.

So, you know, there is a level of discussion that we are just not recognizing here. It is about some of the fundamental assumptions about how securities transactions are regulated, and if that is what you object to, I think we need to put that on the table and have the conversation about that.

Mr. MCHENRY. I recognize myself for 5 minutes. Thank you for answering that question.

Ms. Cross, is this—the number one concern is fraud?

Ms. CROSS. That's certainly a very important concern. We're not talking about regulating just for regulating sake.

Mr. MCHENRY. What are the key concerns?

Ms. CROSS. The key concern would be that investors would part with their money to unscrupulous business operators who just take the money and run, and that we all watched that happen and didn't take the time and effort needed to come up with a system that would provide a level of safety, disclosure, oversight, some ability to watch what's going on. I think—you know, I worry about, as I mentioned, Web sites popping up all over the place and then disappearing, and people put in money and then it is gone, and I think those are the concerns that I would have.

Mr. MCHENRY. Okay, okay. So, for instance, as a former wise investor in pets.com, this has happened with registered securities where the business plan was bad. And so how do we, Mr. Bullard, in your opinion, how do we ensure that we open this area—it sounds like that you are willing to go with the idea of crowdfunding with some exemption. How do we do that while at the same time dealing with that question—that concern of fraud?

Mr. BULLARD. Well, I think that the analogy to pets.com is a very apt one because, you know, we are sort of revisiting the way we have structured the Federal securities laws, and it comes down to the question of, you know, how much paternalism are we going to have because it's—I would have to disagree with Ms. Cross. It's really not about getting information into investors' hands because the way securities laws work is there's no amount of information you get into some people's hands that's going to allow us to allow them to invest. It is a prophylactic rule. It is not a do you have enough information? A lot of these people, simply no matter how much information you give them, the Federal securities laws have decided they're not going to be allowed to invest in certain offerings.

Pets.com jumps through a bunch of hoops, but there are still people who lose their shirts, sophisticated or otherwise.

So I think the answer is you've got to draw that line and say, for example, on a de minimis level you're making a decision that we are going to allow a lot of losses to go on. We are also going to allow an increase in fraudulent losses, not just people investing

in pipe dreams, but good-faith pipe dreams. We're are also going to be allowing people to lose to scam artists.

There's a question about confidence in the markets. There's a question about, you know, how much do you want to make decisions for people based on individual liberty interests, which is a real value at issue here, and I think it's appropriate to draw a line and say were just not going to step in at some point. But above that, I think that you've got to think more carefully about the effect on the structure of the markets and, you know, and what, let's say, a $10,000 exemption would do without the right kind of restrictions.

And my—and so the most specific answer would be I think we need to move generally more into intermediary regulation as one of the solutions to capital raising.

Mr. MCHENRY. Okay.

Mr. BULLARD. And the second answer, it's got to be kind of crowdfunding specific which may militate for changing the triggers for registerings of broker/dealers. As I mentioned in my testimony, that's pretty much an all-or-nothing game.

Mr. MCHENRY. My time is short.

Mr. BULLARD. Right.

Mr. MCHENRY. So, Ms. Mauriello, Mr. Lynn, Mr. Neiss, can you respond to this concern?

Ms. MAURIELLO. Absolutely. I think if we're going to put in protections, which you are right, there's a balance to strike, the most effective party to be doing this—this is not the facilitating party, it is the people themselves. So, for example, the way that purchasers are qualified now by their net worth, whether they're accredited or unaccredited, is that really the best way to determine that someone can make a smart investment decision just based on how much money they have in the bank? I would argue not at all.

So redefining what qualified investors are in this context of crowdfunding I think is an apt path an to go. For example, the sophistication laws, great intention there, but if they're not defined, they can't be used. Define sophistication allows the sophisticated investors regardless of net worth to be able to invest.

Someone who's local should be a qualified purchaser. If I live next door to the coffee shop, I know more about that coffee shop than anybody else, regardless of how much money they have in the bank. I should be a qualified purchaser if I know that person, so liberalizing what substantial preexisting relationship is. The classmate example I gave earlier, if we went to school together, I know more about you. Regardless of what my net worth is, I should be a qualified purchaser. That's how I would prevent fraud as well.

Mr. LYNN. I think there are two key points here. One, in terms of, you know, the qualification to be allowed to invest—and I agree with the previous comments—and just want to emphasize that, you know, regardless of what the system has been since 1933 and regardless of whether we're opening up a broader debate here or not, there is a serious sort of over- and under-inclusiveness to the accredited investor rules. It is a loose proxy that has always been based on just, you know, a very sort of loose cutoff, but it doesn't necessarily say anything about whether people are really qualified to invest as, Congressman, I believe you said earlier.

One of the things we do on Seedrs is before you can invest, you take a quiz, and the quiz is a multiple choice questionnaire and it says things like most startups succeed or fail. Well, we think that people can get through that and it gets to dilution and couple of other issues. We think most people can get through that. That's a pretty good indicator, regardless of how much money they have, of whether they will be able to make the investment decision.

