

**Congress of the United States**  
**U.S. House of Representatives**  
**Committee on Small Business**  
2361 Rayburn House Office Building  
Washington, DC 20515-6515

To: Members, Subcommittee on Investigations, Oversight and Regulations  
From: Committee Staff  
Date: January 13, 2014  
Re: Hearing: "SEC's Crowdfunding Proposal: Will It Work for Small Businesses?"

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On Thursday, January 16, 2014 at 10:00 a.m., the Subcommittee on Investigations, Oversight and Regulations of the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building for the purpose of examining the provisions of the Securities and Exchange Commission's (SEC or Commission) recently issued proposed rules implementing Title III of the Jumpstart Our Business Startup Act of 2012 ( JOBS Act).<sup>1</sup> Title III creates the "crowdfunding exemption" from the laws governing the sale of securities to the public. The provisions include investment restrictions and new compliance requirements for both small businesses seeking to obtain funds through crowdfunding and the portals that will connect entrepreneurs and investors. The Subcommittee will receive testimony from industry leaders regarding how the proposed rules are expected to affect both the crowdfunding model and small businesses seeking to use it as a source of capital.

## **I. Introduction**

Small businesses create two-thirds of net new jobs in the United States,<sup>2</sup> and experience more rapid growth than their larger counterparts. Despite this, these entrepreneurs often cannot obtain capital from traditional sources.<sup>3</sup> An alternative known as crowdfunding has emerged for small businesses. Crowdfunding entails obtaining small amounts of money from large numbers of individuals, generally through various types of Internet portals.<sup>4</sup>

While donation-based crowdfunding has been in existence for several years,<sup>5</sup> the JOBS Act includes provisions directing the SEC to create a regulated equity-based crowdfunding model.<sup>6</sup>

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<sup>1</sup> Pub. L. No. 112-106, 126 Stat. 306 (2012), codified at scattered sections of Chapters 2A and 2B of Title 15, United States Code.

<sup>2</sup> SMALL BUSINESS ADMINISTRATION OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS 1 (Sept. 2012), available at [http://www.sba.gov/sites/default/files/FAQ\\_Sept\\_2012.pdf](http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf)

<sup>3</sup> *Where Are We Now? Examining the Post-Recession Small Business Lending Environment: Hearing Before the Subcomm. on Economic Growth, Tax and Capital Access of the Comm. on Small Business*, 113<sup>th</sup> Cong., 1<sup>st</sup> Sess. (statement of Mr. Jeff Stibel, CEO, Dun & Bradstreet Credibility Corp. at 2, 4), available at [http://smallbusiness.house.gov/uploadedfiles/12-5-2013\\_jeff\\_stibel\\_testimony\\_final.pdf](http://smallbusiness.house.gov/uploadedfiles/12-5-2013_jeff_stibel_testimony_final.pdf).

<sup>4</sup> Thomas Hazen, *Social Networks and the Law: Crowdfunding or Fraudfunding?*, 90 N.C. L. REV. 1735, 1736 (2012).

<sup>5</sup> *Id.* For a description of crowdfunding that does not involve the sale of securities, please see the memorandum prepared for the hearing on the implementation of the JOBS Act held by the Subcommittee on April 11, 2013 and available at [http://smallbusiness.house.gov/uploadedfiles/4-11-2013\\_hearing\\_memo.pdf](http://smallbusiness.house.gov/uploadedfiles/4-11-2013_hearing_memo.pdf).

<sup>6</sup> 15 U.S.C. § 78c note.

