THE JOBS ACT IN ACTION: OVERSEEING EFFECTIVE IMPLEMENTATION THAT CAN GROW AMERICAN JOBS

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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COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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

CONTENTS

THE JOBS ACT IN ACTION: OVERSEEING EFFECTIVE IMPLEMENTATION THAT CAN GROW AMERICAN JOBS

Tuesday, June 26, 2012

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

The subcommittee met, pursuant to call, at 2:00 p.m., in Room 2154, Rayburn House Office Building, Hon. Patrick T. McHenry [chairman of the subcommittee] presiding.

Present: Representatives McHenry, Guinta, and Quigley.

Staff Present: Ali Ahmad, Deputy Press Secretary; Will L. Boyington, Staff Assistant; John Cuaderes, Deputy Staff Director; Linda Good, Chief Clerk; Peter Haller, Senior Counsel; Christopher Hixon, Deputy Chief Counsel, Oversight; and Cheyenne Steel; Jaron Bourke, Minority Director of Administration; Jennifer Hoffman, Minority Press Secretary; Adam Koshkin, Minority Staff Assistant; Jason Powell, Minority Senior Counsel; Brian Quinn, Minority Counsel; and Davida Walsh, Minority Counsel.

Mr. MCHENRY. Good afternoon, and thank you all for being here today. This is the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, and our hearing today is: The JOBS Act in Action: Overseeing Effective Implementation that Can Grow American Jobs.

I will start today's hearing as we always do, as by reading the Oversight and Government Reform Committee's mission statement. The Oversight Committee mission statement: 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.

I will now recognize myself for 5 minutes for the purposes of an opening statement.

Approximately 3 years into our economic recovery, America's labor and capital markets continue to face unprecedented challenges. The U.S. unemployment rate has now been above 8 percent for 40 consecutive months and nearly 24 million Americans are either out of work or underemployed despite various government-driven initiatives. To make matters worse, outdated and even oftentimes new government regulations continue to limit the ability of small businesses to access capital, which is the lifeblood of our economy. Repairing and strengthening our markets will not occur overnight, nor will it be accomplished by more government regulation.

In an effort to address these challenges, the focus of today's oversight hearing is on a bipartisan bill signed into law this past April, meant to promote capital formation for small businesses by relaxing various securities laws. Titled the Jumpstart Our Business Startups Act, it is commonly referred to as the JOBS Act.

Let me first say that the JOBS Act is a significant victory for capital formation and entrepreneurship here in the United States. I am particularly proud that the efforts by this committee, initiated by Chairman Darrell Issa back in March of 2011, his letter to the Securities and Exchange Commission Chairwoman, Mary Schapiro, helped develop the JOBS Act and modernize our securities laws.

For instance, elimination of the ban on general solicitation, a rule that has been in place since the Securities Act of 1933, will improve the ability of small private businesses to communicate with investors and raise capital. Increasing the private shareholder cap from 500 to 2,000 that a company may have before registering with the SEC has been welcomed as a logical adjustment. It simply reduces the number of instances a company is forced to endure a complicated SEC filing process, merely because it attracted too many accredited or institutional investors.

Now, Title III of the JOBS Act, based off legislation that I authored, creates a new federal securities exemption to permit equity-based crowdfunding. After introducing the first crowdfunding bill in Congress, I reached out to my colleagues on the other side of the aisle to build a bipartisan coalition so that we can actually enact this bill to address these concerns of the interested parties.

Specifically, I want to commend Congresswoman Carolyn Maloney, who serves on this subcommittee, as well as Oversight and Government Reform Committee at large, and also serves with me on the Financial Services Committee. Now, Carolyn and I don't often see eye to eye on matters of public policy, but in this instance we collaborated and worked together to take the legislation I introduced to improve it. Now, Carolyn had a number of concerns about fraud and a number of investor protection ideas, and we worked very diligently, very diligently to craft a very balanced bill that we were able to pass not just out of committee, but on the House floor.

And before it came to a vote on the House floor, President Obama put forward a statement of administrative policy that he endorsed and would sign the bill. Well, unfortunately, due to a few Senators who I think misinterpreted the spirit and promise of crowdfunding, the Senate inserted imperfect—we will just call them imperfect provisions that jeopardize the vitality of equity-based crowdfunding and complicated SEC rulemaking.

As the SEC considers comments regarding crowdfunding, the crowdfunding title of the JOBS Act, it is clear that the Senate's eleventh-hour changes have unnecessarily made sections of the JOBS Act ambiguous and inconsistent.

Today's hearing serves as an opportunity for Congress to hear from knowledgeable folks that either participate in the arena of crowdfunding as it now exists. It is not equity-based. It is not on the investorside, but crowdfunding as it now exists market participants, and academic experts about these provisions of the JOBS Act, and I want to get their thoughts, and that is really what this is about.

Our intention is for Congress, interested parties, and the SEC to work together to ensure that effective rules and policies are promulgated that will allow crowdfunding to flourish. And if crowdfunding flourishes, I think our small businesses have another opportunity to flourish.

I thank the witnesses for making the trip here and I want to thank the ranking member, Mr. Quigley, for his involvement on this area of public policy, as well as many others. And with that I recognize ranking member for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman. I want to thank the chairman for holding this hearing to examine the implementation of the JOBS Act. The JOBS Act, as you know, was passed with bipartisan support and signed into law by the President on April 5th of this year. The act alters Federal securities laws and regulations to make it easier for small businesses and startups to raise capital. For example, the act will create a unique status for emerging growth companies that will allow these companies greater flexibility in testing the IPO waters.

The act will also lift restrictions on the ability of the startup companies to raise capital. Startups, if they survive their earliest years, make an outsized contribution to sustainable job growth. Under Title III of the JOBS Act startups will now be able to raise capital they need through crowdfunding. This is a welcome step forward, and I commend the President who endorsed the idea in his 2012 State of the Union Address and the chairman of the subcommittee who sponsored the original crowdfunding legislation for working together on this issue.

At the same time, the regulatory restrictions that were rolled back by the JOBS Act were originally put in place for a reason. There are legitimate concerns that exempting this type of activity from securities regulation would open or expand opportunities for fraud. Just as clean water standards keep our water safe to drink, financial regulations protect us against unsafe financial products.

While Congress judged, correctly in my view, that there were too many hurdles to raising capital, the SEC's mission is still to protect investors and maintain fair, orderly, and efficient markets. New rulemaking under the JOBS Act should follow the same process and procedures as in the past. There is no reason the JOBS Act should be prioritized in front of pending Dodd-Frank rulemakings, which have been delayed as a result of intense scrutiny from Congress and the courts. The same standard should apply equally to all of the SEC's rulemaking that are required by law.

I also believe that Dodd-Frank and the JOBS Act are two sides of the same coin. Before and during the financial crisis our financial regulations were deficient. As banks collapsed and the housing market bottomed out, investors lost their savings, homeowners lost their homes and millions of Americans lost their jobs. By passing and implementing Dodd-Frank, we will ensure that the next generation of Americans is not so vulnerable to financial catastrophe.

At the same time we can also recognize that not all regulations are necessary and that some may inhibit job growth more than protect it. That's why I was proud to support the JOBS Act.

Going forward, I am eager to work with the SEC and both sides of the aisle to ensure that these two acts of Congress are implemented in a timely and responsible fashion.

Thank you, Mr. Chairman, and I yield back.

Mr. MCHENRY. I thank the ranking member. Members will have 7 days to submit opening statements for the record. We will now recognize our panel.

Mr. Brian Cartwright is a scholar, is a Scholar-in-Residence of Marshall School of Business, University of Southern California, a Senior Advisor at Patomak Global Partners, and former General Counsel of the Securities and Exchange Commission. Thank you for being here.

Mr. Alon Hillel-Tuch—did I say that correctly?—is the Co-Founder and Chief Financial Officer of RocketHub Incorporated, and for those of you who are not familiar, it is a fantastic crowdfunding site doing exciting things.

Mr. C. Steven Bradford is a Professor of Law at the University of Nebraska College of Law, and has written numerous works on crowdfunding.

Mr. John Coffee, Jr., is a Professor of Law at Columbia University Law School.

It is the policy of this committee that all witnesses be sworn in before they testify. So if you will please stand and raise your right arm—right hand, actually. Do you solemnly swear or affirm that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth?

All right, thanks. You may be seated. Let the record reflect that the witnesses answered in the affirmative.

In order to allow time for discussion, we have the lights set up for you. We are Members of Congress so they are very simple, right? Red means stop. Yellow means hurry up and finish. Green means go. So we will give you 5 minutes to summarize your opening statements. Your opening statements—your written statements will be in as a part of the record. And so we will begin.

Mr. Cartwright, you are recognized for 5 minutes.

WITNESS STATEMENTS

STATEMENT OF BRIAN G. CARTWRIGHT

Mr. CARTWRIGHT. Well, Chairman McHenry, Ranking Member Quigley, members of the subcommittee, you have honored me with your invitation to appear before you today and I thank you for having me. You have my written testimony, and I won't try to rehearse that testimony again here in these brief introductory remarks. Instead, I want to frame the questions and discussions to follow by offering my perspective on why the JOBS Act was passed with the support of the administration by overwhelming votes in both Houses of Congress and why I think we are here today.

I believe the JOBS Act was passed because there is a widespread, fully bipartisan understanding that something has gone quite wrong in the world of American public companies, particularly the newer up and coming companies. After all, the number of public companies, exchange listed companies has declined dramatically. In the roughest of numbers, we have gone from having somewhere around 8,000 exchange-listed companies to something in the vicinity of 5,000. That's a dramatic drop. It's happened because not enough companies are signing up to go public to replace those who drop out. The number of initial public offerings has trended down far below previous levels.

But the most alarming development of all may be this, and I know this from my days in practice. Back in the day, venture capitalists would take a successful, innovative new company public and many of those companies would then blossom and grow and produce countless jobs, and we know that most of the jobs actually come after a company goes public.

That's what used to happen upwards of 80 percent of the time. But today that number has flipped. Today, over 80 percent, approaching 90 percent of successful venture-backed companies are acquired rather than taken public. And that makes all the difference in the world, because we know that acquisitions rather than growing jobs often subtract jobs, because the acquirer seeks to achieve efficiencies, as the press release will euphemistically refer to it.

So I ask you to just imagine what the world would be like today if Microsoft had been managed to make it as attractive as possible to its most likely potential acquirer, IBM and IBM had in fact then acquired it. And I submit to you that if that had happened Seattle would be a very different city today. And replicate that hundreds of times over, and the U.S. would be a very different country today.

Public companies that were originally ventured back are estimated by some to contribute something like 20 percent of our current GDP. Imagine the problems we would be facing if we didn't have that 20 percent today.

I think those are illustrative of the developments that I believe led to the JOBS Act, which in my view makes only quite modest, incremental tweaks to the existing system. Time will tell, but those modest incremental tweaks may well prove insufficient to get us where we need to be, and maybe some of your questions you will be asking will be directed that way. But the JOBS Act is a welcome, broadly bipartisan attempt to move us in the right direction. And of course, even those modest steps have been resisted by the defenders of the status quo.

So the SEC needs to be encouraged to move with all deliberate speed to implement the JOBS Act promptly and faithfully. And I thank you very much, and I eagerly look forward to your questions on this important topic.

[Prepared statement of Mr. Cartwright follows:]

TESTIMONY OF BRIAN G. CARTWRIGHT

Scholar-in-Residence, Marshall School of Business,
University of Southern California

Senior Advisor, Patomak Global Partners LLC

Former General Counsel, U.S. Securities & Exchange Commission

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

June 26, 2012 at 2 PM IN 2154 RAYBURN HOUSE BUILDING

Chairman McHenry, Ranking Member Quigley, and members of the Subcommittee: thank you for the invitation to appear before you today.

Introduction

The JOBS Act is an important achievement.

It was enacted with overwhelming bipartisan support, even though we're in an election year. If you hear complaints that no one seems to be able to get things done in Washington, you can point to the JOBS Act as an exception. It passed in the Senate with well over 70% of the votes cast in favor. Here in the House, it passed with well over 90% of the votes cast in favor. And if my research is correct, every single member of this Subcommittee voted in favor of the JOBS Act. That's a remarkable level of support.

If you had to pick out the single day on which the process that ultimately led to the JOBS Act got started, you'd probably say it was Tuesday, March 22, 2011.

On that day, Chairman Issa sent a letter to SEC Chairman Schapiro.[1] In that letter, Chairman Issa pointed out that over the preceding decade or so the number of IPOs in the United States had plummeted, while the number of companies listed on US exchanges had also dramatically declined. Chairman Issa's letter then asked a series of questions seeking to determine what could be done to address the crisis in capital formation.

On the very same day, Treasury Secretary Geithner convened the Access to Capital Conference to address the Administration's own concerns about these unfavorable developments.[2] That conference resulted in the formation of a private sector group dubbed the "IPO Task Force." The IPO Task Force subsequently released its report "Rebuilding the IPO On-Ramp"[3] in October 2011, and many of the recommendations in that report ultimately were enacted as Title I of the JOBS Act.

Meanwhile, throughout 2011 a variety of bills were introduced, mostly in the House, but also in the Senate, to address the problems identified in Chairman Issa's letter to Chairman Schapiro. Notable among those bills was H.R. 2930, "The Entrepreneur Access to Capital Act,"[4] which was introduced by Chairman McHenry in September 2011 to legalize the crowdfunding of small enterprises. On November 3, 2011, Chairman McHenry's bill passed in the House by an overwhelming vote of 407 to 17; that is, with about 96% of the votes cast in favor. This bill, along with the other bills, provided the foundation for the other titles of the JOBS Act.

And we know how this story turned out: as I noted just a few moments ago, the JOBS Act passed by overwhelming majorities in both houses and was signed into law by President Obama at a ceremony in the Rose Garden on April 5, 2012.

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[1] Available at: http://democrats.oversight.house.gov/images/stories/FULLCOM/510%20future%20of%20cap%20form/2011-03-22%20DEI%20to%20Schapiro-SEC%20-%20capital%20formation%20due%204-5.pdf.

[2] See http://www.treasury.gov/press-center/media-advisories/Pages/tg1111.aspx.

[3] Available at: http://www.wsgr.com/PDFs/rebuilding-IPO.pdf).

[4] Available at: http://www.govtrack.us/congress/bills/112/hr2930/text.

But, unfortunately, that's not really the end of the story. For despite the truly overwhelming support the JOBS Act commanded in Congress, including – as I noted a moment ago – the votes of every member of this Subcommittee, we know there are those who aren't happy with it, as demonstrated by the blistering editorial in THE NEW YORK TIMES[5] attacking the JOBS Act just before its passage. So it's worth asking how the SEC will discharge its responsibility to implement the JOBS Act.

In that regard, it's illuminating to re-read Chairman Schapiro's response[6] to that letter from Chairman Issa I referred to earlier – the one he sent back in March 2011. Chairman Schapiro's response was lengthy. It was professional. The SEC staff undoubtedly devoted a good deal of careful thought and effort when helping Chairman Schapiro to prepare it. But, unsurprisingly, the letter's principal message is consistent with that New York Times editorial almost a year later: regulation really hasn't been an impediment to capital formation and few, if any, changes were or are necessary or desirable, and certainly not with any urgency.

It's also illuminating to read Chairman Schapiro's March 13, 2012 letter to Chairman Johnson and Ranking Member Shelby of the Senate Committee on Banking, Housing and Urban Affairs stating her "concerns on some important aspects of" the then-pending JOBS Act.[7]

While in her letter Chairman Schapiro recognized that the legislation was "the product of a bipartisan effort designed to facilitate capital formation" and conceded that it included "certain promising approaches" that she did not specify, she went on to pan much of it, asserting that it would "weaken important protections," "remove certain important measures," "cause real and significant damage to investors," "undermine independent standard-setting," include changes that are "unwarranted,"

[5] http://www.nytimes.com/2012/03/11/opinion/sunday/washington-has-a-very-short-memory.html.

[6] Available at: http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf.

[7] Available at: http://www.thevaluealliance.com/Schapiro_letter_Jobs_Act_031312.pdf.

cause investors to focus on materials "without important investor protections," and "adversely impact the IPO review program," among other criticisms.

In light of this letter, it's probably fair to conclude Chairman Schapiro is not a big fan of much of the JOBS Act, which – with the exception of the Merkley-Brown amendment – passed unchanged from the version on which Chairman Schapiro was commenting. And it's not too great a stretch to imagine that the SEC staff may generally share her distaste.

After all, the SEC had sufficient authority to do almost everything the JOBS Act did without any legislation at all. And because of the special expertise of the SEC and its staff, had it chosen to do so, it may have implemented approaches even more effective in facilitating capital formation – and the job creation that results – than those offered by the JOBS Act. Unfortunately, the JOBS Act was necessary precisely because the SEC did not believe in the need for what the JOBS Act seeks to accomplish.

This is not to suggest that the SEC won't implement the JOBS Act in a professional fashion. It will. But it is to suggest that the SEC, informed by the well-intentioned concerns of Chairman Schapiro and the SEC staff, could use the discretion given to it in rulemaking and interpretation to burden unnecessarily one or more of the provisions of the Act. And it is also possible that the SEC may assign the needed rulemakings a low priority, miss the congressionally mandated deadlines where they exist, and stretch out the period before the JOBS Act can become fully effective.

Title I: The IPO On-Ramp

Two titles of the JOBS Act, however, do not require SEC rulemaking. Title I provides an "IPO On-Ramp" designed to reduce the initial burdens of becoming a public company. Those who crafted Title I, led by the IPO Task Force, wisely made it self-executing. Even so, any new legislation inevitably gives rise to interpretive issues. And there also can be occasional circumstances in which the statutory language does not seem to match precisely with what quite evidently was the legislative intent. The JOBS Act is no different from any other legislation in this regard.

I'm pleased to report that to date the Division of Corporation Finance has done a good job navigating through the issues of this sort that have been identified in Title I. Perhaps the Division had its concerns about the wisdom of the legislation; certainly Chairman Schapiro did. But the Division has not sought potential opportunities to derail the operation of Title I. Instead, right from the start, the Division has issued thoughtful interpretations and FAQs in an effort to make Title I work as intended. The director, Meredith Cross, and the staff of the Division should be congratulated for their professional approach.

Title V: Staying Private

Title V (and the quite similar Title VI, which is targeted principally at the special case of community banks) also is self-executing and does not require new SEC regulations to become operative. Title V is designed to permit successful private companies to delay the burdens of becoming and being a public company for longer than previously possible by raising the maximum number of record holders of a class of equity securities (such as stock) a company may have without being required to register with the SEC. Title V raises the limit from 500 to 2,000, provided that no more than 500 holders are non-accredited investors. Title V also for the first time excludes employee stockholders from the count.

The tricky part of Title V for companies will be figuring out how to determine how many non-accredited record holders they have. The SEC or the staff is likely to provide guidance in this area in due course, and I urge you to encourage them to do so in a manner that renders these provisions workable and efficient.

Title II: Rule 506 and 144A Offerings Now May Use General Solicitation

The other titles of the JOBS Act do require SEC rulemaking. For example, Title II requires the SEC to revise its Rules 506 and 144A within 90 days of enactment which, according to my calculation, means July 4th is the deadline. In each case, the required revision is to permit general solicitation in connection with offerings under those rules.

The existing prohibition on general solicitation has two main elements. First, in connection with an affected offering, issuers and placement agents must not permit potential investors who are not qualified to participate to be exposed to the offering materials. Second, issuers and placement agents may contact only potential investors with whom they have pre-existing relationships, even if other investors are known to be qualified to participate. These prohibitions obviously make it harder to reach enough potential investors to make an offering a success.

Prohibitions on general solicitation have become quite controversial, in part because the modern interpretation of the First Amendment casts doubt on their constitutionality. For example, over a decade ago the Supreme Court struck down a Massachusetts law that banned cigarette advertising within 1,000 feet of a school or playground.[8] The Court ruled that the state's desire to prevent the exposure of minors to advertising for products minors are forbidden to purchase was insufficiently compelling to justify curtailing the rights of adults to make and receive commercial messages protected by the First Amendment. The question thus arises why the protection of adult non-accredited investors from advertising for unsuitable investments is more compelling than the protection of minors from addictive, cancerous products.

Be that as it may, Title II has now directed the SEC to lift the ban on general solicitation for offerings made in reliance on two often-used exemptions: Rule 506 and Rule 144A. The staff of the Division of

[8] *Lorillard* v. *Reilly*, 533 U.S. 525 (2001).

Corporation Finance has already addressed certain technical interpretive issues that will arise when the SEC rules are in place and done so in a thoughtful manner. So far, so good. But here's a possible problem: Title II states that the SEC's implementing rules must "require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission."