On the fraud point, which is a little different. I mean, the qualification of investors is about whether you know your—the risks involved and are able to take them. On the fraud point, I disagree with you, Professor. I think that the amount of fraud that occurs in this marketplace among good crowdfunding platforms is actually going to be very minimal.

In our case, we are going to have substantial legal protections in place, and we will go after, very, very quickly and very publicly, any entrepreneur who does try to defraud the investors. We will press criminal fraud charges against them and we will quickly establish reputation as one of the least favorable places to try to run a scam. I think most other platforms are going to do very similar things, and this is going to be a market in that environment under which very little fraud occurs. It's yet to be seen but that's our view.

Mr. NEISS. And I would agree with Mr. Lynn and disagree with the professor as well.

I think first and foremost anyone that's going to register on these platforms is going to have to give over their personal information: Social Security number, address, date of birth, and they're going to have go through a background check to see if they've committed any fraud. So, boom, if you've got a checkered history, you're out.

Second of all, I personally believe most fraud to date has been committed on a one-to-one basis where you don't have this open network that we are advocating for on these platforms, where the communities can come together and give a combined opinion. Lots of voices are going to go into this, and that's going to whittle out people from committing fraud and it's going to expose the people that are trying to take advantage of people on these platforms.

So I just think—and a third point, in an all-or-nothing fashion, which is what we're advocating on these platforms, you have to act to raise the entire amount or you get no money. You have to hit the bar pretty high and convince everyone before you get a dollar.

Mr. MCHENRY. Mr. Bullard, would you like to respond to any of those? Is there some way to get some consensus about how we achieve this?

Mr. BULLARD. The way to achieve is you first have to start with the member of the Mafia who decides to become a broker/dealer and runs one of these businesses. I mean, if you want to have a discussion about what's going to happen, put them on the panel, because we're not talking about legitimate businesses and what they're going to do as a matter of business practice.

What was just described here was business practices. If you want to write them into the law, then it will work, but they're not going to be part of the law. You say you're going to do certain checks——

Mr. MCHENRY. That's why I'm asking. So to this point——

Mr. BULLARD. Right. So I look to the effect of what's the minimum necessary, and I think it's intermediary requirements where the burden has to be placed on the intermediary. There is no way you can make this function where you're always putting the burden on the issuer. That's just inconsistent with the whole idea of crowdsourcing.

Mr. MCHENRY. So Mr. Bullard and Ms. Cross had mentioned this, which is establishing some criteria for intermediaries, right? That that would be the onus of regulation and that would be sort of an initial view of how this could work best?

Mr. BULLARD. Right.

Ms. CROSS. If I could, I just want to be clear. I was expressing my views. The Commission hasn't taken this up yet. So I view intermediary regulation as perhaps a cost-effective way to deal with this because, for an individual company raising $50,000, for example, putting all of the requirements on them may be cost prohibitive. So if someone is running a site and is, for example, taking 5 percent commission and is running a site where they're raising billions of dollars, perhaps, if it turned out great, then they could afford to deal with intermediary regulation; whereas the individual company raising $50,000, that might be the harder question. That's just a personal view as to what might be a way forward.

Mr. MCHENRY. So would they be broker/dealers?

Ms. CROSS. The question of broker/dealer registration requirements depends on what their functions are. If they—under the rules now, if they have a salesman stake, which is, for example, commission for success, and if they deal with client funds and securities, then they may come within the definition. Then you would have to look and see how would regulation work. If they're not engaging in those sorts of activities under the Federal securities laws, it's not clear that they would be broker/dealers, and so then maybe you would come up with an alternative mechanism of regulation that's an oversight-type role. It's an interesting question, what would be the right way to approach it.

Mr. MCHENRY. So that broker/dealer status, Ms. Mauriello, is that too onerous and expensive?

Ms. MAURIELLO. Yes. So we have no salesman stake, no commission being charged. We're basically making no money and still would be told that we need to be a broker/dealer but not by the SEC, but—so I do have experience——

Mr. MCHENRY. You've been told that by your legal counsel?

Ms. MAURIELLO. By the Department of Corporations in California. So through that process, we did learn a lot from approaching many broker/dealers and trying to partner with their license and learned what their criteria was and, most important, education. We were told across the board that it was not advantageous for them to work with us because our average deal size was under $50,000. So the requirements in the compliance that they would need to do as a broker/dealer, it would not behoove them to do deals that small. So unless we're willing to bring our deal size up to an average of, say, $5 million or more, they were not interested. So that's what we're trying to navigate now.

Mr. MCHENRY. Mr. Lynn, is that your experience in Great Britain?

Mr. LYNN. Well, it's actually the opposite. And without having detailed knowledge of what is required of broker/dealer registration, the FSA authorization process is a very flexible one that looks specifically at exactly what a business is doing and then imposes a series of requirements and regulations on it. So far—and I say this as a business that has not yet completed the process—that authorization process seems to have been a very happy medium for us. The costs are not very substantial.