Congressional action was necessary because the selling of stock to the general public through an Internet portal would violate the requirement for registering securities with the SEC prior to their sale.<sup>7</sup> The SEC was required to issue final rules for crowdfunding within 270 days of the enactment of the JOBS Act, a deadline which the agency missed by a wide margin; proposed rules were published in the Federal Register on November 5, 2013.<sup>8</sup>

## II. SEC's Proposed Rules Implementing Title III

The Proposed Rules issued by the SEC span more than 176 pages in the Federal Register.<sup>9</sup> The Crowdfunding Notice of Proposed Rulemaking (NPRM) covers requirements for issuers (small business owners),<sup>10</sup> investors, and operators of the websites, referred to as Internet Portals or intermediaries.<sup>11</sup>

### a. Requirements for Issuers

#### 1. Statutorily Mandated Requirements

The Proposed Rules implementing Title III will require all small companies offering equity stakes through crowdfunding to disclose certain identifying information.<sup>12</sup> In addition to these disclosure requirements, small businesses raising capital through crowdfunding will face specific mandates on compliance, reporting and recordkeeping depending on the amount raised.<sup>13</sup>

The Proposed Rules incorporate the disclosure requirements mandated by Congress including the business's address and names of officers, directors, and shareholders; information about the business, including its business plan; a description and purpose of the intended use of proceeds; the target offering amount and associated deadline, offering price, description of ownership and capital structure.<sup>14</sup> The information required by Congress provides investors needed information about the entity to which they are offering capital.

The Crowdfunding NPRM also varies the detail of the disclosure provided to the public depending upon the amount of funding sought by the small business owner. For those issuers seeking less than \$100,000 through crowdfunding, the entrepreneur must provide tax returns for the most recently completed year, and financial statements certified as accurate by the executive officer

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<sup>7</sup> See Joan Heminway & Sheldon Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 906-07 (2011).

<sup>8</sup> Crowdfunding, Proposed Rules, 78 Fed. Reg. 66,428 (Nov. 5, 2013) ("Crowdfunding NPRM" or "Proposed Rules").

<sup>9</sup> Given the length of the Crowdfunding NPRM, the memorandum only will skim the surface of this important rulemaking.

<sup>10</sup> Under the securities laws, anyone seeking to sell stock to the public is denominated an "issuer." However, this memorandum will use the terms issuer, small business owner, small business, and entrepreneur interchangeably unless the context dictates otherwise. Committee staff recognizes that this is not precise use of terms of art but does so as a convenience to the reader.

<sup>11</sup> The memorandum will use the terms "internet portal" and "intermediary" interchangeably.

<sup>12</sup> Crowdfunding NPRM, 78 Fed. Reg. at 66,437-38.

<sup>13</sup> *Id.* at 66,450-54 (reporting and recordkeeping requirements) and 66,457-58 (compliance requirements).

<sup>14</sup> *Id.* at 66,450-54.

to the SEC, investors, and the intermediary.<sup>15</sup> Issuers offering between \$100,000 and \$500,000 in securities will be required to provide financial statements reviewed by a public accountant independent of the issuer to all of the aforementioned parties. Finally, issuers soliciting more than \$500,000, or a higher amount determined by the SEC, will be required to provide audited financial statements.<sup>16</sup>

## 2. Requirements Beyond those Mandated by the JOBS Act

The SEC, in the Crowdfunding NPRM, requires a number of additional disclosures for small issuers not specified in statute. These include the name, file number, and Central Registration Depository Number<sup>17</sup> of the intermediary through which the offering is being conducted; the amount paid to the intermediary to facilitate the offering (if any); its current number of employees; a discussion of factors that make an investment in the issuer risky; a description of indebtedness and a list of similar offerings conducted in the past three years.<sup>18</sup>

The Proposed Rules also include a non-statutory requirement that all issuers seeking over \$500,000 must submit audited financial statements to the SEC for not only the year in which they are raising capital, but for all years in which the business has been in existence.<sup>19</sup> The SEC failed to utilize the discretion in the JOBS Act to establish a higher dollar threshold above \$500,000 that would necessitate the issuer to provide audited financial statements. The SEC proposed, that for the purposes of determining the scope of the disclosure required by an issuer, the small business must add the amount of capital it is seeking to the amount it raised through crowdfunding offerings in the last twelve months.<sup>20</sup>

The JOBS Act mandates that crowdfunding transactions must be conducted through a intermediary as defined in the law.<sup>21</sup> In its rulemaking, the SEC chose to limit issuers to using only

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<sup>15</sup> *Id.* at 66,443.