Under current market practice, the method generally used for determining whether purchasers qualify to participate in an exempt offering is self-certification: as part of the contract for the sale of the securities, each purchaser is required to represent and warrant that he, she or it meets the qualification standards to be, for example, an "accredited investor." Someone who is prepared to lie – and assume contractual liability for the lie – in order to get in on an offering has unclean hands and should deserve scant protection from the consequences of lying, so self-certification ought to be a sufficient "reasonable step" to verify that a purchaser is accredited. I urge you to encourage the SEC to confirm that self-certification suffices. And if the SEC insists on requiring anything extra, those additional or different requirements should not be unduly costly or uncertain in application.

And now is the time to get the new rules on the books without delay. As I noted earlier, the congressionally mandated deadline is July 4. The new rules will simply implement what Title II directs and, at least compared with many other rules, should be relatively straightforward to draft. I urge you to encourage the SEC to do so forthwith.

<u>Title III: Crowdfunding</u>

Title III of the JOBS Act authorizes crowdfunding. According to Wikipedia, crowdfunding may have gotten its start as a means for fans to fund the activities (such as tours) of musical groups that had not yet enjoyed sufficient commercial success to be self-funding. The idea was to harness the power of the internet as a nearly costless means of communication to pool modest sums from a large enough number of supporters that the resulting fund would be sufficient to enable the group's objective to be attained. The very low cost of solicitation of a large number of potential contributors made possible by the internet makes this approach work.

In its original form, Chairman McHenry's bill attempted to bring this same simplicity to the funding of small entrepreneurial ventures. But Title III picked up a number of additional provisions along the way to passage.

Unlike in Chairman McHenry's original bill, Title III now requires that an entrepreneur engage an intermediary to assist with the process. Although the required intermediary does not need to be an SEC-registered broker-dealer that is also a member of FINRA, the intermediary will still need to have registered with the SEC and joined FINRA, under new rules for such intermediaries yet to be written by the respective regulators.

And, as passed, Title III requires that intermediary (as well as the issuer and its key personnel) to accept a substantially more stringent liability standard – and hence greater risk -- than would be the case for other permissible forms of private financings. In my view, it would be ill-advised to assume such securities law liability without the advice of experienced securities counsel.

Moreover, as passed, Title III requires, even for an offering of less than $100 thousand, that investors be provided with financial statements certified by the principal executive officer. Those financial statements, of course, must be fully in accordance with US Generally Accepted Accounting Principles. So a competent accountant is required, an accountant prepared to accept – and be compensated for – the risks associated with being involved with a securities offering. And for offerings between $100 thousand and $500 thousand, that accountant must issue a review, and for offerings of greater amounts, the financial statements must be audited.

Not only that, but, as passed, Title III imposes an obligation to file with the SEC and provide to investors on-going reports no less frequently than annually, unless the SEC establishes exemptions from this requirement.

So the simple crowdfunding concept has now morphed into a conventional securities offering, with lawyers, accountants and financial intermediaries – plus on-going reporting requirements and also plus a liability standard significantly higher than would apply to other forms of exempt offerings, thereby meaningfully enhancing the risks to those third parties, and thus the compensation they will require for their services, if they are willing to offer their services at all.

The key question is: what percentage of the proceeds of a crowdfunded offering will all those intermediaries consume? If an entrepreneur in your district wants to use crowdfunding to raise $100 thousand (or $500 thousand or even the maximum $1 million) to start a small business, how much of that will the intermediary, the lawyer and the accountant together necessarily consume and how much will be left for use in the business? And how much of what remains available for use in the business will have to be reserved to fund the costs of the annual reporting obligations?

Individual circumstances will vary but, in my judgment, the likely answer often will be: not enough. If I'm right, crowdfunding could end up still-born.

By my count, Title III calls for SEC rulemaking to address more than fifteen separate matters, in addition to necessary rulemaking by FINRA. How all that rulemaking is crafted will help determine whether or not Title III assists in capital formation for small ventures or ends up as a dead letter, clogging the rule books to little effect.

In its rulemaking regarding Title III, the SEC in its cost-benefit analysis should, among other things, rigorously analyze the anticipated compliance costs associated with relying on Title III, including the costs for securities lawyers, accountants and registered intermediaries, as well as the present value of the costs of on-going reporting. In evaluating those costs, the SEC should include such items as the overhead costs an intermediary will bear to build and maintain a compliance infrastructure sufficiently robust to support and survive examination and inspection by the SEC and FINRA, and also give effect to the increased costs associated with addressing the heightened risks arising from the higher standard of liability Title III carries compared with other private offerings. The SEC should then determine the estimated fraction of the proceeds that would be consumed by those costs at various offering sizes within the permissible range allowed by Title III. If, after a rigorous cost analysis, in the judgment of the SEC those costs could render impractical the use of Title III for offerings below a certain dollar threshold or for all such offerings, it should plainly say so, so that Congress may then consider in an informed manner whether any additional legislative action is needed.

Finally, the deadline for SEC rulemaking is 270 days after enactment which, by my calculation, is December 31 of this year. In her letter to Chairman Johnson and Ranking Member Shelby, Chairman Schapiro stated that the bill's "time frame is too short" for SEC rulemaking. She asked for 18 months. Congress did not grant that request. While my experience as the SEC's general counsel has left me sensitive to the challenges facing the SEC in rulemaking, the priority assigned to a rulemaking project matters. I urge you to encourage the SEC to give these rulemakings high priority. Jumpstarting jobs is too urgent to delay.

<u>Title IV: Super Reg. A</u>

Title IV of the JOBS Act amends the SEC's Regulation A, creating what some have dubbed "Super Reg A" or, sometimes, "Reg A+". Early on, Representative Barney Frank, who at the time was Chairman of the House Financial Services Committee, stated that Regulation A reform would not be "partisan or terribly controversial," and indeed Title IV may be one of the least controversial sections of the JOBS Act.

Existing Regulation A offers an exemption from the otherwise applicable registration requirements of the Securities Act in the form of a scaled-back "mini-registration" process that does not lead to on-going reporting requirements. After the mini-registration, an issuer can sell to any investor and employ general solicitations in reaching potential investors. Regulation A, however, has been little used, principally because of the relatively low ceiling of $5 million that can be raised, which has proved too little in light of the costs of the mini-registration process and of the required compliance with the various securities laws of the 50 states, from which Regulation A does not provide preemption. Title IV is an attempt to make Regulation A potentially useful in offerings large enough to bear those costs by raising the ceiling to $50 million.

A prominent law firm has stated that the impact of Super Reg A "will depend in large part on how the SEC exercises its rulemaking authority to define the up-front and on-going obligations of companies that make use of the exemption."[9] I agree, and that means it's far from clear that Super Reg. A will be much used.

That's because Rule 506, as amended by Title II, may well remain substantially more attractive than Super Reg A. Importantly, as passed, Super Reg A, like crowdfunding in Title III, was burdened with a new, more stringent liability standard than applies to other forms of private offerings. That more stringent standard will increase the costs and risks of relying on Super Reg A. Rule 506 offerings remain subject to the usual liability standard. Moreover, Rule 506 offerings afford preemption of state securities law requirements, eliminating the potentially slow and costly process of working with regulators in 50 separate jurisdictions. Super Reg A doesn't, unless the company lists on an exchange. But listing on an exchange is nearly equivalent to conducting an IPO, something companies contemplating an exempt offering are, by definition, not yet

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[9] http://www.cgsh.com/files/News/3b1cdad1-c891-465d-934e-a8afa30a4ce1/Presentation/NewsAttachment/811aee8d-3c42-426f-91cc-abbb9052c371/Alert%20Memo%20-%20JOBS%20Act.pdf.

willing to undertake. Moreover, Rule 506 offerings do not require filings with the SEC and do not subject the company to on-going periodic disclosure requirements, something the SEC has discretion to impose in its Super Reg A rulemakings.

In short, Super Reg A benefits from the higher offering ceiling, but is burdened by other disadvantages and, in the worst case, could turn out to be used just as infrequently as old Reg. A. So I urge you to encourage the SEC in its rulemaking to minimize the costs and burdens to the greatest extent possible, in order to fulfill the Congressional intent of rendering Super Reg A offerings a useful and workable vehicle for capital formation by companies not yet ready or willing to undertake an IPO.

Title VII: Outreach

Title VII provides that the SEC "shall provide online information and conduct outreach to inform small and medium sized businesses ... of the changes made by this Act."

If you go to the SEC's home page[10] today, you'll see in a prominent position the only reference there to the JOBS Act, which says: "Notice: JOBS Act Crowdfunding Exemption." Clicking through takes you to the following:

> Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act
>
> On April 5, 2012, the Jumpstart Our Business Startups (JOBS) Act was signed into law. The Act requires the Commission to adopt rules to implement a new exemption that will allow crowdfunding. Until then, we are reminding issuers that any offers or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws.[11]

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[10] http://www.sec.gov.
[11] http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm.

Also prominent on the home page is a link that takes you to a new page entitled "Spotlight on Topics of Current Interest at the SEC."[12] The "PCAOB Nomination Process" is on the list. Implementing the JOBS Act is not.

I urge you to encourage the SEC and its staff to devote sufficient resources to "getting the word out" in a form that can be understood by the entrepreneurs in your districts and across the nation as to how to avail themselves of the opportunities afforded by the JOBS Act. Major enterprises with large legal departments don't need this kind of assistance. Entrepreneurs do.

Conclusion

The JOBS Act was enacted with the overwhelming support of the Administration and both Houses of Congress. Important parts of the JOBS Act may succeed or fail depending on how they are implemented by the SEC. In our jobs-starved economy, time is of the essence. I thank you for focusing your congressional oversight on this critical topic.

I look forward to your questions.

[12] http://www.sec.gov/spotlight.shtml.

Mr. McHENRY. Mr. Hillel-Tuch.

STATEMENT OF ALON HILLEL–TUCH

Mr. HILLEL-TUCH. So Mr. Chairman McHenry, Ranking Member Quigley, and members of the committee who are able to attend. My name is Alon Hillel-Tuch. I am a Co-Founder and CFO of RocketHub, and I thank you guys for the opportunity to provide testimony on implementation of the JOBS Act and the proper elimination of government barriers to small business capital formation.

Background on RocketHub. RocketHub is an established crowdfunding website, one of the largest in the world, and we have provided a platform for the launch of over 8,000 campaigns so far since 2010 and raised over $2 million to support entrepreneurs and small businesses. These successful campaigns have provided funding to businesses of all types from a local bakery to a startup developer of medical devices to enabling the financing of a film production.

Crowdfunding really is the application of new technology to an old idea. People have always sought support in their community to help raise money for new business. The advent of web-based social networking allows people to expand their community to their online friends and to benefit from the lower costs of the web-based platform.

Thanks to Title III of the JOBS Act, crowdfunding in the U.S. Will soon expand to permit the sale of stock by these entrepreneurs to their supporters. And we at RocketHub look forward to this development, and we intend to register as a crowdfunding portal as provided in the JOBS Act.

While I believe that the JOBS Act will benefit small businesses in the U.S., I also believe that its impact can be improved for the proper use of the Securities and Exchange Commission's discretion in rulemaking, and through certain amendments to the act as well.

I see three areas for improvement. I want to try to fit it into the time I have.

In the JOBS Act, Congress provided that issuers utilizing crowdfunding platforms must provide investors with certain information, including audited financial statements where the issuer seeks to raise more than $500,000 or such other amount as the Commission may establish. I believe that this $500,000 threshold is too low and that the audited financial statement should not be required unless the issuer seeks to raise $1 million. Crowdfunding typically attracts startup companies and small businesses, and audited historical financial statements of these types of companies, which may have little or no operations or relevance. They do not provide investors with more meaningful information as compared to unaudited financial statements, yet they impose a significant cost on the entrepreneur which might really kill this. Making this change could save small businesses tens of thousands of dollars for opening up the opportunity for them to take full advantage of the platform.

A second area where the Commission should exercise its discretion in rulemaking is really by minimizing upfront expenses to the entrepreneurs and small businesses that seek to crowdfund.

Crowdfunding platforms usually charge fees for successful projects. This allows small businesses to access crowdfunding at a minimal initial cost, which is critical. If they attract support for their projects, then they have the funds to pay fees. If their idea does not attract support, their costs are minimal and no support is charged and the entrepreneur can come back in the future with a new idea.

In implementing the JOBS Act, it is important that the Commission considers and is careful around preserving the fee structure. The platform should be able to charge fees on successful projects while not imposing costs on projects that do not attract funding. This structure allows more small companies to use crowdfunding while reducing their risk if they are unable to attract financing.

One area that Congress should address the JOBS Act is to raise the crowdfunding exemption to $5 million from $1 million. The higher amount will allow more small businesses who need capital to utilize the cost-effective crowdfunding methods. Currently, a company that seeks more than $1 million is unable to use crowdfunding and must still rely on traditional venture capital, angel investors, credit card debt, or small business loans. These sources may not be available to all businesses, especially startups, women and minority-led businesses, and those additional small businesses that fall outside the high tech model. Raising this limit will allow crowdfunding to more effectively compete as a source of funds through venture capital and banks and giving small businesses more options to drive down financing costs.

Crowdfunding can be an important economic tool to help small businesses grow and drive job creation. I believe that raising the aggregate limit for crowdfunding to $5 million, limiting the costs associated with audited financials to raises above $1 million and aligning the interests of companies, investors, and platforms with a success fee structure, we can increase the economic benefit provided by crowdfunding.

These reforms will increase the number and type of companies that choose to raise capital and expand the role of crowdfunding in small business finance. We also expand the opportunity and benefits to crowdfunding investors, allowing these small investors the ability to participate in the growth and success of a wider range of companies, including those in their communities.

So I'm going to quickly close with a quick response to two common questions. First is: Will crowdfunding lead to a lot of fraud by issuers? No, it won't. In fact, crowdfunding structures help minimize risk. Crowdfunding is highly transparent and there is substantial feedback from community participants. The crowd helps police players and keeps them honest, and crowdfunding portals and regulators are able to drive standardized understandable terms across offerings.

I thank you for your time and I'm looking forward to questions.

[Prepared statement of Mr. Hillel-Tuch follows:]

Mr. Chairman and Members of the Committee:

Thank you for this opportunity to provide testimony on the implementation of the JOBS Act and the proper elimination of government barriers to small business capital formation.

My name is Alon Hillel-Tuch. I am a co-founder and CFO of RocketHub. RocketHub is an established crowdfunding website, having provided a platform for the launch of over 8,000 campaigns and raised over $2 million to support entrepreneurs and small businesses. These successful campaigns have provided funding to businesses of all types, from a local bakery to a start-up developer of medical devices to enabling the financing of a film production.

Crowdfunding is the application of new technology to an old idea. People have always sought support in their community to help raise money for new businesses. The advent of web-based social networking allows people to expand their community to their on-line friends and to benefit from the lower costs of a web-based platform.

Thanks to Title III of the JOBS Act, crowdfunding in the U.S. will soon expand to permit the sale of stock by these entrepreneurs to their supporters. We at RocketHub, look forward to this development, and we intend to register as a crowdfunding portal as provided in the JOBS Act.

While I believe that the JOBS Act will benefit small businesses in the U.S., I also believe that its impact can be improved through the proper use of the Securities and Exchange Commission's discretion in rule making, and through certain amendments to the Act.

In the JOBS Act, Congress provided that issuers utilizing crowdfunding platforms must provide investors with certain information, including audited financial statements where the issuer seeks to raise more than $500,000, or such other amount as the Commission may establish. I believe this $500,000 threshold is too low, and that audited financial statements should not be required unless the issuer seeks to raise $1 million. Crowdfunding typically attracts start-up companies and small businesses. *Audited* historical financial statements of these types of companies, which may have little or no operations, do not provide investors with more meaningful information as compared to unaudited financial statements, yet they impose a significant cost on the entrepreneur. Making this change could save small businesses tens of thousands of dollars while opening up the opportunity for them to take full advantage of the crowdfunding platform.

A second area where the Commission should exercise its discretion in rule-making is by minimizing up-front expenses to entrepreneurs and small businesses that seek to crowdfund. Crowdfunding platforms usually charge fees for successful projects. This allows small businesses to access crowdfunding at minimal initial cost. If they attract support for their project, then they have the funds to pay fees. If their idea does not attract support, their costs are minimal, no supporter is charged, and the entrepreneur can come back in the future with a new idea. In implementing the JOBS Act, the Commission should be careful to preserve this fee structure. Platforms should be able to charge fees on successful projects, while not imposing costs on projects that do not attract funding. This fee structure will allow more small companies to use crowdfunding, while reducing their risk if they are unable to attract financing.

One area that Congress should address to improve the JOBS Act is to raise the crowdfunding exemption to $5 million from $1 million. The higher amount will allow more small businesses who need capital to utilize the cost-effective crowdfunding method. Currently, a company that seeks more than $1 million is unable to use crowdfunding and must rely on traditional venture capital and angel investors, credit card debt, or small business loans. These sources may not be available to all businesses, especially start-ups, women and minority led businesses, and those traditional small businesses that fall outside of the high-tech model. Raising this limit would allow crowdfunding to more effectively compete as a source of funds with venture capital and banks, giving small businesses more options and driving down financing costs.

Crowdfunding can be an important economic tool to help small businesses grow and drive job creation. I believe that by: raising the aggregate limit for crowdfunding to $5 million; limiting the costs associated with audited financials to raises above $1 million; and aligning the interests of companies, investors and platforms with a success fee structure, we can increase the economic benefit provided by crowdfunding.

These reforms will increase the number and type of companies that choose to raise capital through crowdfunding. By expanding the role of crowdfunding in small business finance, we also expand the opportunities and benefits to crowdfunding investors. These small investors will have the ability to participate in the growth and success of a wider range of companies, including companies in their communities.

I'm very excited by the opportunities provided by crowdfunding, and I again thank the committee for the opportunity to speak with you here today.

If time is available I would like to address the following points and common questions regarding crowdfunding.

Q: Won't crowdfunding lead to a lot of fraud by issuers?
A: Every securities market and/or offering has the potential for fraud, but crowdfunding structures help minimize that risk. Crowdfunding is highly transparent, and there is substantial feedback from other community participants. The crowd helps police players and keeps them honest. Portals provide a clear and central location for communication by potential investors to analyze and share their views on offerings. The web based structure also allows portals and regulators to provide risk disclosure and investor education. In addition, we expect portal operators will undertake a gatekeeping role in authenticating issuer identity and requiring minimum standards for issuers.

Q: What potential does Title III of the JOBS Act have to create new domestic jobs?
A: As shown in the July, 2010 Kaufman Foundation report ("The Importance of Startups in Job Creation and Job Destruction"), startups are the job creation engine in the American economy. Without startups there is no net job growth. Access to capital for small business is a challenge; small businesses have relied on financing from community members as well as sources such as credit card debt, loans, and angel investors. Debt structures often come at a high cost and burden to entrepreneurs, who may lack regular cash flow, during the growth stages of their companies. Furthermore, traditional sources of capital have strict guidelines to the nature of the businesses

they support, excluding a wide range of domestic businesses. Crowdfunding is especially important for women and minority owned businesses that may not have traditional access to funding sources. By using a web-based platform, crowdfunding drives down the cost to companies of raising capital and allows companies to reach out to their natural investor base.

Q: How will crowdfunding investors receive liquidity in their investment positions?
A: As with any private placement we expect that investors in crowdfunded projects seek long term alignment with the issuers. We do not believe this industry is conducive to rapid trading, we believe the industry consists of smaller investors that are looking to participate in long term opportunities they are familiar with and understand.

Q: Why is crowdfunding good for investors?
A: Before the JOBS Act the ability of small investors to participate or invest in private businesses has been limited. The JOBS Act now enables small investors to provide support to capital seeking entrepreneurs. Crowdfunding portals and regulators are able to drive standardized and understandable terms across offerings. This allows crowdfunding investors to become educated and aware of the offering terms and risks. Investors in crowdfunding offerings are able to clearly see the terms and success of an offering, and are able to directly communicate with the issuer and other investors.

Mr. McHenry. Thank you. Thank you so much. Professor Bradford.

STATEMENT OF C. STEVEN BRADFORD

Mr. Bradford. Chairman McHenry, Ranking Member Quigley, members of the subcommittee, good afternoon. My name is Steve Bradford. I am a Professor of Law at the University of Nebraska. Much of my work focuses on small business capital formation under Federal securities law, and it is an honor to be able to address you on that subject today.

I have recently written two articles on crowdfunding, and I would like to focus my comments on the crowdfunding provisions of the JOBS Act. I believe that crowdfunding could spark a revolution in small business financing, opening up much needed new sources of startup capital, but whether that happens depends in good part on the regulatory burden. Those small offerings will be possible only if the cost of complying with securities regulation doesn't consume a large portion of the offering proceeds.

The new Federal securities law crowdfunding exemption created by the JOBS Act is an important first step, but that exemption isn't complete until the SEC enacts implementing regulations. The usefulness of the crowdfunding exemption will depend in part on how the Commission exercises its rather substantial regulatory authority.