To give you a sense, the entire cost of preparing the application and filing it would be between 10,000 and 15,000 pounds, and our ongoing costs would be something like 5,000 pounds a year, which if compared to our marketing and operating budgets aren't that overwhelming.

Mr. MCHENRY. That's reasonable. Is the SEC—is the question of being a broker/dealer—how many broker/dealers do we have in the United States roughly?

Ms. CROSS. I'm going to have to get back to you with answers to those questions. That's the trading and markets division, so I'm not—I'm really not qualified to answer that question. You know, I think that, to the point——

Mr. MCHENRY. But the cost is substantially more to be a broker/dealer in the United States.

Ms. CROSS. I would assume so. So I think, again, one of the points I was trying to make was that in crafting a regulatory approach, if there isn't one that's already appropriate, you would perhaps be able to, depending on what the functions are of the intermediary, craft regulation that fits best on a cost-benefit basis. So I think—it may be that's it scalable the way that it's in London. I think that's a question that would need to be discussed.

Mr. MCHENRY. Okay. Mr. Neiss, in terms of your experience with this, how can we confront this issue of fraud? What's the legitimate way—we're looking for public policy here and that's the idea here. I mean, the whole panel, we have a minority witness, we have a witness from the SEC, and the whole panel is in agreement—well, Ms. Cross has not stated an opinion on that because that's a matter of SEC policy that she wouldn't come forward on—on that type of whether this is a good idea or not. So, just to state that clearly.

But even minority witness agrees that this idea of crowdfunding is a worthy one. The structure of it really is the question here, and so I do want to get to the structural question. How do we structurally allow this to take place because this—having a conduit between small investors and small businesses I think is a worthy one. It's not the full answer.

I mean, you know, the whole idea here is, to Ms. Mauriello's testimony, was how do you get to that venture capital? Well, this might be the best way, getting those initial thousand users of Facebook to put in a couple bucks so they can buy their first server. You know, that idea of crowdfunding to get something initially going, public markets are—still, we want the public markets to function. We still want folks to, you know, have that opportunity. But how do you get that bridge there from idea to rolling?

Mr. NEISS. Well, I think what you have to do is you have to put a structure in place which currently exists on the crowdfunding platforms that are out there. You have to register, and that re-

quires that, like I said before, that you give certain information and then they run background checks on you. Then you sort have to do the business model. You have your business idea. You've got how it's going to make money, and that's where you let the crowd take over and let them decide which ideas they think are worthy. If they think it's worthy and it hits that funding target, then you've got certain mechanisms that are in place. You've got standardized subscription review agreements and term sheets that can be used across the board to make it easier for everyone to communicate, and all of this happens on open platforms where there's this communication channel that's freely open to everyone.

And I think the critical thing to come back to, there is technology out there, like on LinkedIn, where you see the first-degree connectivity of an individual. What we're talking about here is community investment. It's people, it's me going to my friends and family, that first degree people. That's part of the anti-fraud that takes place. These are tools that are new but can be incorporated and that people can see who are the first-degree investors going in here, and the more percent of those that are going in there, the higher trust that you're going to have, because those are the people that know and understand the entrepreneur, the investor—the entrepreneur, the idea, and the business model.

Mr. MCHENRY. So, you know, in terms of a small group of folks like on an individual basis, you—do you have this belief that you can defraud five people but it might be more difficult to defraud 50,000 people? Is that your mindset?

Mr. NEISS. So I started a company here based in Washington, DC, called FLAVORx, and we flavored medicines for children. And I went the traditional route of raising money from people, and you know what, it wasn't easy. You have to talk to a lot of people about what it's that you're trying to do, and I probably could have taken advantage of a small group of people, my closest friends and family. I don't think I would have done that, counterproductive, but the more people I spoke to, the more people I had to convince, the harder it was. It's the nature of the beast.

Mr. MCHENRY. Mr. Lynn, is that your view?

Mr. LYNN. Absolutely. The wisdom of the crowds is a very powerful thing, both in terms of vetting out fraud, sniffing out the Mafia broker/dealer, as well as being able to make good business judgments about the businesses.

One of the key features of our platform—and I think this is true of most platforms like ours—would be that, you know, although we do run certain checks, and although there is an intermediary process, we rely on the investors and the investors voting with their checkbooks in 200, 300, 500, 1,000 people at a time to make judgments. We think that's tremendously powerful, and it's—you know, the discussion earlier about crowdsourcing in general, it really is a big part of the power of crowdsourcing.

Mr. MCHENRY. Mr. Bullard, in terms of the functionality of this, if you have registered intermediaries perhaps at a reasonable cost basis to do it with some oversight, would that—is that more palatable to you? Is that—you know, how would you structure crowdfunding? If we said—what if the President's plan said, you know, to raise up to $1 million and you have a limitation on a per-

centage of annual income, or—what would that look like? What would that dollar amount of limitation on the amount you could raise, the limitation on the individual, if you believe in that, if you think that's right, how would you structure this thing if you were designing not just the legislation but the rules for the SEC? Just walk through that with us, if you would, indulge me with that. If you don't wish to, I mean, I understand.

