Congressional Testimony of
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before the United States House of Representatives

Committee on Small Business

Subcommittee on Investigations, Oversight and Regulations

For the Hearing:

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

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

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

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

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

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

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

Audit Requirements

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

First Tier: $0 - $100,000

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

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

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

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

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

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

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

Pooled Investments Restrictions

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

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

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

Intermediary Participation Restrictions

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

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

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

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

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

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

Funding Portal Liability

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

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

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

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

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

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

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

Respectfully submitted,

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