My written statement includes a number of specific recommendations concerning the crowdfunding rules, and I would be happy to discuss any of those with the members of the committee. But in the time available, I want to limit myself to four important points:

First, cost is a critical consideration for the very small offerings that crowdfunding facilitates. Because of that, I believe the SEC crowdfunding regulations should be as light-handed and unobtrusive as possible. In the name of investor protection, the statute already imposes significant regulatory requirements on both crowdfunding issuers, and on the brokers and funding portals who will act as intermediaries in crowdfunded offerings. Adding additional layers of regulation on top of those requirements would increase the cost of using the exemption without much additional benefit, and would also be inconsistent with the thrust of the JOBS Act to reduce the regulatory burden on small business capital formation.

Second, to the extent that any additional regulation is required, it should be imposed on crowdfunding intermediaries, brokers and funding portals, rather than on the entrepreneurs raising funds. Crowdfunding intermediaries will be more sophisticated and more heavily capitalized than the small business issuers engaging in crowdfunding. Those brokers and funding portals can afford securities counsel to guide them through the regulations. There will also be repeat players so they can spread any regulatory costs over a large number of offerings. Because of that, I think it makes sense to center the regulation on those intermediaries rather than on the companies raising money.

Third, the SEC crowdfunding regulation should be clear, concise, and written in plain English. The SEC requires corporate disclosures to meet those requirements in order to facilitate understanding by investors. In drafting the crowdfunding rules, the Commission should follow its own plain English standard in order to facilitate understanding and compliance by crowdfunding issuers. Many of the small business issuers using the crowdfunding exemption will be legally and financially unsophisticated. If the regulations are dense and legally complex, those businesses will need sophisticated securities counsel to guide them through the regulations. That would significantly increase the cost of the offering, and for these small offerings cost is all important. That leaves issuers with two alternatives, either they try to navigate the complex rules on their own, in which case violations are likely, or they would simply not use the exemption in which case the promise of crowdfunding won't be realized. The best way to deal with the issue is to write the rules so that small business entrepreneurs can understand them without hiring expensive attorneys.

Fourth and finally, the SEC should adopt a substantial compliance rule to protect issuers and crowdfunding intermediaries who inadvertently violate some of the requirements of the exemption. The exemption contains a lot of detail and, as I have said, the issuers using it will not be particularly sophisticated. Because of that, the possibility of an inadvertent violation is high, and the consequences of even a minor, immaterial technical violation are drastic: Loss of the exemption, violation of the Securities Act, and liability to return all of the money to every single purchaser.

Other Securities Act exemptions protect issuers who substantially comply with the requirements of the exemption, or who reasonably believe the requirements of the exemption are met even if it turns out they aren't, and the SEC should include similar rules in the crowdfunding regulation.

My written statement includes a number of other specific recommendations, but my time is just about up so let me just thank you again for the opportunity to talk to you today.

[Prepared statement of Mr. Bradford follows:]

Statement of C. Steven Bradford[1]

Earl Dunlap Distinguished Professor of Law
University of Nebraska College of Law

Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs

Committee on Oversight and Government Reform
United States House of Representatives
112th Congress, 2nd Session

Hearing on *The JOBS Act—Importance of Effective Implementation*

June 26, 2012

[1] Portions of this testimony are derived from C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, forthcoming, SEC. REG. L. J., Vol. 40, No. 3 (Fall 2012), available at http://ssrn.com/abstract=2066088.

Introduction

Chairman McHenry and Members of the Subcommittee:

Thank you for inviting me to appear today to talk about the implementation of the JOBS Act. Much of my work focuses on the interaction of securities regulation and small business capital formation, and it is an honor to be asked to address you on that subject today.

I want to focus my comments on the crowdfunding provisions of the JOBS Act and the SEC's implementation of those provisions. I believe that crowdfunding could spark a revolution in small business financing and help close what some people have called the small business capital gap.[2] But that can happen only if the regulatory burden is limited. For the very small offerings that crowdfunding facilitates, cost is a crucial consideration; it will not take much regulatory cost to eliminate crowdfunding as an option.

The JOBS Act's creation of a crowdfunding exemption is an important first step, but that exemption is not complete until the SEC enacts implementing regulations, and the SEC has been given substantial authority to modify or add to the Act's requirements.[3] As a result, the SEC will have an important influence on the usefulness of the new exemption. The devil, as they say, will be in the details.

General Principles of Regulation

I would first like to offer three general principles that the SEC should follow in drafting crowdfunding regulations. After that, I will turn to specific recommendations.

1. The SEC Regulations Should be as Light-Handed and Unobtrusive as Possible

The SEC crowdfunding regulations need to be as light-handed and unobtrusive as possible. The new crowdfunding exemption already imposes a fairly substantial disclosure cost on small businesses. Additional regulation would significantly

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[2] *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 100-104 (2012), and sources cited therein.

[3] The Act includes a general authorization of "such rules as the Commission determines may be necessary or appropriate for the protection of investors." Jumpstart Our Business Startups (JOBS) Act, Pub. L. 112-106, § 302(c), 126 Stat. 306 (2012).

reduce the utility of the exemption and would be inconsistent with the intent of the JOBS Act—to reduce the regulatory burden on small business capital formation.

The SEC and others are concerned about the possible use of crowdfunding by disreputable elements to engage in securities fraud, and I wholeheartedly endorse the efforts to fight fraud. But the Act already imposes significant regulatory restrictions on issuers and the brokers and funding portals who will act as intermediaries in crowdfunded offerings. Additional regulatory requirements will unnecessarily increase the cost of the exemption. If fraudsters were the only ones affected by additional regulatory requirements, I would endorse them wholeheartedly. But the cost of these requirements is borne primarily by the host of honest entrepreneurs seeking to raise money for their small businesses, not by the fraudulent few.

Imposing additional layers of mandatory disclosure and other regulatory requirements on legitimate small businesses is not the best way to fight fraud. The best way to fight fraud without burdening legitimate small businesses is to go after the fraud directly—to use the antifraud tools already available in the federal securities laws. State securities regulators have an important role to play in that fight against fraud. Many state securities commissioners were disappointed by the Act's preemption of state securities registration requirements, but they can take the funds they were prepared to spend to register crowdfunded offerings and use it to police fraud.

For what it's worth, a significant amount of money is being invested in non-securities crowdfunding right now. From the fraudster's standpoint, the financial incentives and the gains from fraud are exactly the same, whether or not securities are involved. But fraud has not been a major issue. That indicates to me that the structure of crowdfunding—public web sites, neutral intermediaries filtering the requests for funds, relatively small investments—is effective in preventing fraud.

2. To the Extent that Additional Regulation is Needed, it Should Be Imposed on Crowdfunding Intermediaries, Not Issuers

To the extent that additional regulation is required, it should be centered on crowdfunding intermediaries—brokers and funding portals—rather than on the entrepreneurs raising funds. Crowdfunding intermediaries can be used as gatekeepers to keep out the bad actors and to structure the offerings in such a way that investor risks are reduced.

The small companies and entrepreneurs most likely to engage in crowdfunding are poorly capitalized and legally unsophisticated. They do not have and cannot afford sophisticated securities counsel to guide them through complex regulation. Too much complexity at the entrepreneurial level will destroy the exemption's utility and produce a host of unintentional violations.

Crowdfunding intermediaries, on the other hand, will be repeat players. They can spread any regulatory costs over a large number of offerings. They will be more heavily capitalized than almost all of the entrepreneurs using the crowdfunding sites, and they can afford securities counsel. As repeat players, crowdfunding sites will also be much more accessible to securities regulators for enforcement purposes.

3. The SEC Regulations Should Be Simple and In "Plain English"

The SEC regulations should be simple to follow and written in "plain English." In other words, the SEC should itself follow the requirements that its regulations impose on businesses.

The SEC requires issuers to present disclosure to investors "in a clear, concise and understandable manner," using "plain English principles."[4] These rules recognize that clarity facilitates understanding by investors, many of whom lack the skill and resources to interpret dense "legalese."

Clear, plain-English crowdfunding regulations will similarly facilitate understanding and compliance by small-business issuers, many of whom will not be legally or financially sophisticated. Small businesses faced with dense, complicated regulations have three options. First, they can forego the exemption, and the promise of crowdfunding will not be realized. Second, they can hire sophisticated securities counsel to guide them through the regulations, and most of the offering proceeds will be eaten up by the cost of complying with the regulation. Or third, they can try to navigate the rules on their own, in which case violations are likely. None of these outcomes is desirable.

To make it easier on entrepreneurs using the exemption, the SEC should:

- Write the regulations in everyday language that does not require a lawyer to interpret.
- To the extent possible, pose the disclosure requirements in simple, question-and-answer, fill-in-the-blank format.
- Make the regulations completely self-standing, without cross-references to the federal securities statutes or other regulations. Issuers using the exemption should be able to find everything they need in a single document.

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[4] *See* Securities Act Rule 404(b),(d), 17 C.F.R. § 230.404(b),(d) (2012).

- Separate the requirements directed at issuers from the requirements directed at crowdfunding intermediaries, even if that requires duplication. Issuers and intermediaries should not have to wade through material that does not apply to them in order to find the appropriate rules.

Specific Recommendations

With those general principles in mind, I would now like to make some specific recommendations.

1. The SEC Should Adopt a "Substantial Compliance" Rule

To qualify for the crowdfunding exemption, both issuers and crowdfunding intermediaries must comply with a number of detailed requirements. Compliance with *all* of those requirements is a condition of the exemption.[5] If the crowdfunding intermediary fails to comply with any of the requirements of section 4A(a) or if the issuer fails to comply with any of the requirements of section 4A(b), the exemption is unavailable. It does not matter how minor the violation is or whether the issuer or the intermediary reasonably believed it was in compliance.

If, for example, the crowdfunding intermediary allows a single investor to participate without answering just one of the required questions about risk,[6] the issuer would lose the exemption for the entire offering. If the issuer inadvertently sells an investor securities that exceed the cap for that investor by $1, the exemption would be lost for all of the sales, not just those to that purchaser.

Given the complexity of the exemption's requirements, inadvertent violations are likely, and the consequence of even a minor violation is drastic. Absent an exemption, section 5(a)(1) of the Securities Act makes it unlawful to sell a security unless a registration statement is in effect.[7] If the section 4(6) crowdfunding

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[5] Section 4(6) exempts "transactions involving the offer or sale of securities by an issuer . . . *provided that*" the listed requirements are met. Securities Act of 1933 § 4(6), JOBS Act, Pub. L. 112-106, § 302(a), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d(6)) (emphasis added). The required conditions include the intermediary's compliance with section 4A(a) and the issuer's compliance with section 4A(b). *See* Securities Act of 1933 § 4(6)(C),(D), JOBS Act, Pub. L. 112-106, § 302(a), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d(6)(C),(D)).

[6] Securities Act of 1933 § 4A(a)(4)(B), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(a)(4)(B)).

[7] Securities Act of 1933 § 5(a)(1), 15 U.S.C. § 77e(a)(1) (2010). Section 4(6) is an exemption from section 5 of the Act. *See* Securities Act of 1933 § 4, 15 U.S.C. § 77d (2010) ("The provisions of section 5 of this Act shall not apply to -- . . .").

exemption is lost because of some minor noncompliance, all of the sales in the offering would violate section 5(a)(1). Under section 12(a)(1) of the Securities Act, all purchasers would be able to rescind their purchases and get their money back.[8]

Other Securities Act exemptions include "substantial compliance" rules that protect issuers even if the issuer failed to comply with the exemption in certain insignificant ways.[9] The Regulation D exemption also includes several provisions that protect the issuer if it reasonably believed the requirements of the rule were met, even if they actually were not.[10] Section 4(6) needs a similar set of substantial compliance and reasonable belief rules.

Nothing in the Act itself specifically authorizes the SEC to enact a substantial compliance rule, but the SEC has blanket authority to "issue such rules as the Commission determines may be necessary or appropriate for the protection of investors to carry out sections 4(6) and . . . 4A."[11] The SEC has even broader authority in both the Securities Act and the Securities Exchange Act to "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions" from any provision of the statutes, if the Commission determines that "such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."[12] The SEC could use this authority to specify that an issuer that reasonably believed it met the requirements of section 4(6) or that substantially complied with section 4(6) would still be entitled to the exemption, in spite of the noncompliance.

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[8] Securities Act of 1933 § 12(a)(1), 15 U.S.C. § 77l(a)(1) (2010). *See* Carl W. Schneider & Charles C. Zall, *Section 12(1) and the Imperfect Exempt Transaction: The Proposed I & I Defense*, 28 BUS. LAW. 1011 (1973) (proposing a defense where an issuer's failure to comply with a registration exemption was innocent and immaterial).
[9] *See* Securities Act Rule 260, 17 C.F.R. § 230.260 (2012) (Regulation A); Securities Act Rule 508, 17 C.F.R. § 230.508 (2012) (Regulation D). *See also* Carl W. Schneider, *A Substantial Compliance ("I&I") Defense and Other Changes are Added to SEC Regulation D*, 44 BUS. LAW. 1207 (1989) (discussing the addition of Rule 508 to Regulation D).
[10] *See* Securities Act Rules 501(a), 17 C.F.R. § 230.501(a) (2012) (reasonable belief that investors are accredited investors); 501(h) (reasonable belief that purchaser representatives meet the requirements to serve as purchaser representatives); 505(b)(2)(ii), 17 C.F.R. § 230.505(b)(2)(ii) (2012) (reasonable belief that there are no more than 35 purchasers); 506(b)(2)(i), 17 C.F.R. § 230.506(b)(2)(i) (2012) (reasonable belief that there are no more than 35 purchasers); 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii) (2012) (reasonable belief that non-accredited purchasers meet a sophistication requirement).
[11] JOBS Act, Pub. L. 112-106, § 302(c), 126 Stat. 306 (2012).
[12] Securities Act of 1933 § 28, 15 U.S.C. § 77z-3 (2010); Securities Exchange Act of 1934 § 36(a)(1), 15 U.S.C. § 78mm(a)(1) (2010).

2. The SEC Should Require that Crowdfunding Sites be Open to the General Public and Offer an Open Communication Forum for Each Offering

The SEC regulations should require crowdfunding intermediaries to keep their web sites open to the general public. In addition, crowdfunding web sites should be required to include an electronic bulletin board that allows investors, potential investors, and other members of the public to communicate about each offering.

The original House crowdfunding bill included such a requirement,[13] but that requirement was not included in the crowdfunding exemption that was eventually enacted. However, the Act authorizes the SEC to impose additional requirements on crowdfunding intermediaries "for the protection of investors and in the public interest,"[14] and I believe these requirements are consistent with that standard.

Open communication channels can help protect investors from both fraud and poor investment decisions by allowing members of the public to share knowledge about particular entrepreneurs, businesses, or investment risks.[15] Openness of this sort would allow crowdfunding sites to take advantage of "the wisdom of crowds,"[16] the idea that "even if most of the people within a group are not especially well-informed or rational . . . [the group] can still reach a collectively wise decision."[17]

An open bulletin board would help prevent fraud. If an entrepreneur has a shady business background, people with knowledge of the entrepreneur's past can communicate that knowledge to potential investors. If the entrepreneur falsely claims to own a facility in Grand Island, Nebraska, people in Grand Island can expose the fraud.

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[13] *See* Entrepreneur Access to Capital Act, H.R. 2930, § 2(b), 112th Cong. (as passed by House, Nov. 3, 2011) (proposed sections 4A(a)(12) and 4A(b)(11) of the Securities Act).
[14] Securities Act of 1933 § 4A(a)(12), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(a)(12)).
[15] *See* Bradford, *Crowdfunding and the Federal Securities Laws*, *supra* note 2, at 134-136.
[16] *See generally* JAMES SUROWIECKI, THE WISDOM OF CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS, ECONOMIES, SOCIETIES, AND NATIONS (2004).
[17] *Id.*, at xiii-xiv. *See also* Armin Schwienbacher & Benjamin Larralde, *Crowdfunding of Small Entrepreneurial Ventures,* at 12, *in* HANDBOOK OF ENTREPRENEURIAL FINANCE (Douglas Cumming ed., forthcoming 2012), *available at*: http://ssrn.com/abstract=1699183at 12 (although individual crowdfunding investors might not have any special knowledge about the industry in which they are investing, they can be more effective as a crowd than alone).

An open communication channel would also allow investors and potential investors to share knowledge about the issuer's industry, the type of service or product the issuer is proposing to provide, problems with the issuer's business plan or projections, and regulatory issues the issuer might not have considered. These types of communications would not only make investors more informed before they invest, but could help the issuer refine its plans. An open communication channel would also allow investors to monitor the enterprise better *after* the investment is made, sharing information and providing feedback on an ongoing basis.

There is a risk that these open forums could be the target of spammers or advertisements, or that people would post fraudulent comments. Because of those risks, crowdfunding intermediaries should be free to remove inappropriate comments from the bulletin board. In addition, unless the intermediary knows that a particular comment is fraudulent or otherwise improper, it should not be liable for the content of the information posted.

3. The SEC Should Add an Integration Safe Harbor

Congress has made it clear that the crowdfunding exemption is not intended to be exclusive, that issuers who use the crowdfunding exemption may use other exemptions as well. New section 4A(g) of the Securities Act provides: "Nothing in this section or section 4(6) shall be construed as preventing an issuer from raising capital through methods not described under section 4(6)."[18] But a crowdfunding issuer who also sells securities outside the crowdfunding exemption faces a difficult securities law problem.

Section 4(6), like other Securities Act exemptions, exempts "transactions," so the issuer's entire offering must fall within the exemption.[19] As with other Securities Act exemptions, the issuer may not use two or more exemptions to cover parts of what is essentially a single transaction.[20] If the issuer sells securities outside of section 4(6), those other sales might be considered part of the same "transaction" and destroy the section 4(6) exemption, the exemption used for the other sales, or both.

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[18] Securities Act of 1933 § 4A(g), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(g)). This provision was also in the original House bill. *See* Entrepreneur Access to Capital Act , H.R. 2930, § 2(b), 112th Cong. (as passed by House, Nov. 3, 2011) (proposed section 4A(f)(2) of the Securities Act).
[19] Securities Act of 1933 § 4(6), JOBS Act, Pub. L. 112-106, § 302(a), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d(6)).
[20] C. Steven Bradford, *Expanding the Non-Transactional Revolution: A New Approach to Securities Registration Exemptions*, 49 EMORY L. J. 437, 460 (2000).

The SEC has developed a doctrine known as the integration doctrine to determine what constitutes a single offering for purposes of the Securities Act exemptions.[21] That doctrine applies a five-factor test which asks whether (1) the different offerings are part of a single plan of financing; (2) the offerings involve the same class of security; (3) the offerings are made at or about the same time; (4) the same type of consideration is paid for the securities sold; and (5) the offerings are for the same general purpose.[22]

Unfortunately, the integration doctrine is an uncertain, confusing mess.[23] SEC staff interpretations of the test in no-action letters have been confusing and inconsistent.[24] "Everyone seems to agree that these criteria are nearly impossible to apply, principally because neither the Commission nor the courts have ever adequately articulated how . . . [the five factors] . . . are to be weighed or how many factors must be present in order for integration to occur."[25] Because of the uncertainty of the integration test, even legal experts often find it impossible to say for certain whether two offerings will be integrated and treated as one.

Small business issuers seeking to raise money through crowdfunding lack the legal expertise needed to navigate the integration doctrine, and they cannot afford to hire sophisticated securities counsel to advise them. They are, therefore, not in a position to determine the effect of prior fundraising efforts on the availability of crowdfunding—whether, for example, the private solicitation of money from Aunt Agnes will be considered part of their crowdfunded offering for purposes of section 4(6). They also cannot anticipate their future capital needs[26] and how any future

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[21] C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis,* 45 EMORY L.J. 591, 649 (1996). *See also* Darryl B. Deaktor, *Integration of Securities Offerings*, 31 U. FLA. L. REV. 465, 473 (1979).

[22] *See, e.g.,* Non-Public Offering Exemption, Securities Act Release No. 4552, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2770-83 (Nov. 6, 1962).

[23] *See* Bradford, *Transaction Exemptions in the Securities Act of 1933, supra* note 21, at 651–52 (discussing the lack of clarity in SEC releases that detail the standard for integrating offerings).

[24] *See* Bradford, *Expanding the Non-Transactional* Revolution, supra note 20, at 463, and authorities cited therein.

[25] Rutheford B Campbell, Jr., *The Plight of Small Issuers (and Others) Under Regulation D: Those Nagging Problems That Need Attention,* 74 KY. L.J. 127, 164 (1985-86). *See also* Subcommittee on Partnerships, Trusts and Unincorporated Associations, *Integration of Partnership Offerings: A Proposal for Identifying a Discrete Offerings*, 37 BUS. LAW. 1591, 1605 (1982) (no-action letters dealing with integration are "difficult to reconcile even when dealing with similar fact situations involving the same subject matter").