Mr. BULLARD. When asked to, you know, rule the universe, I'm always happy to.

The first thing I would do is to create two tracks. One I would call the de minimis track. Eliminate virtually all of the regulation at the registration reporting level and agree on what the amount—we're going to allow somebody to blow $250 on a dream, and even if it's a scam artist, we're just not going to go there with registration and reporting. And as you pointed out, we do that in commercial environments all the time. People lose money that way in lots of difference scenarios. There's nothing about securities market that I think justifies changing that.

It's important to keep it on a separate track to protect it from all of the burdens that should be applied when it's something other than de minimis. So then I would say, okay, let's do our traditional analysis. Using intermediary for efficiency reasons that Meredith was describing, they can on a one-time basis incur the fixed cost of compliance that can not be distributed to all of the crowdfunders. So there is no other way to really effectuate true crowdfunding unless you have that centralization of fixed cost.

Then I would say, what's your issuer exemption? If you have the accredited investor standard under 506, nothing new is needed for the broker/dealer, but if you have something, say, like your bill, then what I would add to it would be, okay, you want to be a broker/dealer that sells these kinds of issue or securities, here are things you need to do it. And audit was an idea, but I question whether an audit is going to be feasible for somebody raising only $10,000.

I think the quiz idea is an interesting one because it really goes to—not the—I don't think it goes to the sophistication of the investor. I think what it goes to is the expectations of the investor, and social policy is ultimately driven by whether when people lose their shirt, they feel that you should have prevented it from happening. That's an important aspect of social policy.

So I also like the idea of the wisdom of crowds. Just to give an example, the wisdom of a crowd assumes that you have a rule in place that requires what they're apparently doing, which is you have to get a minimum number of people to get to a minimum amount. I like those kinds of innovative approaches to achieving compliance in a different way from the way the SEC really even thinks about it. But the point is, that has to be a rule because if it's not a rule, the person is going to go in not subject to the wisdom of crowds, and only gets to $3,339 and then will put it in a bank account somewhere and disappear off the Internet.

And as far as the ability to commit fraud on the Internet, I mean, I wish that the SEC's Internet fraud person, for which they have a specific office, were here, because they would just flatly contradict what we're being told about what goes on in legitimate

Internet-based marketplaces. The amount of fraud that it's being used for is rampant. It's the ideal vehicle. If I were trying to create a fraud, I would love the opportunity to use the Internet to do what some of the proposals that are on the table to do, because that's precisely the way to raise millions of dollars from 50,000 people.

Mr. MCHENRY. So why don't we simply from—for securities purposes ban the use of the Internet?

Mr. BULLARD. Because the Internet is also an incredibly valuable tool for raising capital.

Mr. MCHENRY. Okay.

Mr. BULLARD. So what you do is just—you have only portals that have satisfied certain requirements being the places where you can do this, and you're also putting the responsibility on the portal, slash, broker/dealer, which is the optimal from an efficiency point of view to place responsibility. But the problem is broker/dealers will unite and say, oh, we don't want this responsibility. And that's what you're hearing from Ms. Mauriello. It's an institutional difference where they would rather have the issuers bear that risk but it's not efficient.

Mr. MCHENRY. Ms. Mauriello, I'll let you respond to that.

Ms. MAURIELLO. Sir, I think something that has come up is the wisdom of the crowds for this protection and how that works versus broker/dealer. One slight variation that we have on that's around the qualification of purchasers. So what made us feel very safe in our issuers and purchasers is that everybody knew each other. This was truly communities. And so I think there is a variation on crowdfunding, which is community funding, which is what we instituted, where you had to verify as the issuer when you invited the purchaser, I do know you and I know you in this way; we went to school together. And the purchaser had to verify, yes, we did go to school, I know about your character, I know about your acumen, and then you were doing the investing. At no point did we allow for the general public or for strangers to be able to invest.

So that's how we got around—not how we got around but how we addressed in most part this fraud issue. We also went through background checks, which Mr. Neiss has recommended, but the fact you actually—both parties know each other I think is the most important starting place, and then you can grow from there on reputation.

Mr. MCHENRY. If a fee structure were similar to what Mr. Lynn discussed—and granted, the pound-to-dollar conversion changes that slightly, but not to a great degree. Let's say it's a $10,000 registration with SEC. Is that something bearable?

Ms. MAURIELLO. Sure. It's not the upfront costs that are problematic at all. It's the ongoing due diligence requirements and ongoing compliance requirements that are necessary for the small deals. So I would have no problem paying an upfront fee. That's the nature of fund-raising and making that happen. But it's how much due diligence I'm responsible for, for even the smallest, de minimis, if you will, deals that are happening on the other side.

Mr. MCHENRY. Okay.

Mr. BULLARD. If I could add just one point. Ms. Mauriello is exactly right about the burdens of broker/dealer regulation in the United States. Mr. Lynn pointed out one of the differences in the

U.K., that we just don't have the flexibility to say, well, let's see what you're actually doing here, and regulate as a broker/dealer on that basis. It's pretty much an all-or-nothing system, in contrast with the regulation of exchanges.