<sup>16</sup> *Id.* at 66,444. Review by an accountant is very different than an audited financial statement. The impact of this distinction will be addressed later in the memo.

<sup>17</sup> The Financial Industry Regulatory Authority (FINRA) is an independent, non-government SRO (or self-regulatory organization) for securities brokers and dealers doing business in the United States. FINRA was created through the consolidation of the National Association of Securities Dealers (NASD) and the member regulation, enforcement and arbitration operations of the New York Stock Exchange in July 2007. *See* <http://www.finra.org/Newsroom/NewsReleases/2007/p036329>. FINRA operates Web Central Registration Depository (CRD), the central licensing and registration system for the United States securities industry and its regulators. CRD contains the registration records of more than 6,800 registered broker-dealers and the qualification, employment, and disclosure histories of more than 660,000 active registered individuals. <http://www.finra.org/industry/compliance/registration/crd/>.

<sup>18</sup> Crowdfunding NPRM, 78 Fed. Reg. at 66,552-53.

<sup>19</sup> Crowdfunding NPRM, 78 Fed. Reg. at 66,451.

<sup>20</sup> Crowdfunding NPRM, 78 Fed. Reg. at 66,443.

<sup>21</sup> Intermediary means a broker registered under Section 15(b) of the Exchange Act (15 U.S.C. § 78o(b)) or a funding portal registered under proposed 17 C.F.R. § 227.400 and includes, where relevant, an associated person of the registered broker or registered funding portal. Web portal, or funding portal, means a broker acting as an intermediary in a crowdfunding transaction carried out pursuant to the statutory exemption in Title III of the JOBS Act. Crowdfunding NPRM, 78 Fed. Reg. at 66,556. Such broker also is prohibited from: offering investment advice; soliciting purchasers of securities displayed on its websites; compensating employees (or any other person) to obtain purchasers of listed

one intermediary, rather than multiple intermediaries, to conduct an offering or concurrent offering.<sup>22</sup> The Commission claimed that allowing an issuer to conduct a single offering or simultaneous offerings through more than one intermediary would diminish the ability of the members of the crowd to effectively share information.<sup>23</sup>

## b. Requirements for Intermediaries

### 1. Statutorily Mandated Requirements

As already noted, the JOBS Act does not simply permit an issuer to create a website and begin obtaining funds from the general public. Rather, there is the requirement that Internet portals will be created or existing ones modified to enable entrepreneurs to raise equity capital.

The Proposed Rules create dozens of new requirements for crowdfunding intermediaries. Some are required by the JOBS Act, while others were left to the SEC's discretion. For instance, the JOBS Act requires intermediaries to register with the SEC as a broker or funding portal, register with the Financial Industry Regulatory Authority, and provide information concerning risk to investors.<sup>24</sup> The JOBS Act also directs the SEC to require intermediaries take measures to reduce the risk of fraud by performing a background check on each director, officer, or person holding more than 20 percent of an issuer's equity, and ensure that investors are not exceeding investment limitations created by Title III of the Act.<sup>25</sup>

### 2. Requirements Beyond those Mandated by the JOBS Act

The SEC interpreted the JOBS Act directive for intermediaries to take measures to reduce the risk of fraud to mean that intermediaries must have a reasonable basis to believe an issuer has established a method to keep accurate records of the holders of the securities it offers and sells through the intermediary's platform.<sup>26</sup> The Proposed Rules indicate that this determination can be accomplished by relying on an issuer's representation, unless the intermediary has reason to question the reliability of the issuer's statements.<sup>27</sup> While the JOBS Act requires intermediaries to conduct background and security enforcement regulatory history checks on each officer, director, and person holding more than 20 percent of the outstanding equity of every issuer, the SEC's proposal extends the requirement to all 20 percent beneficial owners.<sup>28</sup>

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securities; or hold, manage, or handle investor funds or securities. *Id.* The term "broker" is generally defined in Exchange Act Section 3(a)(4) as any person that effects transactions in securities for the account of others. Crowdfunding NPRM, 78 Fed. Reg. at 66,458.