[26] *See* Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J. L. & BUS. 1, 50 (2007) (small companies' capital needs "are often sporadic and immediate").

fundraising might retroactively destroy the crowdfunding exemption. Absent regulatory protection, the integration doctrine could therefore function as a trap for unsophisticated entrepreneurs, who might not even be aware of the issue.

Issuers using other Securities Act exemptions can avoid the five-factor integration test by using integration safe harbors the SEC has included within those exemptions.[27] These safe harbors protect offerings pursuant to those exemptions from integration with other offerings. The SEC should provide a similar safe harbor for crowdfunded offerings. I would suggest something like the following, based on the integration safe harbor in Regulation A:

> *Offerings and sales made in reliance on the section 4(6) exemption will not be integrated with:*
>
> *(1) Prior offers or sales of securities; or*
> *(2) Subsequent offers or sales of securities that are:*
>   *a. Registered under the Securities Act;*
>   *b. Made in reliance on Rule 701;*
>   *c. Made pursuant to an employee benefit plan;*
>   *d. Made in reliance on Regulation S; or*
>   *e. Made more than three months after the completion of the section 4(6) offering.*

4. The SEC Should Clarify that a Purchaser's Violation of the Resale Restrictions Does Not Destroy the Issuer's Exemption

With some exceptions, purchasers in a section 4(6) offering may not resell the securities for a year from the date of purchase.[28] That resale restriction is not a condition of the exemption,[29] so the issuer's exemption should be safe even if a purchaser subsequently resells crowdfunded securities in violation of the resale prohibition. However, the SEC has sometimes taken the position that resales

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[27] *See* Securities Act Rule 147(b)(2),17 C.F.R. § 230.147(b)(2) (2012); Rule 251(c), 17 C.F.R. § 230.251(c) (2012); Rule 502(a), 17 C.F.R. § 230.502(a) (2012).

[28] Securities Act of 1933 § 4A(e)(1), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(e)(1)).

[29] The restriction on resales is in section 4A(e) of the Securities Act. *See* Securities Act of 1933 § 4A(e), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(e)). Section 4(6) conditions the issuer's exemption on compliance with sections 4A(a) and (b), but not subsection 4A(e). *See* Securities Act of 1933 § 4(6)(C),(D), JOBS Act, Pub. L. 112-106, § 302(a), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d(6)(C),(D)).

shortly after an exempt offering are to be considered part of the issuer's offering, with the effect of destroying the issuer's exemption.[30]

Crowdfunding issuers cannot prevent their purchasers from reselling in violation of the resale restrictions, so issuers should not be penalized for such resales. The SEC should make it clear that resales of crowdfunded securities in violation of the statutory prohibition do not retroactively destroy the issuer's section 4(6) exemption.

5. Issuers and Crowdfunding Intermediaries Should Be Able to Rely on Self-Certification by Investors of their Annual Income and Net Worth

The amount each investor may invest in crowdfunded securities offerings depends on the investor's net worth and annual income.[31] The issuer and the crowdfunding intermediary will not, of course, know each investor's net worth and annual income. That information must be obtained from the investor

Crowdfunding, by its nature, will usually involve a large number of investors. If the issuers and crowdfunding intermediaries have to take significant steps to verify the net worth and annual income of each of those investors, the cost of using the exemption will skyrocket. A more sensible approach would be the approach taken in the original House crowdfunding bill: to allow the issuer and the intermediary to rely on the annual income and net worth reported by the investor, with no additional steps required to verify those numbers.[32]

6. Crowdfunding Intermediaries Should Be Able to Rely on Self-Certification by Investors of their Total Crowdfunding Investment

Crowdfunding intermediaries are required to "make such efforts as the Commission determines appropriate, by rule, to ensure" that investors do not exceed the individual investment limits.[33] The limits include all crowdfunding purchases "in the aggregate, from all issuers."[34] Thus, to enforce the limits, the crowdfunding intermediary must know not only how much the investor is investing in the current

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[30] *See, e.g.*, Thomas Lee Hazen, 1 TREATISE ON THE LAW OF SECURITIES REGULATION 490, 573 (6TH ED. 2009).
[31] Securities Act of 1933 §§ 4(6)(B),4A(a)(8), JOBS Act, Pub. L. 112-106, § 302(a),(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. §§ 77d(6)(B), 77d-1(a)(8)).
[32] *See* Entrepreneur Access to Capital Act , H.R. 2930, § 2(b), 112th Cong. (as passed by House, Nov. 3, 2011) (proposed section 4A(c) of the Securities Act).
[33] Securities Act of 1933 § 4A(a)(8), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(a)(8)).
[34] *Id.*

offering, but how much the investor has invested in all crowdfunded offerings in the last twelve months.

The intermediary's records will show how much each investor has purchased through the intermediary's web site, but investors might also have purchased in section 4(6) offerings through other intermediaries. The intermediary has no way of knowing how much the investor has invested through other channels. The only cost-effective way to make this determination is to ask the investor. Unless crowdfunding intermediaries have direct knowledge to the contrary, they should be able to rely, without further verification, on the total amount of crowdfunding investment reported by the investor.

7. The SEC Should Not Add to the Issuer's Disclosure Burden

The statute requires crowdfunding issuers to provide substantial disclosure, including financial statements, to the SEC and to investors.[35] The Act authorizes the SEC to add to the issuer's required disclosure any other information the SEC feels is necessary "for the protection of investors and in the public interest,"[36] and also allows the SEC to impose other requirements on the issuer "for the protection of investors and in the public interest."[37]

The SEC should use this authority sparingly, if at all. The mandatory disclosure requirements of the new crowdfunding exemption are already extensive—probably the most burdensome part of the exemption. Adding additional disclosure requirements will increase the cost of using the exemption with little marginal gain. If the cost of using the exemption increases, it is less likely to be a viable option for very small offerings.

8. The Annual Reporting by Issuers Should Be Relatively Brief and Should Cease after a Short Time

In addition to the disclosures required at the time of the offering, issuers must file annual reports with the SEC and provide those reports to investors.[38] The content of those annual reports is left to the SEC. The Act merely requires such "reports of the

[35] See Securities Act of 1933 § 4A(b)(1), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(b)(1)).
[36] Securities Act of 1933 § 4A(b)(1)(I), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(b)(1)(I)).
[37] Securities Act of 1933 § 4A(b)(5), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(b)(5)).
[38] Securities Act of 1933 § 4A(b)(4), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(b)(4)).

results of operations and financial statements of the issuers, as the Commission shall, by rule, determine appropriate."[39] The SEC is also authorized to create exceptions to the annual reporting requirement and to specify a date after which the reporting obligation terminates.[40]

These annual reports should be relatively short and simple, preferably a fill-in-the-blank, check-the-box form. They should not be anything like the Form 10-K annual reports required to be filed by public companies. If the SEC regulations try to make crowdfunding annual reports similar to the full-blown annual reports required of public companies under the Exchange Act, the crowdfunding exemption will simply not be used. The cost of the annual reporting requirement would be too high for the small business issuers attracted to crowdfunding.

Requiring crowdfunding issuers to file detailed annual reports would also be inconsistent with what Congress did in the rest of the JOBS Act. The JOBS Act made it easier for small business issuers to avoid Exchange Act reporting, increasing the threshold for Exchange Act reporting[41] and requiring the SEC to exclude section 4(6) purchasers from counting towards that threshold.[42] Requiring crowdfunding issuers to file the equivalent of Exchange Act annual reports would be inconsistent with the thrust of those changes.

Instead, the SEC should make the required annual report as simple to complete as possible. The Commission should not require annual financial statements, and certainly not audited financial statements, and it should only require a brief summary of the company's operations during the previous year. Moreover, the annual reporting requirement should terminate after a couple of years if the issuer has engaged in no further crowdfunding.

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[39] *Id.*
[40] *Id.*
[41] Prior to passage of the JOBS Act, Section 12(g)(1) of the Exchange Act, as modified by Rule 12g-1, required an issuer to register any class of equity security held of record by 500 or more shareholders if the issuer has total assets exceeding $10 million. *See* Securities Exchange Act of 1934 § 12(g)(1)(B), 15 U.S.C. § 78l(g)(1)(B) (2010), *amended by* JOBS Act, Pub. L. 112-106, §§ 303(a),501,601(a) 126 Stat. 306 (2012) (total assets exceeding $1 million and a class of equity security held of record by five hundred or more persons); Exchange Act Rule 12g-1, 17 C.F.R. § 240.12g-1 (2012) (increasing the total assets threshold to $10 million). The JOBS Act changed the record holder threshold to 2,000 persons or 500 persons who are not accredited investors. *See* JOBS Act, Pub. L. 112-106, § 501, 126 Stat. 306 (2012).
[42] Securities Exchange Act of 1934 § 12(g)(6), JOBS Act, Pub. L. 112-106, § 303(a), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 78l(g)(6)).

9. The Investor Education Requirements Should Be Designed to Educate Investors, Not to Limit Crowdfunding to Sophisticated Financiers

To participate in a section 4(6) offering, investors must review investor-education information, although the exact content of that information is left to the SEC.[43] Investors must also answer questions demonstrating an understanding of

- the risk of investments in startups and other small businesses;
- the risk of illiquidity; and
- any other matters the SEC deems appropriate.[44]

I believe that the purpose of these requirements is not to certify that the investor is sophisticated, but to give notice to investors of the risks involved in crowdfunded investments. The investor-education materials and the required questions should be designed by the SEC with that purpose in mind. The questions investors are required to answer should not be designed to test the investor's knowledge, but leading questions designed to inform the investor of the risks.

Clarity and brevity are also important; the required materials should be neither so complex nor so long that investors lose sight of the basic message. Investors should not have to pass through an informational minefield to invest in crowdfunding. The goal is not to drive away investors, but to educate them. Ideally, the required educational materials and questions should take no more than ten minutes to complete.

Finally, the regulations should make it clear that investors only have to meet these education requirements once. I see no value in having investors repeat this experience each time they wish to invest.

10. The "Risk Reduction" Steps Required by Crowdfunding Intermediaries Should Not be Unduly Burdensome

Crowdfunding intermediaries must "take such measures to reduce the risk of fraud" in section 4(6) transactions as the SEC shall establish by rule.[45] The Act specifically

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[43] A crowdfunding intermediary is required to ensure that each investor "reviews investor-education information, in accordance with standards established by the Commission." Securities Act of 1933 § 4A(a)(4)(A), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(a)(4)(A)).

[44] Securities Act of 1933 § 4A(a)(4)(C), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(a)(4)(C)).

requires that these steps must include background and securities enforcement regulatory history checks on the issuer's officers, directors, and persons holding more than 20 percent of the issuer's outstanding equity.[46]

I believe that intermediaries should not be required to conduct independent background checks, but should be able to rely on material supplied by third parties—particularly credit reporting agencies and the Financial Industry Regulatory Authority (FINRA). At most, intermediaries should be required to do an ordinary credit check on the persons listed and a FINRA regulatory check. Unless one of those reports raises a red flag, they should not have to do any further investigation. The cost of any independent investigation is likely to be passed on to issuers, and the cost would unnecessarily increase the cost of using the exemption.

11. The SEC Should Clarify the Restriction on Solicitation by Funding Portals

A funding portal is not allowed to "solicit purchases, sales, or offers to buy the securities offered or displayed on its web site or portal"[47] or to "compensate employees, agents, or other persons for such solicitation."[48] The SEC takes a very broad view of solicitation under the Securities Act,[49] and the exact bounds of what is or is not an offer to sell a security is unclear.

Read literally, the prohibition on solicitation could prevent funding portals from operating crowdfunding sites at all, since issuers' listings on crowdfunding sites are soliciting purchases and offers to buy the issuers' securities. Since the statute clearly allows funding portals to operate crowdfunding sites,[50] the listings themselves must not violate this prohibition. But what else would the prohibition on solicitation cover? Could a funding portal advertise its site? If so, would it be barred from mentioning particular offerings in those advertisements? Could it contact

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[45] Securities Act of 1933 § 4A(a)(5), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(a)(5)).
[46] *Id.*
[47] Securities Exchange Act of 1934 § 3(a)(80)(B), JOBS Act, Pub. L. 112-106, § 304(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 78c(a)(80)(B)).
[48] Securities Exchange Act of 1934 § 3(a)(80)(C), JOBS Act, Pub. L. 112-106, § 304(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 78c(a)(80)(C)).
[49] *See, e.g., Publication of Information Prior to or After the Effective Date of a Registration Statement*, Securities Act Release No. 3844, 1957 WL 3605 (Oct. 8, 1957). *See also* Thomas Lee Hazen, 1 TREATISE ON THE LAW OF SECURITIES REGULATION § 2.3[2] (6th ed. 2009).
[50] *See* Securities Act of 1933 § 4A(a)(1)(B), JOBS Act, Pub. L. 112-106, § 302(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 77d-1(a)(1)(B)).

prospective investors by e-mail and provide a link to the site? Could it do anything more than just provide that link? Even if such communications did not solicit people to buy *particular* securities, they would be soliciting people to purchase "the securities offered or displayed on its web site."

The SEC regulations should, to the extent possible, clarify exactly what crowdfunding intermediaries may and may not do without violating the prohibition on solicitation. A safe harbor listing activities that do not constitute solicitation for purposes of this restriction would be particularly helpful.

12. The SEC Should Make it Clear that Non-Broker Funding Portals Do Not Lose Their Status Because Some of the Transactions They Handle Fail to Qualify for the Crowdfunding Exemption

Non-brokers may operate section 4(6) crowdfunding sites, as long as they register as funding portals.[51] To be a funding portal, the entity must act as an intermediary in transactions "solely pursuant to section 4(6)."[52] This language should not be interpreted to disqualify a funding portal if a single transaction on its site does not meet all of the requirements of section 4(6) and therefore does not qualify for the exemption.

If a funding portal limits itself to offerings attempting to qualify for the section 4(6) exemption, it should retain its status as a non-broker funding portal even if some of those transactions ultimately fail to meet the requirements of the exemption. Funding portals cannot control the actions of issuers and investors using their sites. As long as the funding portal makes a good faith effort to insure that all transactions meet the requirements of section 4(6), it should not be penalized if some of them ultimately do not.

13. The SEC Should Adopt a Safe Harbor Protecting Funding Portals from Being Treated as Investment Advisers

Funding portals may not "offer investment advice or recommendations."[53] If they do, they not only risk losing their Exchange Act status, but they could also be

[51] Securities Exchange Act of 1934 § 3(h)(1), JOBS Act, Pub. L. 112-106, § 304(a), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 78c(h)(1)).
[52] Securities Exchange Act of 1934 § 3(a)(80), JOBS Act, Pub. L. 112-106, § 304(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 78c(a)(80)).
[53] Securities Exchange Act of 1934 § 3(a)(80)(A), JOBS Act, Pub. L. 112-106, § 304(b), 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 78c(a)(80)(A)).

investment advisers within the meaning of the Investment Advisers Act.[54] Unfortunately, the meaning of investment advice under the Advisers Act is murky at best,[55] and the provisions added by the JOBS Act do nothing to clarify that uncertainty. If, for example, a funding portal places a few offerings in a "featured offerings" section, would that constitute investment advice or a recommendation? What if it offered a search engine that allowed investors to identify offerings that met certain criteria?

Even funding portals that do not "offer investment advice or recommendations" could still be investment advisers for purposes of the Advisers Act. Under the Advisers Act, anyone who, "for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities" is also an investment adviser.[56] One who merely provides information about companies and investment opportunities can be an investment adviser under this part of the definition even if no formal recommendation is made.[57] The SEC staff has indicated in several no-action letters that providing investors with information of this type falls outside the definition of investment adviser only if certain conditions are met.[58]

The SEC regulations should provide detailed guidance to funding portals, preferably in the form of a safe harbor, about what they may do without violating these restrictions. Funding portals would know that, if they stayed within the bounds of the safe harbor, they would not violate the restriction on investment

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[54] *See* Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2010).
[55] *See* Bradford, *Crowdfunding and the Federal Securities Laws*, *supra* note 2, at 69-73, and authorities cited therein.
[56] Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. §
[57] *See* Abrahamson v. Fleschner, 568 F.2d 862, 870 (2D Cir. 1977) (general partner providing financial reports on the partnership's investments to limited partners); SEC v. Saltzman, 127 F.Supp.2d 660, 669 (E.D. Pa. 2000) (same). The general partners in both cases were also making investment decisions for the partnerships, but the courts apparently held that the reports alone were sufficient to make the partners investment advisers.
[58] The information provided must be readily available to the public in its raw state; the categories of information presented may not be highly selective; and the information may not be organized or presented in a manner that suggests the purchase, holding, or sale of any security. *See, e.g.*, Angel Capital Elec. Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996); Mo. Innovation Ctr., Inc., SEC No-Action Letter, 1995 WL 643949 (Oct. 17, 1995); Media Gen. Fin. Servs., Inc., SEC No-Action Letter, 1992 WL 198262 (July 20, 1992); Investex Inv. Exch. Inc., SEC No-Action Letter, 1990 WL 286331 (Apr. 9, 1990); Charles St. Sec., Inc., SEC No-Action Letter, 1987 WL 107616 (Jan. 28, 1987). *See generally* HOWARD M. FRIEDMAN, SECURITIES REGULATION IN CYBERSPACE 17-3 (3d ed. 2005); THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF INVESTMENT ADVISORS 7 (2011).

advice or become investment advisers subject to regulation under the Investment Advisers Act.

Conclusion

Whatever the SEC does to implement the crowdfunding exemption, I hope that Congress, and this subcommittee in particular, will revisit crowdfunding at some point in the future. I am concerned that the cost of the exemption's regulatory requirements, especially after those requirements are augmented by the SEC rules, may be excessive—that small businesses, especially very small startups, may find the crowdfunding exemption too expensive to use.

I hope I am wrong because I believe crowdfunding has extraordinary promise for small business capital formation, but experience will show how well the crowdfunding rules work. Congress can take advantage of that experience to hone the exemption, eliminating unnecessary, overly burdensome requirements and shoring up the exemption as needed to correct any problems.

Thank you for the opportunity to talk with you today. I would be happy to discuss these ideas further with any member of the Subcommittee or with any staff member.

Mr. MCHENRY. I certainly appreciate it, and we will now recognize Mr. Coffee.

STATEMENT OF JOHN C. COFFEE, JR.

Mr. COFFEE. Thank you, Chairman McHenry, Ranking Member Quigley, members of the subcommittee. My name is Jack Coffee and I have been working in the field of securities regulation and initial public offerings for over 40 years. Let me make three basic points all briefly.

First, I believe the greatest enemy of job creation today is not overregulation, but the loss of investor confidence. Today, American investors have lost confidence in the IPO marketplace. This is evidenced by the Facebook fiasco, the drying up of the IPO pipeline, and the low trading price of most of the recent social media initial public offerings, all of which are trading below their offering price. This erosion in confidence probably goes all the way back to the burst of the Internet bubble in 2001, and confidence has not been restored.

But more recently, there has been a new focus. Investors are again and again complaining about the prevalence of selective disclosure in IPOs, as issuers, underwriters and analysts seem to be tipping, as seems to have occurred in Facebook, projections and forecasts to preferred institutional investors. I think there are a number of problems with the IPO marketplace today, and I agree with many of the comments made by Oversight Committee Chairman Issa in his recent letter to the SEC, particularly his views that there should be greater attention given to the role of auctions in this process.

But in the oversight and overviewing the IPO process, I would point you particularly to the problem of selective disclosure. There is no efficiency in selective disclosure. This is an issue of fairness, and I think there are ways in which is JOBS Act actually compounds this problem, as I set forth in my written testimony.

Let me move now to my second point. The JOBS Act on virtually every page requires the SEC to adopt new rules to implement the JOBS Act, and it imposes fairly tight timetables. And the first of those deadlines expires on July 4th with respect to crowdfunding.

Under recent decisions of the D.C. Circuit Court of Appeals, these proposed rules that the SEC must adopt shortly are vulnerable to judicial second guessing. Either the D.C. Circuit might find some costs to be overstated, or it might find some benefit to be understated, or it might even say that the empirical studies done by others that the agency is relying upon are just not reliable. All this has happened repeatedly in recent decisions. As a result, the SEC stands at risk that its rules could be found to be arbitrary, capricious, as has happened on three or four recent occasions. As a result, virtually everyone affected by SEC rules today under the JOBS Act has an incentive to sue. If they are not happy, they are going to find an attorney and many are going to go to court. This will result in continuing uncertainty, confusion, and delay in the implementation process. Even if the SEC makes a superhuman effort, litigation is still predictable because someone who is not happy with the rule now has a fair option of going to court and suing.