The SEC has been very innovative. You haven't heard anybody complain about being treated as an exchange which is—the same kind of issue arises with respect to being a broker/dealer because there is an SEC exemption that applies.

So what—the solution to Ms. Mauriello's problem and Mr. Lynn's problem is to have more sensitive broker/dealer regulation that says, well, if you're only doing this and this is your business model, this is what we want you to do in return, especially if—and this is key—if the custody of assets component is removed from their responsibility, then you have eliminated a huge amount of broker/dealer regulation.

It's my understanding all of these models put custody somewhere else, and custody is the root of many problems with fraud; custody, meaning the person who actually holds the dollars. That was the Madoff problem. That's really the problem with many broker/dealer abuses.

Mr. MCHENRY. You know, this question of fraud, though, is interesting because, Mr. Bullard, I was going to respond to you before I recognized Ms. Mauriello, because the idea that the Internet is a perfect conduit for fraud. Well, let's be honest about it, let's shoot straight. Taking advantage of one person is much more—you're much more able to do that rather than take advantage of 1,000 people.

I mean, is that—because the example I would use is the eBay. You have the exchange of very valuable goods, and individuals get to look at that seller and that seller's recommendation and all the information about it. So you have some confidence with certain people, there is no confidence with others, and the thing shakes itself out; versus the individual who, in a parking lot, purchased an iPad that turned out to be a piece of wood. Right? I mean, so fraud does occur. I mean, we have had extensive—you know, the SEC has been around for 80 years and provides a wonderful function, wonderful amount of safety and security and disclosure and all of that, but we also had Madoff and you also had individuals following Madoff that submitted information to the SEC. So there is some wisdom in crowds. There is some wisdom in crowds.

But to the question of—that you mentioned before which is—you know, is the SEC there to mandate disclosures or to prevent dumb people from doing dumb things, you know, for being taken advantage of from fraud which is a larger ideological question, and you mentioned it in those terms. I think that's reasonable.

I've got a couple of other questions I want to hit, and I'm not sure if we have the full—ranking member from the full committee returning, but I want to make sure he has an opportunity to ask questions if he does.

So you all have different approaches. So how important is it for the SEC to create flexibility and recognize the different models? All have some valuable attributes. We will start with Mr. Bullard and work backward.

Mr. BULLARD. Again, just—I've been using too much time already—just again to reiterate, I think the two-tracks approach, one of them being a de minimis approach, is the way to really move the ball on this and make progress, at least for those who are more into the kind of original crowdsourcing approach where it's almost a form of social activism where you have the investing going on.

And then, second, I think we've got to look at this as an intermediary issue for efficiency reasons so that you can allow crowdsourcing to maximize its potential. You've got to place the burdens on the portal, on the central point, and then you have to look at the issue where—the burdens you want to relieve issuers of. You then have to convert them into a broker/dealer context and figure out what do we need to replace those with that broker/dealers can do much more efficiently and do better?

And what you're hearing is a description of models that they have chosen to adopt that work very well. I do wish the SEC would be much more creative at looking at the kinds of ways that eBay and these Web sites establish trust and confidence that are not really reflected in the securities laws at all.

Mr. MIGLIOZZI. The way I see this is that I believe that having this wide open would allow small businesses absolutely to—where you have a possibility of, let's say, going to an SBA. It's almost impossible to get a loan from an SBA for a small up-and-coming business. This would allow you that access. I truly believe that we need to maintain some openness on this. Transparency is key, I will have to say that. Constant communication is key, and you will end up with—there's no way to prevent for absolute fraud. There's going to be some cases that are going to slip through, but I truly do believe that transparency is absolutely something that will keep clear on what we need to do.

Mr. NEISS. Listen, fraud, investor protection, and capital formation were the three things that we looked at at our August 1st symposium that we held in San Francisco where we brought thought leaders together, lawyers, professors, all interested parties, even some crowdfunding sites, to work out our framework in the startup exemption. That literally crafts the rules under which another exemption, a different—like a rule 507 that would allow this to happen, and it addresses all of these points. So it's in my written testimony.

Mr. MCHENRY. Thank you.

Mr. LYNN. I think in answer to the question about the need for a flexible form of regulation, absolutely. As I say, we have benefited I think from the flexible approach that the FSA takes, and I have no doubt that there's a way—I don't know what it is, but there's got to be a way to design some form of intermediary regulation that's not as burdensome as broker/dealer, but that nonetheless addresses a lot of these issues. And I said in my testimony, I do support some level of intermediary regulation. I think it is and can be the most effective way to make this market work.

I would add one quick other point in response to Mr. Bullard. In terms of having a separate regime specifically for de minimis investments, if when we're talking de minimis we're talking about $100 or $250, don't bother. I mean, there's just no point in putting it in place. The market will never function. Deals won't get done,

and we're all wasting our time. If de minimis is $1,000, $5,000, $10,000, I'm not sure that I support that, but it becomes a little bit more feasible. But if we're really expecting crowdfunding platforms to function on the basis of $100, $250 caps, it's a waste of time.