<sup>22</sup> *Id.* at 66,435.

<sup>23</sup> *Id.*

<sup>24</sup> JOBS Act, § 302(b), 126 Stat. at 315 (codified at 15 U.S.C. § 77d-1(a)(3)).

<sup>25</sup> *Id.*

<sup>26</sup> Crowdfunding NPRM, 78 Fed. Reg. at 66,461.

<sup>27</sup> *Id.* at 66,462.

<sup>28</sup> *Id.* at 66,463.

In setting forth liability provisions, the JOBS Act provides that an issuer is liable to the purchaser of its securities if the issuer makes an untrue statement, or omits pertinent facts needed to make a statement not misleading.<sup>29</sup> The Proposed Rules interpret the JOBS Act's definition of an issuer as "any person who offers or sells the security in such offering" to mean that intermediaries, including funding portals, would be considered issuers for the purpose of this liability provision and therefore subject to its requirements.<sup>30</sup> At the same time the Commission determined intermediaries can be held liable for the sale of securities, it interpreted Congress's determination that funding portals should not give investment advice to mean they cannot exercise discretion based on an issuer's merits in selecting which businesses solicit investment through their platform.<sup>31</sup>

### c. Limitations on Investment

In implementing the JOBS Act's limitations on the amount of capital that can be raised through crowdfunding, the SEC did not include requirements beyond the scope of statute as it did with those for intermediaries and issuers. Specifically, the aggregate amount of securities sold to investors in a 12-month period cannot equal more than \$1,000,000.<sup>32</sup> Defining limitations on specific individual investors, the Proposed Rules state that during a 12-month period, an issuer cannot offer more than the greater of \$2,000 or 5 percent of the annual income or net worth of an investor with an annual income or net worth of less than \$100,000.<sup>33</sup> Investors with an annual income or net worth of greater than \$100,000 are permitted to purchase securities with a value of up to 10 percent of their annual income or net worth, not to exceed a total of \$100,000.<sup>34</sup>

## III. Potential Effects on Small Issuers and Intermediaries

If the primary purpose of the JOBS Act was to reduce regulatory barriers to the use of crowdfunding to raise capital, the additional burdens proposed by the SEC for both issuers and intermediaries seem to belie that promise. While there may be valid rationales for the additional requirements, it is not clear that the SEC has established either the validity of these rationales<sup>35</sup> or that the benefits to investors of these extra-statutory disclosure requirements and liability provisions will outweigh the costs associated with limiting the ability of small businesses to raise capital through crowdfunding.

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<sup>29</sup> Sec. 4A(c)(2)(A) of the Securities Act of 1933, as added by § 302(b) of the JOBS Act (codified at 15 U.S.C. § 77d-1(c)(2)(A)).

<sup>30</sup> Crowdfunding NPRM, 78 Fed. Reg. at 66,498-99.

<sup>31</sup> *Id.* at 66,486.

<sup>32</sup> *Id.* at 66,431.

<sup>33</sup> *Id.* at 66,433.

<sup>34</sup> *Id.*

<sup>35</sup> For instance, the Commission argues that the limitation on the use of multiple web portals is needed to enhance the sharing of information among investors and issuers. Under closer scrutiny, the rationale proffered by the Commission is unsatisfactory. Since the Commission rules already require the listing of all websites of which an issuer is listed, the individuals who will be investing can always check these portals for information thereby protecting the investor. In fact, listing on multiple portals is likely to garner more input to the investor than on one portal since some portals may be underutilized while others are used frequently.