Third point, which relates to the second, I reviewed the Commission's most recent policy statements, including the statement dated March 16, 2012, setting forth its "current guidelines on economic analysis and SEC rulemaking." I believe these new guidelines properly integrate economic analysis with the rulemaking process. They do require the Commission to consider economically reasonable alternatives to the rule being proposed, and they do require the careful matching of costs and benefits. Of course, I cannot tell you that the Commission will always follow these principles and rules that have not yet been proposed or formulated, but I can tell you that whatever the Commission does, whatever heroic effort it may make, there is still a real prospect that the D.C. Circuit could disagree and substitute its judgment for the Commission's judgment. If that happens, I cannot tell you that a Federal Court has a better judgment or greater expertise than the Securities and Exchange Commission. It is not more expert. It is not more sensitive to the market. Thus, I do not think we will come out with better rules through that process.

My bottom line here is that the SEC is today caught between the rock and the hard place. It has been asked to expedite rules and it is trying to do so, but it faces a somewhat unsympathetic bench that is quite skeptical of rulemaking in general. I could give you some specific examples and might like to do so if we have questions. For example, the SEC has to adopt rules both on the use of audited financial statements, on the use of follow-up periodic disclosure after an offering. This is true both under Section 3(b) and under the new crowdfunding exemption.

I think in all of those areas the Commission is doing what Congress has told them to do, but I think we are going to see a long battle because I predict that those unhappy with these rules are going to try to exercise the judicial option. Ultimately, the danger here is that we can be led back to the Lochner era of the 1930s, when courts could substitute their analysis and their preferences for those of the agency by saying that it interfered with freedom of contract. Today instead they will be saying it interferes with proper cost-benefit analysis. There is a danger that looms here, and I will stop at that point.

[Prepared statement of Mr. Coffee follows:]

Statement of Professor John C. Coffee, Jr.
Adolf A. Berle Professor of Law
Columbia University Law School

at

Hearings Before the Subcommittee on TARP, Financial Services and
Bailouts of Public and Private Companies
of the
Committee on Oversight and Governmental Reform

United States House of Representatives

"The JOBS Act in Action: Overseeing Effective
Implementation That Can Grow American Jobs"

June 26, 2012
Room 2154 of the Rayburn House Office Building
Washington, D.C.

Chairman McHenry, Ranking Member Quigley and Fellow Members of the Subcommittee:

I. Introduction

I thank you for inviting me, and I share the common concern that we need to spur job creation. Basically, I will make three points:

First, the greatest enemy of job creation today is not overregulation, but the loss of investor confidence. In particular, American investors have lost confidence in the initial public offering ("IPO") process and in the integrity of the mechanisms for capital raising. This is evidenced not only by the much discussed failure of the Facebook offering, but by the fact that the IPO pipeline has dried up over recent months and that the stock prices of the other companies in the "social media" industry that recently went public— i.e., Zynga, Groupon, Ren-Ren, and Zipcar[1] — are now trading well below their initial offering prices.

Second, virtually every page of the JOBS Act imposes obligations on the SEC to adopt rules implementing it. Yet, in light of recent decisions of the D.C. Circuit Court of Appeals, this is a task that is both time-consuming and fraught with peril, because the D.C. Circuit Court of Appeals has repeatedly indicated its willingness to substitute its judgment for that of the Commission as to whether the costs of an SEC rule exceed its claimed benefits. The D.C. Circuit has also indicated its readiness to invalidate SEC rules which are in its judgment not based on sufficient empirical data, and the level of data that is adequate is often more in the eye of the beholder than objectively clear.

[1] For a recent review of the price discounts on these offerings from the time of their IPOs, see Larry Doyle, "Social Media: You Know You're in a Bubble When . . .," Benzinga.com June 19, 2012.

Third, given that the risk of judicial invalidation is real, many have an incentive to sue to challenge SEC rules under the JOBS Act, as and when they are proposed. More than any other factor, this will create uncertainty and legal confusion for entrepreneurs, underwriters, promoters, and investors alike and will slow the implementation of the JOBS Act.

The timetable for the implementation of the JOBS Act has been determined in substantial part by the legislation itself. Congress gave the SEC just 90 days after enactment to issue rules relaxing restrictions on general solicitations and advertising for purpose of Rule 506 and Rule 144A (see Section 201 of Title II); that date expires on or about July 4, 2012. In contrast, the SEC has 270 days to issue rules relating to crowdfunding (Title III), and no deadline at all for rules relating to the new Regulation A (Title IV). Given Parkinson's Law that work expands to fill the time available for its completion, I will review the JOBS Act in terms of the approaching deadlines beginning with Title II.

I. IPOs and the JOBS Act

Let me begin, however, by returning to the context of IPOs. There are multiple explanations for the burst of the apparent bubble surrounding social media IPOs (IPO pricing is after all always uncertain), but the factor that has the greatest future relevance is the sense that retail investors now have that they are not receiving accurate information about IPOs and generally receive allocations in "hot" IPOs only when more sophisticated and better informed institutional investors spurn their full allocations. Please understand that I am not suggesting that anything unlawful happened in the Facebook offering or any other recent IPO. Actually, the problem is the reverse. What is eroding investor confidence begins from the fact that it is today basically permissible for issuers, underwriters, and their analysts to make selective disclosure of information, projections and forecasts in the IPO process, releasing information to favored investors, but withholding it from retail investors. This is because the key regulation prohibiting selective disclosure — Regulation FD[2] — has an express exemption for registered securities offerings "for capital formation purposes for the account of the issuer."[3] This is a loophole the size of Paris's Arc de Triomphe, and much information can and does pass through it. Indeed, the conventional roadshow is the structural embodiment of selective disclosure, as institutions attend roadshows to hear oral projections and estimates that are denied to retail investors (who cannot attend).

I believe that bipartisan concern exists today that some aspects of the IPO process have become dysfunctional.[4] My goal today is not to review IPO procedures, but to suggest that in implementing the JOBS Act, Congress and the SEC must exercise care not to compound this loss in investor confidence or exacerbate serious conflicts of interest. In some respects, because of the speed with which the JOBS Act was drafted and passed, this danger is real. For example, if we are concerned about selective disclosure, it is disquieting to realize that by raising the threshold for "reporting company" status from 500 to 2,000 shareholders of record, the JOBS Act will effectively make it possible for a much greater number of issuers (i.e., those with less than 2,000 shareholders of record) to

[2] See 17 C.F.R. § 243. 100 to 103.

[3] See 17 C.F.R. § 243. 100(b)(2)(iii). Also, under the definition of "issuer" in Rule 101 of Regulation FD, only "reporting" companies are subject to Regulation FD. See 17 C.F.R. § 101 (b). Thus, most IPO issuers will be exempt on this grounds as well.

[4] See Richard Blackden, "New Rules Needed for Public Floats, Says Congress Watchdog," The Daily Telegraph (London), June 22, 2012, Business at p. 5 (quoting Congressman Darrell Issa, Chair of the House Oversight Committee).

engage lawfully in selective disclosure (again, because non-reporting companies are exempt from Regulation FD). Although it may be justifiable to require less substantive financial disclosure from smaller issuers and to spare them from some of the costs of "reporting company" status, it is far less clear that Congress wanted to legitimize selective disclosure on the part of smaller (and even medium-sized) companies. That is an issue of fairness, not efficiency. In this light, in implementing the JOBS Act, the SEC should re-examine rules — such as Regulation FD — that work off of "reporting companies" status. Certainly, it would be possible for Regulation FD to use a lower than 2,000 shareholder of record threshold.

In other areas, however, the SEC's hands are tied, as some statutory provisions are triggered only by "reporting company" status. For example, the Williams Act (and particularly Section 13(d) thereof) protects companies against sudden raids or stealthy accumulations of their stock in "creeping" control acquisitions by requiring acquirers to disclose when they (or a group in which they are a member) accumulate more than 5% of any class of equity security of the issuer. But Section 13(d) applies only to "reporting companies." If smaller companies had the choice, I strongly suspect that they would have preferred to retain the protection of Section 13(d) against sudden and hidden stock accumulations. This is, I respectfully suggest, an example of the cost of haste and the likelihood of unintended consequences.

If investors are dissatisfied with the IPO process today, the role of the securities analyst has particularly disenchanted them. In their view, analysts quietly ferry information from the issuer to favored institutional investors. The JOBS Act may compound this lack of trust because it preempts most existing regulations affecting what securities analysts can do (and cannot do) in public offerings in the case of "emerging growth companies" (which category will include the vast majority of IPOs). Section 105(a) of the JOBS Act permits the publication and distribution of analyst research reports about "emerging growth companies," even during the quiet period before a registration statement is filed, and it deems such a report to constitute neither an offer to sell a security nor a statutory prospectus. As a practical matter, this means that underwriters in the future could start the marketing process by circulating an analyst's report instead of a "red herring" preliminary prospectus.

Security analysts are also permitted by Section 105 to engage in oral communications with accredited investors, which means that they can attend and make forecasts at road shows (at least so long as non-accredited investors are not present). Existing rules prohibiting analysts working for an underwriter from circulating research until 25 or 40 days after the offering are also preempted, and analysts are authorized to participate in the "bake-off" sessions at which issuers choose an underwriter (based in part on the level of analyst support for the offering that the underwriter can demonstrate). In short, in the future, analysts may play an even larger role in the marketing of public offerings (particularly IPOs), and their objectivity will come under greater question.

The SEC could respond by framing rules that require better broker-dealer supervision of research analysts in the their employ, but as later discussed these rules may be challenged in court.

III. Title II: <u>Access to Capital for Job Creators</u>.

Section 201 ("Modification of Exemption") of the JOBS Act instructs the SEC to (i) to revise its rules to eliminate "the prohibition against general solicitation or general advertising contained in" Rule 502(c) of Regulation D to the extent that it applied to offers and sales of securities to "accredited investors," and (ii) revise Rule 144A(d)(1) to provide that securities sold under that exemption "may be sold to persons other than qualified institutional buyers, including by means of general solicitation or advertising, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer."

In short, general solicitation and general advertising may be used, but the SEC is also authorized by Section 201(a)(1) to "require the issuer to take reasonable steps to verify that the purchasers of the securities are accredited investors." In this light, the principal issues for the SEC fall under the following headings:

1) If general solicitation is now permitted (as it is), should the SEC require that any additional specific disclosures be made to accredited investor when general solicitation or advertising is used. Today, Regulation D does not mandate any specific disclosures to accredited investors (but only to other investors). But arguably, the use of a general solicitation could justify the inclusion of some more specific warnings, caveats or disclosures in such a solicitation or advertising. Conceivably, some issuers or promoters may soon use television (including less-expensive cable channels), "blast" emails directed to many investors, and internet web sites. Arguably, special disclosures advising the investor about the generic risks of such an offering are more justifiable when the broker or promoter has no prior relationship with the investor. Indeed, in Title III of the JOBS Act, Congress

outlined in detail many of the disclosures that should be required when the promoter and the investor are strangers, and many of those disclosures might be appropriate here as well.

2) Section 201(a)(1) does expressly instruct the SEC to mandate by rule that "the issuer take reasonable steps to verify that purchasers are accredited investors, using such methods as determined by the Commission." What should the SEC do here? Should it require the issuer to receive some form of financial statement from the purchaser? Or should it be sufficient that the purchaser simply sign a written representation that he or she is an "accredited investor" (possibly with the criteria fully spelled out in the representation)?;

3) Should a seller under Rule 144A also be required to obtain similar documentation that its buyer is a QIB for purposes of that exemption? Although no corresponding language is set forth in Section 201(a)(2) to specify "the reasonable steps" necessary for the seller to take "to verify the buyer's status" as a "qualified institutional buyer" (or "QIB" in the parlance), Section 201(a)(2) does require that the seller "reasonably believe" that is purchaser is a "QIB." Arguably, what it is reasonable for the SEC to require under Section 201(a)(1) may also be necessary to support a reasonable belief in "QIB-hood" under Section 201(a)(2).

Beyond simplifying private placements, Section 201 also contains a sweeping exemption for persons who otherwise might be characterized as "brokers" or "dealers."

Specifically, Section 201(b) exempts both (i) persons who maintain "a platform or mechanism that permits the offer, sale, purchase or negotiation of or with respect to securities," and (ii) persons "associated with" them, from the definition of broker or dealer for purposes of Section 15(a)(1) of the Securities Exchange Act of 1934. The impact of this provision could be considerable, as it seems to permit persons having no prior professional relationship with the securities industry (and not members of FINRA) to maintain a web site on which securities are offered for sale or resale in private placements and follow-up secondary transactions. The principal conditions for this broker-dealer exemption are that (i) such person "receives no compensation in connection with the purchase or sale of such security," and (ii) such person "does not have possession of customer funds or securities in connection with the purchase or sale of such security." See Section 201(c) of the JOBS Act (adding a new Section 4(b)(2) to the Securities Act of 1933), Here, SEC rulemaking seems desirable to define what forms of compensation or consulting activities might disqualify a person from this exemption. For example, if a person who maintains such an above-described web site for private placements has received advisory fees from the issuer for general consulting with the past year, it is certainly arguable that such receipt should render such person ineligible for this exemption. But the rules need to be clear.

This broker-dealer exemption might also be used by the issuer, itself, provided that it did not hold customer funds or securities. This could result in a major change in current practice, and issuers might use a broker simply to hold the customer's securities and funds while they handled sales and resales on their own web site. The result is to place marketing activities beyond the scrutiny of FINRA (and also the SEC, except to the extent that antifraud rules were violated). Again, careful SEC rule-making seems justified.

Because SEC rules implementing Section 201 will presumably be proposed and adopted shortly, it is premature to comment on what the SEC has not yet done. Nonetheless, the biggest issues are those associated with the appearance of "non-brokers" who perform the traditional marketing roles of a broker in a private placement to accredited investors and others. Section 201(c) would appear to permit such an intermediary to maintain a "platform or mechanism" that also reached persons who were not accredited investors, if no general solicitation or advertising was conducted. In any event, these new "non-brokers" will not be subject to the rules or oversight of any self-regulatory organization (such as FINRA), so long as they do not hold customer funds or securities. The potential for fraud and abuse does loom here.

IV. Title III — <u>Crowdfunding</u>

Crowdfunding attracted disproportionate attention during the process leading up to the JOBS Act, and ultimately the exemption was significantly refined and improved late in the drafting of the JOBS Act (as the result of the considerable efforts of Senator Merkley of Oregon). In my judgment, new Section 4(6) of the Securities Act of 1933 will be much less used than Title II's liberalized private placement exemption and probably even less used than the JOBS Act's new Regulation A exemption. This is both because of Section 4(6)'s low $1 million annual aggregate ceiling and the detailed requirements discussed below. Still, this exemption will be used by a particular class of issuer: very small start-ups that lack any access to an underwriter or broker-dealer.

These issuers may also be unable (or unwilling) to afford legal counsel, and hence compliance with Title III's requirements may be spotty (or worse).

The first requirement under Section 302 of the JOBS Act is that the issuer not sell more than a specified amount or percentage of each investor's annual income or net worth. These levels are:

1) the "greater of $2,000 or 5 percent of the annual income or net worth" in the case of an investor with income or net worth less than $100,000;
2) 10% of the annual income or net worth (not to exceed $100,000) if the investor's annual income or net worth is equal to or greater than $100,000.

Obviously, the incentives here are for the issuer to induce the client to advise it that the client has annual income or a net worth of above $100,000 (and so can be sold at least $10,000). In response, the SEC could well follow its recent rules dealing with accredited investors and seek to exclude the value of the investor's principal residence from this net worth computation. This may elicit, however, a legal challenge.

Interestingly, Title III does not say that the issuer must only "reasonably believe" that the investor had the requisite annual income or net worth, and the SEC's rules must address the impact of a mistaken belief on the part of the issuer (which may or may not be a negligent belief). SEC rules need also to provide what documentation the issuer must receive and the degree to which it can rely on any broker's assurance as to income or net worth.

To satisfy new Section 4(6) of the Securities Act, the Crowdfunding issuer must conduct the transaction through an intermediary — either a broker or a "funding portal" that complies with the requirements of new Section 4A(a) of the Securities Act. Meanwhile the issuer, itself, must comply with new Section 4A(b) of the Securities Act.

"Funding portal" is a new form of intermediary, which is defined in Section 3(a)(80) of the Securities Exchange Act. The "funding portal" must register both with the SEC and any applicable self-regulatory organization (which might be FINRA or a new body). Whether the issuer uses a broker or a funding portal, either one must:

a) "provide such disclosures, including disclosures related to risks and other investor education materials: as the Commission may require by rule;
b) ensure that each investor "reviews investor education information," "positively affirms that the investor understands that the investor is risking the loss of the entire investment and that the investor could bear such a loss," and "answers questions demonstrating . . . an understanding of risk generally applicable to investments in startups, emerging businesses, and smaller issuers," "an understanding of the risk of illiquidity," and "an understanding of such other matters as the Commission determines appropriate by rule." (See Section 4A(a)(4)).

In addition to preparing these disclosures and monitoring investor review of them, the broker or funding portal must also "take such measures to reduce the risk of fraud, with respect to such transactions as established by the Commission by rule," including "obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding" 20% or more of the issuer's equity. Finally, the broker or funding portal is given responsibility under Section 4A(a)(8) of the Securities

Act to "make such efforts as the Commission determines appropriate by rule to ensure that no investor in a 12-month period has offered securities pursuant to Section 4(6) that in the aggregate, from all issuers, exceed the investment limits set forth in Section 4(6)(B)." This is a somewhat roundabout way of stating that an investor with an income of $101,000 may not buy $10,000 in one offering and $5,000 in another during the same 12-month period, because the ceiling (which would here be $10,100) applies to all offerings during that 12-month period in the aggregate. But the enforcement responsibility is placed on the broker or funding portal, and the penalty for noncompliance is not specified.

My point in reciting all these requirements is that each requires new SEC rules at each step, requiring the SEC to develop mandated disclosures and procedures. In addition, the JOBS Act asks the SEC to decide broadly "what else should be done." Many brokers may prefer to sidestep these new requirements by instead conducting a private placement, which places none of the foregoing obligations on it. Others, however, may seek to challenge any new SEC rules.

Under new Section 4A(b), the Crowdfunding issuer must also file certain information with the SEC, including (i) "a description of the business of the issuer and the anticipated business plan of the issuer," (ii) "a description of the financial condition of the issuer," including financial statements. In the case of a very small offering (under $100,000), the issuer must file both its income tax return for the last completed year and "financial statements of the issuer , which should be certified by the principal executive officer of the issuer to be true and complete in all material reports." For offerings in the $100,000 to $500,000 range, the financial statements must be "reviewed by a public accountant, who is independent of the issuer, using professional standards and procedures for such review or standards or procedures established by the Commission by rule for such purpose." In short, although, Section 4A(b) does not require audited financial statements, it stops only an ambiguous distance short of such a requirement, leaving it up to the Commission to specify how much less will be accepted. In the case of offerings over $500,000 (to $1 million), the financial statements must be audited, unless the Commission rules otherwise (by raising or lowering the level at which audited financial statements are required). Again, the SEC is instructed to make the judgment call.

Thus, the idea that an entrepreneur could simply post some Powerpoint slides on a web site and receive checks of up to $10,000 from individual investors did not survive the final revisions of the JOBS Act. Financial statements are required; the intended use of proceeds of the offering must be described; and the names of officers, directors, and 20% shareholders must be disclosed. This means that a would-be entrepreneur with a mere brainstorm (for example, one who wished to go to the market with the marketing pitch "I would like to form a company to make a better cellphone using the following idea") will not be enabled by Section 4(6) to do so. Much more must be done.

Other restrictions in Section 4A address conflicts of interest. The broker or funding portal must prohibit its directors, officers or partners "from having any financial interest in an issuer using its services." Similarly, the Crowdfunding issuer may not "compensate or commit to compensate, directly or indirectly, any person to promote its offerings through communication channels provided by a broker or funding portal without taking such steps as the Commission shall, by rule, require to ensure that such person clearly discloses the receipt, past or prospectus, of such compensation, upon each instance of such promotional communication."

In addition, there is a continuing disclosure obligation for an annual report to the SEC and to investors "of the results of operations and financial statements of the issuer," with the SEC being authorized to determine the contents of this report by rules (See Section 4A(b)(4)). Finally, the Commission is given authority to specify "such other requirements as the Commission may by rule prescribe for the protection of investors and in the public interest." (See Sections 4A(a)(12) and 4A(b)(5). This is open-ended, and again broad new requirements might be subjected to a cost/benefit-based judicial review.