Mr. BULLARD. Even though they're already functioning in the debt markets on precisely that basis?

Mr. LYNN. It's simply not going to happen for equity investments and startups. People aren't going to be investing that small of an amount. It's very different with peer-to-peer lending when you have constant returns and a constant cycle of interest payments. There will be—I should say—I should clarify there will be a lot of people who will invest at that level, just not a sufficient number in any given investment, given the nature of equity, given the importance of high upside versus, you know—you know, high upside versus losses in those cases. You know, the deals just won't get completed. We've done a lot of research around it, and that's what we'd back.

Ms. MAURIELLO. And I would concur at that point for what it's worth, and I would add two more that haven't been mentioned already about some flexibility in rulemaking which would be very useful.

The first one, which is in the bill that you proposed, is national preemption, and although we have automated all the State-by-State laws, it's extremely difficult to build a scalable platform to facilitate these things if all of the States can put in their own laws on top this. So I very strongly advocate and support what you said about national preemption.

And secondarily, the most important thing for a lot of the businesses that are using these functions, that they can raise more capital later, as you said. This is not the end-all, be-all to capital formation. This is step one. So ensuring that the rules that are put in place play well together with the other rules.

So, for example, if you're doing a 504 raise and you can only raise up to $1 million and you want to raise a VC round 6 months later, you can't. You have to wait that appropriate period of time. So I would encourage that to be taken into account with rulemaking as well.

Mr. MCHENRY. Okay. Ms. Cross, let me state the question in a different way because I understand the limitations you have as an employee of the SEC, and so I know it's a unique position, but you've always done very well testifying before Congress and being forthright, you know, based on those constraints, and I do appreciate that.

So is the SEC currently looking at recognizing the different models in terms of broker/dealers, you know, that type of model, and providing some level of flexibility?

Ms. CROSS. What I would say—and I appreciate your kind remarks. Thank you. What I would say is that at the staff level, as we've been thinking through what would be the best way to advise our Commission, we've talked about the fact that there may be a need to have scalable regulatory approaches and, frankly, to think about this creatively.

So, yes, from the staff level perspective, we've been having meetings pretty regularly recently to talk through what would be the

safest way to roll this out if the Commission were to decide that it wanted to do it on a cost-effective basis, and questions around—depending on what the role is of the intermediary, could you make the regulation of it scalable so that it's cost effective?

Mr. MCHENRY. Have you looked at the FSA model in Great Britain?

Ms. CROSS. I read all about it last night, and I thought it was fascinating actually, and I look forward to discussing it with Mr. Lynn. I took his card and I think it will be very helpful to hear what the experience is there. I think that's a fascinating approach. It gives me less pause than the idea of having—what really does scare me is the idea of people just opening up sites, stealing people's money, closing the sites, and you know, they're not even in our country, they're someplace else, and set up fake businesses; and everybody, you know, puts in their several hundred dollars and it's just gone. I think that would be a real shame and would tar this market, and so the approach that the—that he described for the FSA sounds quite interesting.

Mr. MCHENRY. Even with that great diligence provided by the SEC, fraud still does occur, and so, you know, I think it's important the SEC keep in mind the cost-benefit analysis of potential lost profits and lost opportunities at the same time. But you know, is there—well, what are the SEC's regulations on peer-to-peer lending?

Ms. CROSS. First of all, I need to start by saying that I used to represent one of the two large peer-to-peer lenders before I came to the SEC. So I'm recused on talking about particular peer-to-peer lenders.

The regulations that are currently being complied with by the peer-to-peer lenders require that they file registration, same as to register their securities that are backed by the notes that come from the individual borrowers, and I believe that they're not regulated as broker/dealers. I believe that they—there are alternative trading systems that are associated with the peer-to-peer lenders where the members can trade the notes and that the ATS is—is run by a broker/dealer. But the site itself, I believe the money runs through a bank; people put their money in a bank, and so there isn't any concern that the money would be stolen, and that's how it's done.

Mr. MCHENRY. Okay. And so that's to Mr. Bullard's point of who actually possesses the assets in the transaction.

Ms. CROSS. Right. It's in a bank is my understanding.

Mr. MCHENRY. Okay. And so that model is different than a broker/dealer model for that peer-to-peer lending site or account?

Ms. CROSS. That's right. They're not—they're not registered as broker/dealers is my understanding. It's been 2 years since I've been back to the Commission. So I have not paid attention to what they've been doing lately. So that was what the model was in the past.

Mr. MCHENRY. Mr. Lynn, you mentioned something earlier that I wanted to touch on, which is you said that larger investors should be permitted to invest alongside smaller investors. Why? Why do you think that's worthy of beneficial proffer?