The Crowdfunding NPRM requirement that all firms raising more than \$500,000 per year must submit audited financial statements to the SEC for the life of the business is frequently cited as too costly for small businesses.<sup>36</sup> For a business that has been in existence for many years, it is quite possible that it had no reason to maintain records beyond those required by either state law or the requirements of the Internal Revenue Code. In such cases, auditors may have insufficient data to perform an audit under Generally Accepted Accounting Principles, thereby eliminating many firms from access to crowdfunding. At a recent SEC forum on small business capital formation, a partner from a leading accounting firm predicted the cost to small businesses of providing audited financial statements could be upwards of \$18,000 to \$25,000.<sup>37</sup>

One industry expert says that this provision will discourage businesses from raising the full amount of capital they need, predicting most will limit their crowdfunding raise to \$499,000 in order to avoid the requirement.<sup>38</sup> Another indicates that with this requirement, “it’s hard to imagine attractive companies will take advantage of the Crowdfunding NPRM,” indicating the manner in which it is proposed would be a disappointing outcome for not only small companies, but investors.<sup>39</sup>

In proposing that intermediaries can be held liable in the same way as an issuer if the issuer makes an untrue statement or omits pertinent facts needed to make a statement not misleading, while concurrently proposing to limit their discretion in listing or promoting any issuer’s offering over another on their site, the Commission has created a scenario which could subject intermediaries to unforeseen liability, potentially discouraging the implementation of the Title III model within their platforms. In other words, the SEC imposes portal liability but does not permit the portals to protect themselves by prohibiting an issuer of questionable worth from utilizing the portal.

#### IV. Conclusion

With this rulemaking, the SEC has the opportunity to create a new marketplace. As it is currently written, the Proposed Rules are complex and create a number of potentially onerous requirements for small issuers and funding portals. As the Commission moves forward with final rules, it is important they do not discourage small businesses, of whatever age, from seeking capital through crowdfunding.

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<sup>36</sup> J.D. Harrison, *New Crowdfunding Rules: The Good and Bad News for Entrepreneurs and Investors*, WASHINGTON POST, Oct. 29, 2013, available at [http://www.washingtonpost.com/business/on-small-business/new-crowdfunding-rules-the-good-and-bad-news-for-entrepreneurs-and-investors/2013/10/28/c634045e-3fe7-11e3-9c8b-e8deeb3c755b\\_story.html](http://www.washingtonpost.com/business/on-small-business/new-crowdfunding-rules-the-good-and-bad-news-for-entrepreneurs-and-investors/2013/10/28/c634045e-3fe7-11e3-9c8b-e8deeb3c755b_story.html).

<sup>37</sup> Kim Wales, *Is Financial Disclosure for Crowdfunding Companies Too Expensive?*, CROWDFUNDINSIDER, Dec. 18, 2013, available at <http://www.crowdfundinsider.com/2013/12/28428-is-financial-disclosure-for-crowdfunding-companies-too-expensive/>. The cost of audited financial statements for businesses seeking over \$500,000 is significantly higher than the cost of financial statements reviewed by a certified public accountant for those companies seeking between \$100,000 and \$500,000, which is estimated to be between \$6,000 and \$15,000 depending on the complexity of the review. <http://www.cpataxmag.net/feature-stories/65-feature-stories/834-cpas-are-ready-to-perform-reviews-for-crowdfunded-startups>.

<sup>38</sup> Sherwood Neiss, *It might cost you \$39K to crowdfund \$100K under the SEC’s new rules*, VENTURE BEAT, Jan. 2, 2014, available at <http://venturebeat.com/2014/01/02/it-might-cost-you-39k-to-crowdfund-100k-under-the-secs-new-rules/>.

<sup>39</sup> *Supra* note 36.