If all this were not enough to persuade an entrepreneur to avoid Crowdfunding and instead use a private placement, Section 4A(c) authorizes the SEC to create a negligence-based cause of action largely paralleling Section 12(a)(2) of the Securities Act. This new cause of action places the burden on the issuer to show that it "did not know, and, in the exercise of reasonable care could not have known of such untruth or omission." This is in sharp contrast to the private placement context where the issuer can only be sued under Rule 10b-5, which requires the plaintiff to prove scienter. Although Section 4A "authorizes" the SEC to adopt this new standard, the SEC is not simply given discretion to frame such a litigation remedy, as Section 4A(c)(2) provides that "an issuer <u>shall be liable</u> in an action under paragraph (1), if the issuer . . ." (emphasis added). This is mandatory language.

The one comparative attraction of the "crowdfunding exemption" in Section 4(6) is that it does permit the general solicitation of retail investors. This may be important for would-be entrepreneurs who lack access to investment banking firms or others with lists of accredited investors. But, given the required disclosures (including the need for financial statements), the need for "funding portal" registration, the restrictions on compensation and ownership, and the "restricted security" status of securities issued under §4(6), all these factors seem likely to chill most issuers from relying on this exemption. To be sure, some may attempt to rely on this exemption without making more than a token effort actually to comply with its rules. That will present a likely new enforcement challenge for the SEC.

V. Title IV — Small Company Capital Formation

The third new issuer exemption adopted or liberalized by the JOBS Act is the expanded Regulation A exemption set forth in Section 401 of the JOBS Act. Section 401 increases the 12-month exemption for small offerings under Section 3(b) of the Securities Act from $5,000,000 to $50,000,000. As in the case of Section 4(6), these securities can be sold to retail investors based on a mandated disclosure document, but, unlike Section 4(6), the securities so issued are not "restricted' and may be resold by the investor immediately. Given this factor and the obvious contrast between the $50 million ceiling under Section 3(b) and the $1 million aggregate ceiling on Section 4(6) (plus the limitation in Section 4(6) on sales to individual investors to either 5% or 10% of their annual income or net worth), Section 3(b) seems likely to dominate Section 4(6) in terms of relative use.

The SEC is given discretion by Section 401 to make three decisions about the scope of Section 3(b): (1) whether to require a disclosure document containing audited financials (See Section 3(b)(2)(6)(i)); (2) whether to adopt disqualification provisions paralleling those in Section 526 of the Dodd-Frank Act (See Section 3(b)(2)(6)(ii)); and (3) whether to require that an issuer utilizing the §3(b) exemption to make subsequent periodic disclosures resembling those required of a reporting company.

It would be relatively surprising if (a) the SEC did not require a disclosure document with audited financials (at least for larger offerings), (b0 it did not specify similar disqualification rules, and (c0 it did not require some periodic disclosures. But the prospect exists that some will challenge these rules, claiming that the SEC did an inadequate cost/benefit study and seeking to rely on the D.C. Circuit's decision in the Business Roundtable case. This issue will be deferred momentarily, because it overlaps with other areas in which the Commission is given discretion by the JOBS Act.

VI. Title V — Private Company Flexibility and Growth.

In probably the most important provision in the JOBS Act, Section 501 amends the "reporting company" threshold under Section 12(g)(1)(A) of the Securities Exchange Act of 1934 so that companies are only covered if they have "a class of equity securities . . . held of record by either

i. 2,000 persons, or
ii. 500 persons who are not accredited investors (as such term is defined by the Commission) . . . "

The practical issues raised by this dual test is whether the issuer must engage in any factual investigation to ascertain whether it has more than 500 record shareholders who are not accredited investors. Moreover, how frequently must the issuer review this determination? Shares trade on a daily, and thus shares issued in a private placement to accredited investors could be resold to non-accredited investors. Indeed, under Rule 144, shares sold in a private placement could be resold to non-accredited investors after a one year holding period, even though the stock is not listed, at least if certain information is made publicly available by the issuer.

Issuers that want to avoid "reporting company" status may take a variety of measures to assure that the stock is not transferred to non-accredited investors. For example, restrictions might be placed on the shares' alienability (and prominently displayed on the share certificate to comply with state law rules); such restrictions would deny shareholders the ability to transfer to a non-accredited investor (and possibly require the issuer or its counsel to approve the transfer as a permissible one). Still, some SEC standards are necessary here, both in terms of what the issuer must do and how frequently it must check.

VII. Judicial Cost/Benefit Review and the Future of the JOBS Act.

In a series of decisions, the D.C. Circuit Court of Appeals has recently invalidated SEC rules on the grounds that the SEC failed to conduct as adequate cost/benefit analysis. In particular, it has ruled repeatedly that "the Commission has a unique obligation to consider the effect of a new rule upon 'efficiency, competition, and capital formation.'" See Business Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (citing Section 3(f) of the Securities Exchange Act, 15 U.S.C. § 78(c)(f)). See also Chamber of Commerce v. SEC, 412 F.3d 133, 143 (D.C. Cir. 2000); American Equity Investment Life Insurance Co. v. SEC 613 F.3d 166, 167-168 (D.C. Cir. 2010).

Potentially, an SEC proposed rule could be rejected by the D.C. Circuit either because the SEC failed to consider, or give adequate weight to, some possible costs of the proposed rule or because the SEC relied on inadequate empirical studies. As a result, any rule quickly adopted by the SEC is vulnerable. To be sure, the D.C. Circuit is unlikely to invalidate every SEC proposed rule, particularly pedestrian ones specifying what an issuer must disclose and when.

But let me give some possible examples of potentially vulnerable rules. First, in the case of the new Regulation A, the SEC is authorized to decide whether (i) the issuer must used audited financial statements (which are not required in most private placements or in the case of the traditional Regulation A exemption, which was limited to $5 million in any 12-month period). Second, the SEC is authorized to decide whether such a Regulation A issuer must make any subsequent disclosures to investors (regardless of whether it becomes a "reporting company" under the new 2,000 shareholder of record standard).

Let's suppose that the SEC decides to require audited financial statements in Reg. A offerings over $25 million and to require periodic disclosure to shareholders as well in the case of such $25 million or greater offerings. Let us suppose next that some unhappy entrepreneurs (or a national organization representing them) decide to sue to challenge these proposed rules. Arguments can be made on both sides of the question: for example, similar companies that instead conduct an IPO would not be required to make follow-up periodic disclosures if they had less than 2,000 shareholders of record. A plaintiff might thus question why it should be singled out because it instead used Regulation A.

Foreseeably, these lawsuits might drag on for a year or more, with the outcome being uncertain. Moreover, the SEC would be more likely to lose if it could not present empirical studies supporting its position, and such studies do not exist on every question (or they have been conducted by consulting firms in the employ of the objecting litigants). The bottom line is that legal uncertainty seems likely to persist in a variety of areas. Moreover, in my judgment, the SEC has been to a degree traumatized by its defeat in the Business Roundtable case. As a result, it may be moving more slowly and incrementally than in the past. Some may see this as desirable, but the cost is that the JOBS Act will be implemented slowly, and revisions may be necessary.

I have no panacea to offer for this problem. Although it would be possible legislatively to amend the Administrative Procedure Act or to take appeals of SEC proposed rules out of the hands of the D.C. Circuit (perhaps transferring them by lottery or random assignment to all Circuits), there is little likelihood of legislation being enacted along such lines in the near future. One lesson for the future is that Congress in enacting securities legislation probably should not simply authorize the SEC to act, but should mandate them to do so, unless the SEC reached specific findings that the mandated action would be harmful to investors or the public interest. This would take some of the burden of cost/benefit findings off the SEC's shoulders. But for the present judicial second-guessing of the SEC seems likely to persist. Ultimately, this means that the implementation of securities legislation is likely to be halting, slow, and punctuated by judicial reversals from time to time.

Conclusion

Both the revision in Title II (i.e., the general solicitation rules) and Title IV (the expanded Regulation A) are likely to increase small entrepreneurs' access to capital. The great danger is that excessive deregulation could cause investors to lose confidence in the offering process. The SEC has traditionally sought to maintain investor confidence through active regulation and enforcement. Today, however, the SEC is caught between the rock and the hard place, as the JOBS Act (much like the Dodd-Frank Act) asks it to promulgate rules quickly, while the D.C. Circuit stands ready to strike down precisely those rules that are quickly promulgated.

Mr. MCHENRY. Well, I thank the panel for their testimony, and your written testimony will be in the record. I will now recognize myself for 5 minutes.

Now, securities regulation, you know, we have a foundation of 1933 and 1934 for the essence of our securities regulations. That is still the foundation of what we deal with today. And at the time, we were, Congress was acting to deal with a challenge, which was the folks standing on the street corners hawking securities. Right? Times have changed. We now have the Internet. What we have found and what I have said multiple times before is that under the mentality of the SEC, the website eBay would not be able to exist. Because the SEC would not be there to root out folks that have lower net worth from purchasing products. Instead, we know that eBay sells, you know, billions of dollars on a yearly basis between people that don't know each other, two individuals of average means that don't know each other. But under the SEC mentality, that simply would not be able to take place without massive fraud. But then we have the SEC, and we have known the very large failures of the SEC to root out fraud among regulated entities that they oversee, and that is unfortunate. We don't want that. We don't want any fraud in this, in the crowdfunding space or in securities at all.

So there is a question of how we root this out. Mr. Hillel-Tuch, you mentioned that you believe that fraud could be, in essence, rooted out through the power of the crowd. Can you explain why you believe that?

Mr. HILLEL-TUCH. Yeah, absolutely, not a problem. Crowdfunding is very transparent. As I mentioned earlier, there is a lot of feedback from community participants. In essence, the crowd basically polices players. It keeps them honest. The beauty about crowdfunding is you have a centralized location, which is the portal, and it allows for communication by potential investors to analyze and share their views on offerings, and web-based structure also allows portals and regulations to provide risk disclosure and investor education.

We definitely expect portals and their operators to undertake a gatekeeping role in authenticating issue identity and require minimum standards. But what we have noticed, historically, both on our platform and others, is the crowd is extremely wise in assessing potential risk. On top of that, looking at 1930, for example, you didn't have the access to information you have now. I am able to go on to Google, for example, and research a company to see their track history, see their online presence as well as off-line. I am able to pull of a credit score. I am able to research individuals all from the comfort of my home. This is something that every investor is able to do now that simply did not exist before the computers and before the Internet. The access to information to an individual now is at a level that is unheard of. We are just not utilizing it for fraud prevention, which is very unfortunate.

Mr. MCHENRY. So fraud prevention. Professor Bradford, you mention in your writings, you mention also in your testimony today that imposing additional layers of mandatory disclosure on the issuer rather than the portal is not the best way to root out fraud. Can you flesh that out for us?

Mr. BRADFORD. Well, it is mostly because the entrepreneurs that are going to be using this, and these are relatively small offerings, relatively inexperienced entrepreneurs, simply can't bear the cost of that burden. If I'm making a $200,000 offering, it doesn't take much cost before I simply can't do it. Every dollar that is paid for regulatory cost, every dollar that is paid to the intermediaries is a dollar that I don't get to use for my business.

And therefore, it makes more sense to try and do it structurally through the entrepreneurs and protect fraud that way than imposing a whole bunch of complicated disclosure requirements that these people probably aren't going to fully understand in any event without having to hire securities counsel, which is another expense.

Mr. MCHENRY. So do the 50 States as it stands now have the ability to root out fraud?

Mr. BRADFORD. Well, the 50 States and the SEC. I mean, nobody was talking about taking away the antifraud rules. The States under the JOBS Act still have the ability to enforce their fraud restrictions. That's not preempted. The SEC has the existing antifraud rules plus an additional antifraud rule in the crowdfunding provisions. And that is the best way to attack fraud because that only imposes costs on the fraudsters. The problem with expensive mandatory disclosure requirements is you are imposing costing on everyone that wants to raise money, most of whom, at least I believe, are honest entrepreneurs and acting in good faith to raise money for their business, and everything that we impose on them in the name of fraud protection is going to be borne mostly by honest people.

Mr. MCHENRY. Well, thank you for your testimony. We expect a second round of questions. So I will now recognize Mr. Quigley for 5 minutes.

Mr. QUIGLEY. Well, the same two gentlemen, just for the sake of argument, you recognize a little bit of the difference of most of the transactions that take place on eBay. Most people know when they are buying a bike on eBay what a bike should be, right? But some of these investments, Mr. Hillel-Tuch, you acknowledged that there is a little more sophistication involved here, and I supported this act, but just for the sake of argument let's talk about how we implement it.

At least some sense of protecting those, because of the level of sophistication that is involved with this, and the concerns that are—that can take place with people who aren't as practiced. You acknowledge that. They are not as practiced at investing in the first place.

Mr. HILLEL-TUCH. That's actually a great position we can discuss. What is very critical what a portal provides over any other kind of real structure is standardization of a lot of the requirements and the education that absolutely is necessary to the different levels of sophistication. Granted, assuming an accredited investor is sophisticated is ludicrous in itself. That said, through a portal, what you are able to provide is, and we completely agree with Professor Bradford, it is critical to make it as seamless and low friction as possible, and cost is the decisive factor. The SEC can very easily make this cost prohibitive when that is completely unnecessary.

Fraud and investor education go very much hand in hand. One of the things we have noticed with crowdfunding right now is a lot of the net worth comes from individuals who are in your neighborhood. I mean, we have an example right now of a tea shop in Shelbyville, Kentucky, trying to raise funds. It did so last year. And they raised it from within their community. Their community knows that shop. The community raises funds together to help that shop succeed. And those are the kinds of businesses that are not venture backable right now, but they do have members in their community who believe in that business, want to support that business, and are right now not permitted to do so.

And the education level is different. They don't have the interest of getting a short-term return on their investment. They are looking at the long-term strategy.

Mr. QUIGLEY. Professor Bradford?

Mr. BRADFORD. I'm perfectly willing to concede that what is sold on eBay is different from securities, and that securities are without a doubt more sophisticated than most of the products that are sold on eBay. But I do think that what eBay has learned through their platform about preventing fraud, is useful to crowdfunding. For a fraudster, if I get money it's money. It doesn't matter whether I am pretending to sell people securities or whether I am pretending to sell them goods that I don't eventually deliver. And I think the experience with eBay shows a couple of things.

Number one, it shows that we can use an Internet platform to sell things. We can have fraud protection techniques in place to help prevent fraud. But having said that, I wouldn't, I'm not going so far as to say that securities crowdfunding ought to be unregulated. I think some of the things we have in the exemption, a limit on how much people can invest that you don't see when people are buying goods on eBay; some disclosure about what is going on, what the entrepreneur is going to do. Clearly, there ought to be more regulation of crowdfunding than there is of eBay. No dispute about that.

Mr. QUIGLEY. Mr. Cartwright, if you want to weigh in.

Mr. CARTWRIGHT. Yes, thank you. We are talking about fraud in small offerings. And I would like to start with the baseline of where we stand today because—and I feel very passionate about this. If you spend most of your career in a large law firm where you are too expensive to work with small offerings, you don't really see much of this. But when you go to work at the SEC, you discover that there is an alarming, shocking amount of low-level fraud. I call it security street fraud. It is guys who make up completely fraudulent press releases in pump and dump schemes that claim that the company has achieved a major contract with some Chinese company or a big technological breakthrough that has commercial advantage. Totally made up. I mean, this is hard core securities fraud, hard core wire fraud. This is hard core criminal behavior, or they exploit an affinity group, the members of their house of worship, or if they are of an ethnic background, recent immigrants who are trying to make their way in America and struggling. And there is way too much of it and it is disgusting. And they are doing that under the existing law. And they are using—sometimes most of them don't even care about the exemption from

Section 5. I mean, if you are willing to blow through the most fundamental fraud provisions in the criminal law, you are not worried about whether you have an exemption from the otherwise applicable provisions of Section 5 of the Securities Act.

But if they are, they are claiming 504, typically, Rule 504, typically erroneously. The way to address this, and it is a problem, because it is left to the SEC to address, and the SEC doesn't have the tools. And we talk about the SEC being the cop on Wall Street, but it is not a cop. That's hype. It has a civil jurisdiction. It can't do search warrants. It can't do wiretaps. It can't do stings, and most importantly, it can't go into Federal Court and bring a case that ends up with a conviction that puts people in jail. That's under the Department of Justice. But the U.S. Attorneys offices around the company who are responsible, they have got a lot on their plate, and this stuff is pretty small time.

At the SEC, the enforcement attorneys used to refer it to dismissively as little cases. They don't get much press. But small people who are innocent are harmed. I think the way to boot out fraud as it exists under existing law and under crowdfunding or any other change in the law is to direct resources in an efficient fashion to bring criminal cases against these people. Very frustrating for SEC enforcement lawyers. They know these guys shrug off a civil case from the SEC. It is a cost of doing business. It is a risk. They don't mind when they are taking the proceeds from an offering and spending it on sports cars and speed boats instead of what they claimed.

We need something like, and maybe there is other ways to do this, but something like a National Task Force in Justice. National, so it has the scope and scale to develop the expertise and the efficiency to root these people out. And the U.S. Attorneys offices around the country can refer those small cases for criminal prosecution. The SEC can refer those small cases. If we started putting these people in jail the way we should, they would pretty soon, there would be a lot less of them. I think that's what we ought to do.

Mr. McHenry. Thank you for your comments and to that point, we have retained State fraud prevention and prosecution within the law that currently exists for crowdfunding. That way you have, you know, your county prosecutors and State prosecutors that can actually go after these quote "small fraudsters," and I appreciate your explanation.

Mr. Cartwright. And State law, as you say, Mr. Chairman, State law enforcement is critical here, because they do, at least in some jurisdictions, they are prepared to handle matters that are somewhat smaller than the Federal authorities will. But I frankly, I think we still need more.

Mr. McHenry. Absolutely, thank you.

With that, we will now recognize the vice chairman of the committee, Mr. Guinta of New Hampshire, for 5 minutes.

Mr. Guinta. Thank you, Mr. Chairman. Thank you all for testifying today. I wanted to address my first remarks to Professor Coffee. Thank you for being here.

You had mentioned in your testimony the arbitrary and capricious findings by the courts. I'm assuming you are aware of the fact that the SEC recently instituted new and stronger cost-benefit analysis policy.

Mr. COFFEE. That is in the March 19th statement from the SEC.

Mr. MCHENRY. If you will put on your mic. Turn your mic on. Thank you.

Mr. COFFEE. Sure, I understand that and I was referring to their new guidelines as of March 19, 2012.

Mr. GUINTA. Well, I guess my—okay, I appreciate that. My question would be, just by the fact that there is going to be a greater effort now put into cost-benefit analysis, wouldn't that necessarily reduce the amount of risk of any arbitrary and capricious finding?

Mr. COFFEE. Well, I hope that we have a better understanding and we have a workable accommodation between the SEC, one of our best Federal agencies, and the D.C. Circuit Court of Appeals. Only time will tell. Because right now, the ease with which these prior findings were overturned creates a strong litigation incentive. Someone will always feel injured by a new SEC rule, and there is a strong incentive to sue. I hope there is an understanding that is quickly reached, though.

Mr. GUINTA. Would you say that the SEC in the past has put a lot of effort and energy into performing legitimate and serious economic analysis?

Mr. COFFEE. I think that I would agree with maybe your subtext and say sometimes it has been pro forma. I think, however, the burden cannot be overstated. If you look just at the crowdfunding provision in the JOBS Act, I count eight different sets of rules that Congress has directed the SEC to promulgate just under Section 4(a). So they have a burden and they have very short time limits. It is hard to do everything overnight.

Mr. GUINTA. Mr. Cartwright, can you comment on that? I happen to think that cost-benefit analysis should be performed. I think that the SEC can perform a valuable commodity here for just about everybody, but I wanted to hear your comment on it.

Mr. CARTWRIGHT. Well, the law requires it. The SEC is required to consider efficiency, competition, and capital formation in most of its rulemaking activities, and it's been required to do that for quite some time. I think too often in the past, and I hope this is changing, too often in the past it was an afterthought. Someone decided that there ought to be a rule, the Chairman, the Division Director or whatever. They get a rule writing team going writing it. They write the rule, and then at the end of the process, in the past at least, someone would say oh, my goodness. You know, there is that cost-benefit analysis, the efficiency competition and capital formation we have got to do that was kind of a compliance exercise. And it was done at the end. The SEC is a lawyer-dominated agency and the expertise that is really required here is more in the economics and the economist regime, and those people were typically often not consulted at all or, if they were, peremptorily.

So I frankly think that it is wonderful here in America that if you believe that an agency has exceeded its authority or acted arbitrarily or capriciously, you do have a chance to get into court and question the agency's exercise of its jurisdiction. That historically didn't happen at the SEC very often, but other agencies have had this experience. The EPA, almost every matter they do is litigated by one side or another, and you get better at it I think as an agency if you have to respond to these legal requirements.

I applaud the March statement. I think it's a very good statement. And I think that it's a huge step forward. The real question is whether this is going to be implemented in a way that gets the economists and people who are asking these questions in up front at the very beginning, so the design of the rule is shaped in part by these considerations that the law requires rather than creating a rule and then trying to justify it, basically a lawyer, do a brief at the end to try to justify what you have done in any event.