Mr. LYNN. Well, getting to the point I made about the problem with the de minimis exemption, the key here is if we think crowdfunding is a good thing and if we would like to see these platforms function effectively in the market, deals have to get completed. And I'm operating under the assumption that most platforms will work on an all-or-nothing basis as ours will. It's not going to be very appealing to investors to risk putting a few hundred dollars into a business and then finding that a business can't do anything because it didn't raise the rest.

So assuming that these are $50,000, $100,000, maybe more, 250, 500 capital raises, they need to get completed for the businesses to be able—for crowdfunding platforms to be able to function. And our view, based on our research, is that the way they will get completed will be through a mix of high volume of smaller investors, alongside a number of larger investors being able to invest $1,000, $5,000, $10,000, potentially even $50,000. And what you will see in this spread across—and you do see this to some degree with peer-to-peer lending already, but we think it will be more pronounced given the nature and appetite for risk in the equity markets—in the private equity—private companies.

We think that the way that deals will get done and the only way that they will get done is if you have some large investors in there. As I said in response to the ranking member earlier, you could set up a bifurcated system if you wanted to, but there isn't really a whole lot of benefit in doing so, and it adds additional administrative burden.

And in fact, by having larger investors come in on our platform, they're going to go through the same—the exact same qualifications, the exact same screening that our smaller investors do. So, if anything, they get an additional level of protection.

Mr. MCHENRY. Does the President's proposal limiting it to $1 million raise—does that provide significant investor protection?

Mr. LYNN. No. I mean, I don't know that it necessarily does. I think in terms of, you know, switching from the size of investment or investor to the size of raised per business, it's difficult for me to foresee a whole lot of online crowdfunding successes at much above $1 million. It's not to say that they won't happen. Certainly, the PBR case is a great exemption and there will be others. Our view is that the sweet spot in this market, you know, is at hundred—in Britain 100,000 pounds or less, here maybe $100,000 or 250- or less. And that that's partially because that's where, you know, once you get above those levels, that's where venture capitalists become more active and there are a lot of other routes to capital. So we don't see a tremendous amount of detriment to a $1 million cap, but I'm not sure I see the advantage to it either, necessarily.

Mr. MCHENRY. Ms. Mauriello, do you see it the same way?

Ms. MAURIELLO. I would agree. Our sweet spot is around $50,000, and again, it's two different markets. I do think there's going to be some really outstanding cases. Eline Kickstarter is an outstanding case of raising $1 million or more and I applaud those and those are wonderful, but I do think the bulk of the market is going to be in that of $50,000 to $100,000 range.

Mr. MCHENRY. Okay. Mr. Neiss.

Mr. NEISS. All I want to add to that is that I agree that it's the $50,000 range, but I think the whole point of having the million dollar in there is if you're successful at $50,000 and that's your proof of concept and you need to go out and grow it from there, you can go back and show the crowd what you did with that $50,000, be held accountable to that $50,000 in an open, transparent platform, and then go out and raise $250,000 under this framework, up to $1 million, to really get it going. And I think the most critical thing is, the most successful companies that come out of this will be the breeding grounds for the VCs and the private money.

Mr. MCHENRY. Okay. So to go right back through the three of you as well. The limitation, 10 percent of your income or $10,000, do you think that's wise—a wise limitation? It's the President's proposal, which is also in the legislation that I filed yesterday.

Ms. MAURIELLO. Absolutely. I think it's very wise to have a limit there. I would propose that the limit on percentage is going to be more protective than the dollar limit. The dollar limit is going to be outdated very quickly and constantly need to be updated, whereas the percentage limit will always hold.

And I agree with Mr. Lynn—we've seen the 80/20 rule in place—that you do need to have a few investors who are going to carry the bulk of this, and they might be investing more than $10,000 if that's less than 10 or even less than 5 percent of their net worth.

Mr. LYNN. I agree 100 percent. I think that a percentage-based limitation is fine. Our own is 20 percent of the investor's net worth. An aggregate across the platform, 10 percent of income, I think that's all arguable. I don't see the value and I see a lot of detriment in a dollar limit.

Mr. MCHENRY. Okay.

Mr. NEISS. We're in favor. We actually had it in our exemption initially, and we took it out because we thought the self-reporting on it was just—we left it up to the person to be responsible with what they wanted to invest.

Mr. MCHENRY. Mr. Bullard.

Mr. BULLARD. Yeah, I just—I think Mr. Lynn just misunderstands my proposal.

Mr. MCHENRY. No, no. I wish you to answer the question I just proposed, which is the $10,000 or 10 percent of your income cap. Do you think that's sufficient or appropriate?

Mr. BULLARD. No. I would take—I would draw a paternalistic line that someone living below the poverty line not being allowed to put $1,000 or $1,500 into an offering over the Internet without substantial additional protections through an intermediary platform other than those just voluntarily adopted by the firm. But I would draw an income level—maybe it's $50,000. I think it's—I agree completely with the structural absurdity of the current accredited investor standard. We can fix that, but going all the way down to say, you know, persons with $10,000 in income, I think that's a mistake.

Mr. MCHENRY. Okay. Mr. Migliozzi, how does it make you feel when these three crowdfunders to your right say that, you know, it's going to be about $50,000 to $100,000 you can raise, and with an idea you had, you got $200 million of commitments.

