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

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

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

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

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

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[1] In order to differentiate non-financial-return "crowdfunding" (or the donation and rewards model) and the financial-return model envisioned by Title III of the JOBS Act, I will use the term "crowd investing" when referring to the capital-raising model created by the law.

[2] For example, there are numerous instances where the SEC uses its discretion to allow for greater participation by the crowd in this new market, and permits broad activities by platform intermediaries. Where there was ambiguity in interpretation of the statutory investor caps, the SEC proposed an interpretation that would allow investors to invest up to the greater cap limit suggested by the law. *See* Proposed Rule: Crowdfunding; Release No. 34-70741; File No. S7-09-13 (hereinafter "Proposal Release"), at 24; Proposed 17 CFR § 227.100. And, the SEC proposes the creation of a fairly broad safe harbor of acceptable funding portal activities in order to enhance the utility of these portals. *See id.* at 228-229; Proposed 17 CFR § 227.402.

[3] *See* Elizabeth M. Gerber, Julie S. Hui, and Pei-Yi Kuo, "Crowdfunding: Why People Are Motivated to Post and Fund Projects on Crowdfunding Platforms," Northwestern University, Creative Action Lab (2012), available at http://www.juliehui.org/wp-content/uploads/2013/04/CSCW_Crowdfunding_Final.pdf (noting that funders of crowdfunding projects seek rewards, support creators and causes with similar values, and enjoy engaging with and contributing to a creative community).

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

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

**Key Regulatory Objectives**

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

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

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

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

**Observations and Recommendations**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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