Mr. GUINTA. And quickly, on a different subject matter, can you quickly describe the changes to the 500 shareholder cap in the JOBS Act, and what benefits you would foresee?

Mr. CARTWRIGHT. Are you asking me?

Mr. GUINTA. Yes.

Mr. CARTWRIGHT. Yeah, sure. As the law exists today, prior to the JOBS Act, let's say, rather, prior to the JOBS Act, if a company had $10 million in assets, which is a very small amount for a company of any size, so almost always that test is satisfied, and 500 record holders, then it is required to basically become a company, a public company. It has to register with the SEC. And it is an unfortunate development that today many of the most successful entrepreneurs no longer want to have their companies go public.

When I started practice every entrepreneur, that was the holy grail. Let's see if we can go public and do it fast, and the sooner the better. Now, some of the most successful companies, the most successful business leaders try to keep their companies private as long as possible because the disadvantages and burdens of being public are too great. So the JOBS Act and the title in question increases the threshold to 2,000 holders, provided that no more than 500 are accredited—unaccredited.

Mr. GUINTA. So did you just say that you think people are keeping their companies private for a longer period of time because of the challenges of bringing it public, correct?

Mr. CARTWRIGHT. Well, it's the challenges of, in part, the challenges—there's two things. First——

Mr. GUINTA. I guess my question is, is it investor confidence or is it overregulation?

Mr. CARTWRIGHT. No, I think it is not a question of investor confidence. This is coming from the company side. It has two aspects to it. The first is, companies that, let's say 15 or 20 years ago were of a scale where a public offering was feasible and the burdens of being public were not so costly, those companies would go public. Today, there is a band of companies in size and scale that no longer can swallow the overhead costs of operating as a public company and maybe of becoming a public company. So they have to wait longer until they grow bigger in order to become public. But what's really surprising is that even when they have gotten big enough so they could meet the requirements, the most successful entrepreneurs today, and if you hang out in Silicon Valley lots and lots of people will tell you this, they want to keep their companies private as long as they can because they believe even once they are big enough to go public the burdens are greater than the benefits, and you can see that. Google, for example, some years ago, 2004, I think if I have got that right, they held on longer than they could have. They picked up an SEC enforcement action against themselves and their General Counsel for going too long. I think some of the recent IPOs, if you just look what happened you can see that they held out until the last possible moment, and that's one of the reasons why we have this—there is in the Economist, I don't know if you saw it. The Economist magazine, thought by many to be the preeminent financial weekly, had on its cover story a few weeks ago the vanishing public company. And it showed on the cover, the cover art was sort of a scruffy paleolithic band rushing the mastodons over the cliff. And they are—the mastodons were all Inc's. They are the public companies. So we got a problem here and it has completely reversed since the early years of my career.

Mr. GUINTA. Thank you, Mr. Chairman, for the additional time.

Mr. MCHENRY. Well, thank you so much. The questions have been very good, and we will start with a second round of questions. And I will recognize myself for 5 minutes.

For the whole panel, from your review of the crowdfunding provisions of the JOBS Act, do you all agree that SEC holds a great deal of discretion over the implementation of this section?

Mr. CARTWRIGHT. Start with me?

Mr. MCHENRY. Just say briefly.

Mr. CARTWRIGHT. Yeah. I will be brief. I understand I can sometimes not be so brief.

Mr. MCHENRY. No, thank you. Mr. Hillel-Tuch. We will come back. I promise.

Mr. CARTWRIGHT. Clearly true.

Mr. MCHENRY. Okay.

Mr. HILLEL-TUCH. Yes.

Mr. MCHENRY. Thanks.

Mr. HILLEL-TUCH. It's that simple. I mention in my testimony one example is audited financials. It is at their discretion to change it.

Mr. MCHENRY. Okay, Professor Bradford.

Mr. BRADFORD. Yes, although I believe that discretion goes more in the direction of adding additional regulation than it does in the direction of cutting some of the existing requirements.

Mr. COFFEE. You want an answer, and the answer would be yes. But it is largely because Congress has delegated in every provision of the JOBS Act rulemaking discretion to the SEC. The SEC can't duck this. They were told to consider rules.

Mr. MCHENRY. Right. So the legislation we passed, there were 400 votes that I authored here the House with the help of Carolyn Maloney, was a different construct. So does this discretion, Professor Bradford, place at risk the viability of crowdfunding to actually take place in the real world? Does that—you know, even if the SEC acts counter to the bipartisan support of this provision and the idea and even the President and the same party as the majority of the SEC Commissioners.

Mr. BRADFORD. Well, as I said, for these small offerings, cost is an extremely important consideration. The more regulation the SEC adds, the stronger that regulation, the greater the cost of, number one, understanding what the requirements are and, number two, complying with that regulation. And at some point if the statute itself hasn't already reached that point, we reach a point where the regulatory cost makes use of the crowdfunding exemption infeasible.

Mr. MCHENRY. So what are the areas of greatest concern for you, Professor Bradford, in how the law is actually written dealing with crowdfunding? What are the number one through—what are your top-level concerns, you know, number them and tell me the level of importance.

Mr. BRADFORD. Are you talking about in the way the law is written or the regulations the SEC has to add to it?

Mr. MCHENRY. Yes.

Mr. BRADFORD. Oh.

Mr. MCHENRY. And I'm giving you a rare opportunity. Oftentimes before these panels you don't get a chance to answer, but I'm giving you the rare opportunity to school Congress, so——

Mr. BRADFORD. My greatest concern is in the disclosure requirements imposed on issuers, particularly some of the accounting disclosure, audited financial statements for companies raising a relatively small amount of money, and even for really small offerings, financial statements required of all issuers, even, for say, a $10,000 offering.

That, and then there are some disclosure provisions in the statute that are relatively difficult to understand. For example, issuers have to describe the risk to investors associated with possible future deals that the company might do. I'm not using the exact language, and so that requires these relatively unsophisticated entrepreneurs to think about future buyouts, mergers, IPOs, whatever, to predict what the effect of that could be on these crowdfunding investors, and try to disclose it subject to a liability provision that makes them liable if they are negligent in doing so, in failing to disclose properly.

And so that portion of the crowdfunding act is probably my primary concern. I guess my secondary concern is a general one that I sort of mentioned in my opening statement, and that is just the lack of clarity, the complexity, the need for entrepreneurs and intermediaries to understand various provisions in the act. For example, I mentioned in my written statement, the prohibition on solicitation. Solicitation as interpreted by the SEC is a very broad concept, and people like Mr. Hillel-Tuch—did I get that right?

Mr. HILLEL-TUCH. Yes.

Mr. BRADFORD. —need to know exactly what they may or may not do in terms of advertising their site.

Mr. MCHENRY. So the concern I had with the Senate provision from the get-go was as simple as the origin of Congress' action—and I can say the origin of Congress' action because I filed the first bill. And the reason why I filed the first bill was because of PBR. Right? And many of you have heard this story, but you had an advertising guy who put up, he tweeted, said, "Let's buy a beer company." Pabst Blue Ribbon was putting themselves up for sale or they were going to close. And it was this sort of idea on a whim until he had Federal agents visit him. Right? And he realized he was—he was then told that he was breaking Federal securities law because he tweeted that he wanted to buy a beer company—well, later he put up a Web site.

So, you know, the idea of crowds buying their favorite beer company. I don't think these individuals were pledging money because they thought they were going to make a million off of it. They wanted to support the brand that they liked.

So this is what I see on crowdfunding sites as they exist now, is you have an idea that you like. Could be your local coffee shop, could be your favorite cupcake. And you invest in it because you believe in the product, not because you are going to make a million. It is the same reason why a lady I know, her father was a fan of the Boston Celtics. He invested in the Boston Celtics so he could say he owned a piece of the team. He is an Irish immigrant, of course. He loved that. Right?

So it is not—it is a slightly different idea and motivation to this point. And so the disclosure piece is important whether or not the expense of that is too great to bear for small issuances.

Mr. Hillel-Tuch, you talk about your current platform that you have, and that is, on the charitable side, you can preorder a product, you can get a T-shirt, you can do a number of things. What are your offerings? What is the smallest offering you have had on your site, roughly?

Mr. HILLEL-TUCH. We have had offerings as small as $500, but——

Mr. MCHENRY. And how large? What was your biggest?

Mr. HILLEL-TUCH. They go over $100,000. It really depends on your community.

Mr. MCHENRY. Okay. So in that range from $500, which—getting financials on that would make it a little unworthwhile, right?

Mr. HILLEL-TUCH. "Ludicrous" is a mild way of putting it. You know, you are asking, for example, in an offering for a new company to put up historicals on a timeline of zero. It just doesn't make sense.

I mean, it is an education issue. I think what happened is—and I read your original bill, and I have seen all the changes. A lot of the changes that happened were due to educational issues, where we are trying to approach this from an old-world perspective while—you are spot-on in your statement, is not everybody's looking for the million-dollar return. It is just not what this is about.

We are really democratizing access to capital in a way that didn't exist before. And that is allowing your cupcake store, your T-shirt shop to get financing that is not debt. They don't have to run a credit card debt. They don't have to run a mortgage, which we saw—we saw what happened with that a few years ago. And this is completely different. You are getting support from a whole other side of your community that wants to invest in you and is simply not allowed to do so right now.

Mr. MCHENRY. Well, Mr. Cartwright, to that end, this cost of going public, at what point under current regulations does it just—under what point of money that you have to raise going public does it simply make it not possible to go public, is it not economical to go public? Is that——

Mr. CARTWRIGHT. That is an investment banking question, and I am not sure——

Mr. McHENRY. I know, but, you know, you are a good lawyer, you are willing to venture off into areas you don't know—no, I am kidding, kidding.

Mr. CARTWRIGHT. I would say almost a hundred million, and these days it is probably larger than that. And what is sad is, so often, companies that might meet that threshold cannot—don't want to go public even then.

Mr. McHENRY. Okay. So you are talking about a much higher threshold?

Mr. CARTWRIGHT. A vastly higher threshold.

Mr. McHENRY. Different world.

Mr. CARTWRIGHT. A different world. A different world.

Mr. McHENRY. So the idea of having light-touch regulation on the intermediary and regulate this security in a very different way, is that something that could be done, that we could do in a—speaking from your former hat as an SEC——

Mr. CARTWRIGHT. Yeah, I think the original idea behind crowdfunding was to have a quite different mode available, now that the Internet, among other things, makes communication so easy, to raise quite modest sums for entrepreneurial purposes. And what has happened is we have overlain on that original idea the model of a big offer. So you need lawyers and accountants and financial intermediaries, and they all need compliance infrastructures, and you need financials that are in accordance with—I mean, all these additional requirements, which are the model of a big-dollar offering, but it doesn't work if you are raising $40,000 for a company that is going to make cases for iPads.

Mr. McHENRY. Uh-huh. Well, thank you for your testimony.

I will now recognize the ranking member, Mr. Quigley.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Mr. Chairman, as to your earlier point about Pabst Blue Ribbon, I want you to know we are in total agreement about purchasing beer. I have served here 3 years now. The longer I serve, the more I support purchasing beer.

In a letter to the SEC on May 24th of this year, Professor Coffee, the Consumer Federation of America, Consumer Action, and several others wrote the following, and I quote, "We are concerned that the SEC's slow pace on Dodd-Frank, while investing resources in other lower-priority initiatives and testifying to its prompt efforts to implement the JOBS Act, creates at least the appearance of bowing to political expediency. We believe that leapfrogging rulemakings whose deadlines are months away ahead of rulemakings whose deadlines are months passed and, in some cases, cherry-picking which congressional mandates the Commission will even choose to follow violates both the spirit and the letter of the law and is inconsistent with the SEC's duty to protect investors and facilitate capital formation."

Obviously, the question gets to how important it is for Dodd-Frank to be implemented. But in your view, as well, is there any reason that the implementation of JOBS should be prioritized over the implementation of Dodd-Frank?

Mr. COFFEE. I am not sure I would call it a priority because Dodd-Frank was passed in 2010, and it was 2 years ahead of the line.

What I would tell you in the simplest terms is that the biggest problems in our financial economy are the problems associated with systemic risk. We have not yet solved those problems—issues like the Volcker Rule and how you can keep banks that are too big to fail from taking on risk that could cause them to fail; or the problems with the money market funds, where there could be a bank run on money market funds. Those are huge, difficult problems. They affect not only investors, they affect everyone in the United States, because a major failure will push us back into a depression.

Therefore, I would say the problems associated with systemic risk deserve a priority. I do agree, however, the problems with small issue offerings, access to capital for smaller companies, are quite important and they should be pursued.

Mr. QUIGLEY. You see no reason to leapfrog one set of priorities over the other, in terms of time?

Mr. COFFEE. I think one is enormously important: systemic risk. All of the future of our economy depends upon being able to solve in a credible fashion the problems of major bank failure. And we all are under the shadow of what could happen in Europe within a matter of weeks.

Mr. QUIGLEY. Thank you, Mr. Chairman. I yield back.

Mr. MCHENRY. I certainly appreciate it. I have a few final cleanup questions if the panel doesn't mind and if the ranking member doesn't mind.

Professor Coffee, to your comment, I am grateful for you saying this, that the SEC prioritized their rulemaking. For instance, they spent enormous resources trying to write a rule on conflict minerals that was in Dodd-Frank. That certainly isn't systemically important, especially in light of the whole world we are going through. Your point is exactly right, and I do appreciate that.

Now, we also have the general solicitation—the change and relief of the ban on general solicitation contained in the JOBS Act. And they had to write very, you know, very basic rules, I would foresee, seeing as it is a lifting of something. It is supposed to be done by July 4th.

Now, what do you foresee as the consequences of them not doing this by the timeline?

Mr. Coffee? Mr. Cartwright? This is your stock in trade. We will start with you, Mr. Coffee.

Mr. COFFEE. The simplest rules are those associated with private placements.

What I would tell you, which I think I have to tell you to add a little reality to this discussion, is that if any entrepreneur advised by any of the great majority of securities lawyers were to consider what is the most feasible option today to raise capital for a small business, they would basically choose between the new liberalized private placement and the new expanded 3(b) small-issue exemption. They are much more attractive and more feasible than a still novel and still very esoteric crowdfunding exemption. And you usually issue——

Mr. MCHENRY. Well, crowdfunding is still not allowed because we are still waiting for the SEC to write regs by the end of the year, so——

Mr. COFFEE. Even if they write those regs, they have to address so many different things, that it is simpler using the very time-honored, established clear path through private placements with a general solicitation. I think that will be very feasible. I testified in favor of it in December. I still think it will work. And I think those are easy to write.

Mr. MCHENRY. To take that to the next step, is it because you think that crowdfunding, as was written into law, is too cumbersome, too complicated, too complex?

Mr. COFFEE. Remember that the ceiling is low. The amount you can sell any investor is $10,000, if they are fairly wealthy. They are restricted securities, and they come with a negligence-based liability regime. An issuer hears that and says, the alternative is a private placement to accredited investors who are numerous, and to sue me you have to prove intent to defraud. I would think most issuers would say, regardless of the SEC rules, I want that way which I can't get sued and I can sell unlimited amounts.

Mr. MCHENRY. Well, you have made Professor Bradford's point on the liability provision within crowdfunding.

Mr. COFFEE. —Congress is not the SEC.

Mr. MCHENRY. Oh, no. I know. I know. And it is my colleagues, my good friends on the other side of this institution that put in imperfect language that, if you read it, you realize that they did not reconcile their differences between paragraphs. Ah, the wisdom of the great debating society of the Senate. No offense. This is not a partisan matter, because we can agree the Senate is the true enemy. No division between parties there.

Mr. QUIGLEY. A cul-de-sac, not an enemy.

Mr. MCHENRY. Ah, that is a better point. Absolutely.

So, to your point, that provision, that liability provision, is higher than what you would have in private placement?

Mr. COFFEE. Yes.

Mr. MCHENRY. Okay. Yes.

Mr. COFFEE. It just affects the choice that an issuer will make.

Mr. MCHENRY. Okay. Well, this is fantastic. You know, we have a bipartisan—you know, a whole variety of views on this panel, but there is consensus here.

Mr. COFFEE. I would add, too, I agree with my colleague on one other thing stated slightly differently. There is a rule known as Rule 508 in Regulation D, the Private Placement Rule. It is known to most lawyers as the innocent and immaterial exemption. And it says, even if you screw up under private placement, if your mistake is innocent, immaterial, and it is not intentional, the offering, at least to those people, or at least to most people, will still be good.

I think that rule could be generalized for both 3(b) and crowdfunding, as well. And right now it is totally ambiguous what these standards will be.

Mr. MCHENRY. Okay. Wow. Thank you. That is amazing.

Mr. Cartwright, the ban on general solicitation, this removal—the SEC is supposed to write regs by July 4th. If they fail to do that, what are the consequences to the marketplace?

Mr. CARTWRIGHT. And I will just, you know, second much of what was just said.

And with respect to general solicitation, as has been said, those rules should be relatively easy to write, so we shouldn't have to wait too long for them, I don't think. And if they are not written, then the existing regime will continue, which is an impediment, makes it harder to raise sufficient funds to reach enough investors. Lots of offerings are completed nonetheless, but presumably at the margins. It is slowing down capital formation, and at this time in our economic history, we could use more.

So I think the SEC ought to be urged to promulgate those forthwith.

Mr. MCHENRY. Mr. Hillel-Tuch, you mentioned that you desire to become a crowdfunding portal for equities. So this provision that the JOBS Act opens up, you desire and your firm desires to do that, to become a portal.

So, as the law is currently written, how can you compete against broker-dealers, given the disadvantages the law imposes on portals? Is that a distinct challenge?

Mr. HILLEL-TUCH. The way the JOBS Act is written right now, we are still at a place where, if the SEC is given the education, awareness, and the proper nudging, it could fall out in a way that we can actually become an equity-based platform.

That said, there is a risk that if they make it too tight, they add additional requirements, we will not do it. And the reason is we don't think it will serve the issuer or the investor properly.

When it comes to, you know, making this actually happen and what is their motivation to do so, we believe that you need to be able to offer both perks and equity and makes sense for different individuals.

One of the things that we haven't really addressed here and I was hoping to bring up is the concept surrounding job creation. And what we are actually trying to accomplish here is allowing small businesses, who are one of the largest job creators out there, to actually access capital in a way that is easier than what a broker-dealer can do.

By making it basically transparent and providing clear communication, which is our intent—and we hope the SEC is going to let us do so—is very empowering to individuals right now who are dependent on very costly access forms of capital. Broker-dealers are not the world's cheapest people out there. And if they are licensed, they can charge up-front fees, they can charge back-end fees. And for a small business, the ones who actually create some of the largest job-growth numbers out there, they are looking for $30,000, $50,000 sometimes, maybe $100,000, maybe $200,000.

A broker-dealer is an extremely expensive way to access capital. And you are putting your faith in another person's hands to guide you throughout that process, and you are not able to get support from your community.

Mr. MCHENRY. So, under section 304, that undermines a portal's ability to truly act as an intermediary between the issuers and investors. And, specifically, the Commission prevents portals from offering investment advice and recommendations, soliciting sales and offers, and holding, managing, or possessing investor's funds or securities.

And, additionally, the Commission—or, well, National Securities Association, presumably—we presume FINRA, may exercise very broad discretion over portals. That seems to me to be disproportionately affecting portals to the benefit of, well, the existing regime or broker-dealers. Is that how you see it?

Mr. HILLEL-TUCH. In part, we do. And what we did in order to try to combat that—and a lot of that is education. We produced a white paper, ourselves, back in May. And the SEC and FINRA both have a copy of it, and we met with both groups, as well, to discuss it to some extent.

This—the requirements out there and, you know, offer investment advice and recommendations and things of that nature—is way more strict than some of the Reg D things out there. The level of oversight that they are providing here is sometimes excessive, sometimes right; you do have to find a right balance. We are probably leaning more toward the stricter end than the end that might allow looseness.

Mr. MCHENRY. Stricter or more costly?

Mr. HILLEL-TUCH. They go hand-in-hand. And it is an issue where—going back to what is the easiest way to access capital, I don't want it to be private placement, because while that is the traditional form of access, it is expensive, and we have to recognize that fact. That should not be your cheapest option when there are other means to do so.

Mr. MCHENRY. Okay.

So, Mr. Coffee, how would you fix the provisions within the crowdfunding title of the JOBS Act so that it could work, it could function, and do so in a costly manner with as minimal amount of fraud as possible?

Mr. COFFEE. I do not think the Senate bill is nearly as bad as everyone else seems to think. I have to say the Senate has——

Mr. MCHENRY. Well, we are starting with you.