Mr. MIGLIOZZI. Two hundred eighty-two million.

Mr. MCHENRY. Oh, 282, I'm sorry.

Mr. MIGLIOZZI. Okay. This is—this particular case is obviously a think big with, you know, with crowdsourcing a brewery. I think limitations is going to limit business growth on the amounts. I think that having the opportunity to allow businesses to be able to get that brass ring, go a little bit further, those opportunities should be there. I don't see why we would want to artificially hold back entrepreneurs from getting from point A to point B and then be able to put themselves into the larger investment market at some point. So I would say that in my opinion, obviously, think bigger.

Mr. MCHENRY. Okay. In terms of final, you know, wrapping up here, just so everyone—for planning purposes, in terms of what the economic impact would be if we followed the President's proposal, you know, can you go through and just give me your estimate? We'll start with you, Mr. Bullard.

Mr. BULLARD. Well, yeah, I think you would see a substantial increase in fund-raising over the Internet under that approach. There's no question it would assist capital formation. It would give investors more options than they currently have, and it would be a kind of liberalization that I think would be a good thing to some extent. But I think it also would, as described in his proposal, which is this unadorned $10,000 limit, it would open the door to a substantial amount of fraud. I think it would inappropriately sort of eliminate any kind of cutoff as to the sophistication and/or income of the person investing in unregistered securities.

Mr. MCHENRY. Okay. Mr. Neiss.

Mr. NEISS. I just think preventing investments doesn't equal preventing fraud, and the only protection that we can give is an informed investor, and that's going come through education in an open, transparent platform. I think when we get the capital flowing based on our projections, we can create 500,000 companies in the next 5 years and employ 1.5 million jobs—new jobs.

Mr. MCHENRY. Mr. Lynn.

Mr. LYNN. I mean, in terms of economic impact, I can just tell you our estimates for Britain, which you can then multiply by five, based on population, and maybe assume a slightly higher entrepreneurial appetite here. You know, in Britain we plan at scale to be able to see 1,000 to 2,000 new businesses funded per year. Of those, we assume that somewhere between 20 and 40 percent will actually turn into something and create some number of jobs. And you can work backward from there to think about the sort of economic impact, and that's our platform alone. There will be other competitors out there, other businesses starting.

We see a vast level of nascent entrepreneurship in Britain, in Europe, and the United States and around the world where people would love to start a new business, have value-creating ideas, but don't have the access to the very first capital they need. And we think that platforms like this can help them overcome that hurdle and be absolutely transformative for an economy.

Mr. MCHENRY. Ms. Mauriello.

Ms. MAURIELLO. I absolutely agree. One of the statistics that got us most excited about the potential for change in this industry is that over $100 billion currently transacted between friends and

family informal investing networks every year. It is the second most common way of starting your business after your personal credit card, which you mentioned yourself.

So I see a tremendous potential to both putting more protections on that market. Currently it has no protections. Those are checks that cross the dinner table, that nothing's happening around and growing at substantially the capital is there. It just needs to be accessed.

Mr. MCHENRY. Thank you all for your testimony. I do appreciate it. It is so helpful in forming policy. There is some give and take here, but I think the input has been absolutely fantastic and unfortunately you're here on one of the mornings where Congress had about 20 different things going on. And so that has been the attendance question here this morning.

The subject matter is fascinating, absolutely fascinating. I look at my father's example where he had a great idea and a business partner. He had five kids and he had a garage in the backyard. And so he's looking for money to feed those five kids. He had an idea with his business partner, who also had five kids who was looking for money too. The only way they could get lending was through that new invention called the credit card. And I still have my father's credit card that he founded his business on. Today my brother owns that business and runs that business with my father's business partner and he employs about 400 people. That is the beauty of innovation and small business.

We want to make sure that those folks have opportunities to take their idea from the dinner table out to the markets. And so much of the focus and discussion has been about the accredited investor. You are talking about the folk, the guy—Mr. Bullard, in your testimony you mention this and I certainly appreciate that, I very much appreciate it. You have a million dollars net worth, you're an accredited investor so you have great access to startup companies. So Facebook, a lot of these tech companies had these folks that had access to it, whereas the average investor, even the superior investor who doesn't have that high net worth doesn't have that same opportunity.

I want to make sure, and it's my thought to democratize this process, to give the small investors the opportunity for that upside potential, not simply to make a contribution to a worthy charity over the Internet, but to get the upside in this and that's the point of my legislation.

Now the structure of this I think is the point of the discussion today, to make sure we have a proper structure so you can root out fraud to the best of our abilities. But making sure that investors have information and access to make an investment are both very worthy things that I would hope that the SEC would look diligently at and we intend here in Congress to move forward on that as well.

Thank for your time. If you have additional remarks, you may submit it for the record. And Members will have 7 days to submit questions for the record and comments for the record.

With that, the committee stands adjourned.

[Whereupon, at 11:45 a.m., the subcommittee was adjourned.]