Mr. COFFEE. Okay. But I would say what I was trying to say earlier. Right now, if you were to make one sale to an unqualified person because they didn't get the right disclosure, they didn't get the right investor education materials that Congress has mandated, or they didn't answer questions that proved they understood them, there would be an issue of whether the whole offering was bad.

I think what you need is this "innocent and immaterial" exemption, which is what we have under private placements. And I think it might as well be applied to 3(b), as well, so that mistakes that do not have any suggestion that they were intentional and were not widespread should not cost the offering.

Mr. MCHENRY. Must that be done—must that be done legislatively?

Mr. COFFEE. No.

Mr. MCHENRY. Or can the Commission act——

Mr. COFFEE. 508 is not based on legislation of Regulation D. The SEC can do in one context what it has done in others.

Mr. MCHENRY. Well, we are hopeful that the SEC is either watching this—and if so, hello——

Mr. COFFEE. I will get angry emails if they are.

Mr. MCHENRY. —and if not, we would hope they would read the transcripts. And if not, we have Chairman Schapiro in on Thursday morning, and I will read her the transcript. It should be for a very entertaining and maybe lengthy hearing.

Mr. Cartwright, same question. How would you improve this crowdfunding section of the JOBS Act so that this offering, these low-dollar offerings, can actually occur in an affordable fashion.

Mr. CARTWRIGHT. Well, I think the simplest way to say that in very general terms is to move it back in the direction of the bill that came out of the House.

What we have done is overlaid the model for big offerings with lots of intermediaries and gatekeepers, who are very expensive, on an original idea that was not designed for small-dollar offerings by entrepreneurs for small-scale businesses with a very different model. And they really are incompatible.

So there are probably lots of places where you could move things back in the direction of the original idea that would be helpful. And you probably need to do a number of those before you get to the point where there has been enough change to make this approach viable.

I think that, as it is currently written, it may well have been strangled in its crib, just because there has been so much added to it, that it will be, at least for the lower end of the range, the $100,000, $200,000 end of the range, the costs will be prohibitive.

And I suggested in my written testimony that when the SEC does do rulemaking, it ought to carefully evaluate what those costs will be. And if in the SEC's judgment after rigorous cost analysis it turns out that all of that layering is going to consume the proceeds and more, then the SEC ought to say that in their release so that Congress can then be aware and take whatever action Congress feels is appropriate under that circumstance.

Mr. MCHENRY. Mr. Hillel-Tuch, the same question.

Mr. HILLEL-TUCH. I saw the original bill, and, personally, naturally, I favored that one a lot. Of course, I understand that intervention was necessary in order to get it passed, and it did so with bipartisan support. It is a tough one for us, because we come from experience, having done this for several years already, and we understand how people behave and what the cost structures are.

Going back to the example mentioned to you before, that $500 raise came at a cost to that individual of only $20. That is not expensive. It just simply isn't. We do a lot now already on the back end that you don't even get with Carnes' Reg D exemption work. I am able to check an individual with OFAC, for example. That is simply not done otherwise. I am able to track funds and how they are moved, how they are handled, how they are spent, whether there is fulfillment, what is the performance. The oversight I am able to perform with a Web-based platform is so much more significant than the paper-based trail from the 1930s which we are still using. It is mind-boggling to me that we are not adopting the modern perspectives.

And, naturally, if the SEC is listening, I would love to explain to them how crowdfunding works. We have tried it in the past, and we have had some opportunities. But one of the issues right now is there is a big difference in education. When people don't grasp something, they tend to move back to the older roots of understanding. And laying the investment banking fold over this thing is not going to work. We are in a different era right now, and we need to be able to strive for it and drive innovation.

When other countries are already effectively implementing equity crowdfunding, we are one of the last developed nations out there not doing so. And, you know, that, for me, is personally very troubling, considering we have a huge opportunity here and entrepreneurship really was born in this country.

Mr. MCHENRY. Professor Bradford, same question, final word.

Mr. BRADFORD. It is hard to answer that question quickly because I have written a 60-page article basically talking about the problems with the act and what I would change.

Mr. MCHENRY. Yeah. I have it right here.

Mr. BRADFORD. I assumed you did.

Mr. MCHENRY. And for those of you who are watching or listening to this, Professor Bradford has, in essence, written the bible on crowdfunding, something that my whole staff has read and I have read as well.

But, for the record, if you could outline those items.

Mr. BRADFORD. Absolutely.

If I could boil it down to two things, number one, something we really haven't talked about a lot here today, the first thing I would do is clear up the ambiguities and the drafting errors in the bill. There are a lot of problems. There are a lot of things that are unclear in exactly what the meanings of the language is. There are inconsistencies that need to be cleaned up even if we don't change any of the regulation.

And then, second, to echo what many people have said today, I would just generally reduce the regulatory burden, particularly for the—if I had to limit it, I would say particularly for the smaller offerings. The burden is—the exemption is simply too expensive.

Mr. MCHENRY. So the ambiguity you are mentioning, one of which, as I recall, is the distinction between how much you make and how much you are worth, your net worth versus your income. In the drafting, it doesn't distinguish between either, nor does it give any indication which one should be the one you look to if somebody's net worth is under the amount that they make or their net worth is over the amount that they make.

Mr. BRADFORD. Yeah, the exemption creates three categories of individual investment limits. And the middle category, where somebody's annual income or net worth is over $100,000 and the other of those two figures is below $100,000, both limits apply to that middle category. I mean, obviously you can't have two limits applying to one investor.

And then there is also, for higher-end investors, it is unclear whether it is the greater of 10 percent of their annual income and net worth or the lesser of those two numbers.

Mr. MCHENRY. Interesting. Well, you know, the ambiguities need to be resolved, obviously. There is some consensus in terms of what is material as opposed to incidental errors or omissions in this offering. And I think we have had a very informative panel today.

Mr. Quigley, do you have any final——

Mr. QUIGLEY. No. Thank you.

Mr. MCHENRY. Okay. Thank you.

And I want to thank the panel. I thank you for the opportunity to ask questions of you. You have been very generous with your time and very instructive in terms of your words and your explanation. I thank you. We hope that this furthers the cause of helping small businesses, especially, get the capital they need to grow or to survive. And we certainly appreciate your willingness to engage in this exchange. Thank you for your time.

This hearing is now adjourned.

[Whereupon, at 3:30 p.m., the subcommittee was adjourned.]

Patrick McHenry Opening Statement

OGR Subcommittee on TARP: "The JOBS Act in Action: Overseeing Effective Implementation that Can Grow Jobs"

Tuesday, June 26, 2012

Approximately three years into our economic recovery, America's labor and capital markets continue to face unprecedented challenges. The U.S. unemployment rate has now been above eight percent for 40 consecutive months and nearly 24 million Americans are either out of work or under-employed, despite various government-driven initiatives.

To make matters worse, outdated and even oftentimes new government regulations continue to limit the ability of small businesses to access capital, which is the lifeblood of our economy.

Repairing and strengthening our markets will not occur overnight, nor will it be accomplished by more government regulation. In an effort to address these challenges, the focus of today's Oversight hearing is on a bipartisan bill signed into law this past April meant to promote capital formation for small businesses by relaxing various securities laws.

Titled "The Jumpstart Our Business Startups Act," it's commonly referred to as the JOBS Act. Let me first say that the JOBS Act is a significant victory for capital formation and entrepreneurship here in the United States.

I'm particularly proud that the efforts by this committee, initiated by Chairman Darrell Issa, back in March of 2011, his letter to the Securities Exchange Commission chairwoman, Mary Shapiro, helped develop the JOBS Act and monitor -- and modernize our securities laws.

For instance, elimination on the ban on general solicitation, a rule that has been in place since the Securities Act of 1933, will improve the ability of small, private businesses to communicate with investors and raise capital.

Increasing the private shareholder cap from 500 to 2,000 that a company may have before registering with the SEC has been welcomed as a logical adjustment.

It simply reduces the number of instances a company is forced to endure a complicated SEC filing process merely because it attracted too many accredited or institutional investors.

Now Title III of the JOBS Act, based off legislation that I authored, creates a new federal securities exemption to permit equity- based crowdfunding.

After introducing the first crowdfunding bill in Congress, I reached out to my colleagues on the other side of the aisle to build a bipartisan coalition so that we could actually enact this bill to address these concerns of the interested parties.

Specifically, I want to commend Congresswoman Carolyn Maloney, who serves on this subcommittee as well as Oversight and Government Reform Committee at large and also serves with me on the Financial Services Committee.

Now, Carolyn and I do not often see eye-to-eye on matters of public policy but in this instance we collaborated and worked together to take the legislation I introduced to improve it.

Now, Carolyn had a number of concerns about frauds and a number of investor protection ideas. And we worked very diligently, very diligently to craft a very balanced bill that we were able to pass, not just out of committee but on the House floor.

And before it came to a vote on the House floor, President Obama put forward a statement of administrative policy that he endorsed and would sign the bill.

Well, unfortunately due to a few senators who, I think, misinterpreted the spirit and promise of crowdfunding, the Senate inserted imperfect -- we'll just call them imperfect provisions that jeopardize the vitality of equity-based crowdfunding and complicated SEC rulemaking.

As the SEC considers comments regarding crowdfunding, the crowdfunding title of the JOBS Act, it's clear that the Senate's 11th hour changes have unnecessarily made sections of the JOBS Act ambiguous and inconsistent.

Today's hearing serves as an opportunity for Congress to hear from knowledgeable folks that either participate in the arena of crowdfunding as it now exists -- it's not equity-based, it's not on the investor side, but crowdfunding as it now exists, market participants and -- and academic experts about these provisions of the JOBS Act.

And I want to get their thoughts and that's really what this is about. Our intention is for Congress, interested parties and the SEC to work together to ensure that effective rules and policies are promulgated that will allow crowdfunding to flourish.

And if crowdfunding flourishes, I think our small businesses have another opportunity to flourish.

I thank the witnesses for making the trip here. And I want to thank the ranking member, Mr. Quigley, for his involvement on this area of public policy as well as many others.

Redrawing the Boundaries: JOBS Act's Impact on the Crowdfunding Phenomenon and the Regulatory Framework of the Restricted Securities Market

Aaron J. Horn

1. Introduction

As the SEC seeks to create and implement the JOBS Act regulatory requirements, the question arises: what would an appropriate regulatory framework be, and, more specifically, is there any way for the SEC to construct and implement rules applicable to the CROWDFUND Act that will provide a useful and timely platform for emerging growth companies to raise capital?

This article seeks to provide: 1) a brief overview and background of the crowdfunding phenomenon; and 2) a cursory outline of the major outstanding practical and regulatory impediments that require clarification and resolution before crowdfunding develops in any significant way.

2. Crowdfunding, JOBS Act, and a Series of Unfortunate Events

The equity capital market is a space that exists between companies and financial institutions that works to provide capital for those companies. The financial crisis has had significant effects on the market and affected a changing landscape for the private equity realm and the entrepreneurs that look to it for financing startups and emerging companies.

For most private companies, the capital markets have not been a hospitable place in recent times; for startups, this is especially true. The near disappearance of debt financing in the market, primarily between 2008 and 2010, led to a lack of exit opportunities for private equity. In turn, this has led to fewer investments of lesser amounts for private equity.

Specifically, in all of 2009 there was only $61 billion invested in 1,349 deals. In 2007, $595 billion was infused into 3,002 deals. As of January 2012, the cumulative overhang in the private equity having has fallen by approximately 25% since 2008; while there has been some thawing in the market, private equity, for a number of reasons, has remained close to useless for most startups.

The conventional wisdom is that companies follow a fairly defined pattern of financing: 1) they use their savings and family and friends to start the business; 2) once the business has started generating revenue, there is a movement to private equity (angels or, for larger investments, VCs); and 3) an IPO or M&A exit.

Recent studies, however, have shown that in reality most startups businesses use lines of credit, such as credit cards or home equity, for their first step in financing a small business. The problem with this is two-fold: since 2008, fewer people have access to either credit lines or home equity sufficient to start a business; and starting a small business with capital financed at around 15-25% interest on a credit card can ensure failure of the business.

Further, unemployment has been at a historical high among those between the ages of 25 to 35; coincidentally, people in the same age group are the most likely to be first time entrepreneurs. In a time of unprecedented technological and educational advancement, those minds with creative and new ideas, the willingness to take the risks to implement them, the technological and educational wherewithal to advance them and the time to invest in them, have not been able to access the historically small amount of capital they have needed to bring wealth of innovative products and companies to our society.

The phenomenon of crowdfunding is longstanding and, in more recent times, has picked up momentum in the arena of the arts and has been spilling over into more entrepreneurial pursuits. With the advent and recent acceleration of social media, it is easier than it has ever been to source support for a cause from the broader public.

In order to better facilitate the crowdfunding process, companies have created new platforms for crowdfunding. The platforms vary in focus from benevolent societal impact ideas, such as 33needs.com, to broader focused platforms, such as IndieGoGo.com. Currently, there are over 25 crowdfunding websites; none of them currently provide a platform for exchanging securities in newly formed companies.

A number of impediments have prevented the crowdfunding phenomenon from working to provide capital to emerging growth companies via the exchange of equity. Chiefly among them are: 1) issuers have been prohibited from advertising their companies via general solicitation; 2) crowdfunding platforms have faced high barriers to entry through the broker dealer registration requirements; 3) there has been an absence of a '33 Act exemption that would be relevant to the style in which crowdfunding would raise capital.

Generally, Rule 504 of the Securities Act has been viewed as a main avenue for entrepreneurs who are looking to raise less than $1 million. Because of the accredited investor requirement, among a number of other issues, Rule 504 has remained mostly useless to the kind of fundraising crowdfunding seeks to provide.

On September 15, 2011, the Committee on Oversight and Government Reform held a hearing: "Crowdfunding: Connecting Investors and Job Creators." The hearing pressed the economic need of crowdfunding and the overall trend of using the masses to fund endeavors. It further called for the legal and political changes needed to make crowdfunding a viable alternative for financing.

On April 5, 2012, President Obama signed H.R. 3606, the JOBS Act, into law. Title III of the JOBS Act, the CROWDFUND Act, amends Section 4 of the '33 Act to provide a crowdfunding exemption. The CROWDFUND Act, in theory, would exempt issuers from the requirements of Section 5 of that Act when they offer and sell up to $1 million in securities, provided that individual investments do not exceed certain thresholds and the issuer satisfies the other conditions provided in Section 302 of the CROWDFUND Act. These other conditions which must be satisfied require additional rulemaking by the SEC. The JOBS Act directs the SEC to adopt rules to implement the CROWDFUND Act within 270 days of April 5, 2012.

3. Impediments to Crowdfunding

Despite the passage of the JOBS Act, there are a number of outstanding issues that, without clarification and resolution, will continue to impede any meaningful development of crowd funding in the securities market:

- Major obstacles to advertising the securities of emerging growth companies;
- Barriers to entry higher than overwhelming majority of potential crowdfunding portal providers can afford; and

- ➢ Reporting requirements for issuers, buyers, and intermediaries that the participants will have the resources to fulfill.

3.1. Soliciting in General

Setting aside the usual issues of general solicitation in restricted securities offerings (which will still be problematic in a crowdfunding scheme), there are a number of hurdles concerning promotion of securities within a crowdfunding paradigm.

Section 4A(b)(2) requires that any issuer relying on 4(6) shall "...not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker."

Section 4A(b)(3) requires that any issuer relying on 4(6) shall "...not compensate or commit to compensate, directly or indirectly, any person to promote its offerings through communication channels provided by a broker or funding portal, without taking such steps as the Commission shall, by rule, require to ensure that such person clearly discloses the receipt, past or prospective, of such compensation, upon each instance of such promotional communication..."

Section 4A(b)(5) requires that any issuer relying on 4(6) shall "...comply with such other requirements as the Commission may, by rule, prescribe, for the protection of investors and in the public interest."

Section 304(b) defines funding portal as "...any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to section 4(6)...that does not—

(A) offer investment advice or recommendations;

(B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;

(C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal

...

(E) engage in such other activities as the Commission, by rule, determines appropriate."

Major outstanding issues:

- What exactly will constitute "advertising the terms" from the SEC's perspective?
- If the SEC takes a narrow view of what the issuer is allowed to do to promote the equities, how are issuers expected to make buyers aware of opportunities to fund new ventures?
- To what extent will the regulations concerning compensation for promotion impede promotion all together?

- What other requirements does the SEC foresee creating for the protection of the investors and in the public interest and how will they affect the possibility of crowdfunding as a viable source of capital?
- What does "solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal" entail from the SECs perspective?
- What role does the SEC foresee the portal playing in the marketplace?
- If both the issuers and portals are limited in their ability to advertise and solicit, what is the likelihood that emerging growth companies will be able to connect to potential investors?

3.2. Barriers to Entry

Issuers. For issuers in the securities markets, the primary regulatory barrier to entering the market is the registration of the securities. With the development of the market, a number of exemptions have been introduced over the years, notably Section 4(2) of the Securities Act, which acts to exempt from section 5, transactions by an issuer to buyers who are "sophisticated." For issuers who prefer to be on the safe side, the SEC has issued safe harbors, such as Rule 506, which provides prescriptions for falling within 4(2) and, thus, avoiding the regulatory costs involved with registration.

Under Section 302(b) of the JOBS Act, and in order to qualify for the 4(6) exemption, an issuer shall "file with the Commission..." all the information provided in sections (A) – (I), "...not less than annually, file with the Commission...the results of operations and financial statements of the issuer, as the Commission shall, by rule, determine appropriate, subject to such exceptions and termination dates as the Commission may establish by rule," and "...comply with such other requirements as the Commission may, by rule, prescribe, for the protection of investors and in the public interest.

Major outstanding issues:

- How do the barriers presented by 4(6) compare to those of other exemptions, such as 4(2)?
- To the extent that the barriers are substantial under the exemption, and the issuers are predominately startups, what affect are such barriers likely to have on a potential crowdfunding market?
- How does the SEC foresee implementing the filing requirements under 302(b) in a way that a typical startup will be able to afford?

- What does the SEC project the costs to the issuers of compliance with the regulations under 302(b) to be?

Intermediaries. One of the major barriers to entry for market participants seeking to provide a platform or otherwise act as an intermediary in the crowdfunding arena, and restricted securities market generally, has historically been the registration requirements of becoming a broker. Section 304 of the JOBS Act, which provides a limited exemption to section 15(a)(1) of the '34 Act, was, by some accounts, intended to provide relief from the registration barriers so platforms would be able to facilitate a crowdfunding market.

Section 302(b) requires "...a person acting as an intermediary in a transaction involving the offer or sale of securities for the account of other pursuant to section 4(6)..." to register as either a broker or a funding portal, register with an SRO, provide disclosures as determined by the Commission, ensure, take "such measures to reduce the risk of fraud with respect to such transactions, as established by the Commission, and to further comply with the requirements of 302(b).

Section 304(b) defines funding portal as "...any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to section 4(6)...that does not—

(D) Hold, manage, possess, or otherwise handle investor funds or securities; or
(E) Engage in such other activities as the Commission, by rule, determines appropriate."

Major outstanding issues:

- From a cost perspective, how does broker registration compare to portal registration, and what is the likely affect on a potential crowdfunding market?
- What does it mean to "hold, manage, possess, or otherwise handle" investor funds or securities?
- Would it be possible to execute a crowdfunding transaction without a registered broker?
- What is the potential benefit of a market participant registering as a portal compared to the cost of registration?

3.3. Reporting and Other Requirements

A predominate barrier not only to entry but to maintaining a going concern in the financial industry, has been initial and ongoing reporting, oversight, and other requirements.

Section 302(b) outlines a number of requirements for both issuers and intermediaries, including "taking such measures to reduce risk of fraud with respect to such transactions, as established by the Commission...," "...make[ing] such efforts as the Commission determines appropriate...to ensure that no investor in a 12-month period has purchased securities offered pursuant to section 4(6) that...exceed the investment limits...," and "...file with the Commission and provide investor reports of results of operations and financial statements of the issuer, as the Commission shall...determine appropriate.

Major outstanding issues:

- What "measures" is the SEC likely to expect from participants to reduce risk of fraud?
- What "efforts" is the Commission likely to require of participants to enforce aggregation rules?
- What level of detail and what auditing requirements is the SEC likely to require from participants in their filings?
- What are the likely costs of compliance to participants on a per company basis?
- Taking into account that the crowdfunding market would be a low investment, high volume industry, how will the costs of compliance influence the ability of emerging growth companies to use crowdfunding as an avenue for raising capital?

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Aaron Horn has written a number of articles on regulatory issues, startup funding, equity markets, and other matters concerning emerging growth companies which have been featured in publications such as the *International In-House Counsel Journal*; his work is acknowledged in a recently published book on capital formation and business planning, *Raising Capital: Get the Money You Need to Grow Your Business*; and he has advised NASDAQ OMX on Dodd-Frank related regulatory matters.

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