LEGISLATIVE PROPOSALS TO ENHANCE CAPITAL FORMATION FOR SMALL AND EMERGING GROWTH COMPANIES, PART II

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

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LEGISLATIVE PROPOSALS TO ENHANCE CAPITAL FORMATION FOR SMALL AND EMERGING GROWTH COMPANIES, PART II

Thursday, May 1, 2014

U.S. House of Representatives,
Subcommittee on Capital Markets and
Government Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:35 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Neugebauer, Fincher, Mulvaney, Hultgren; Maloney, Scott, Carney, and Kildee.

Also present: Representatives McHenry and Heck.

Chairman Garrett. Good morning, all. The Subcommittee on Capital Markets and Government Sponsored Enterprises is called to order. Today's hearing is entitled, "Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies, Part II."

We welcome all of the panelists. We will now go to opening statements. I yield myself 6 minutes for an opening statement.

So, good morning, once again, and welcome to today's hearing. Thanks in large part to the JOBS Act, 2013 was the best year for initial public offerings (IPOs) since 2000, with more than 175 IPOs raising more than $40 billion in much-needed growth capital, and at least 80 percent of these companies qualify as emerging growth companies (EGCs) under the JOBS Act. And while this is a very positive development, we believe that more work needs to be done.

For example, according to one small business survey, government regulation red tape remains at the very top of the list of the most important problems facing American job creators. Another survey shows that small business demand for private capital continued to outpace access in 2013, while at least 60 percent of the respondents found it difficult to raise new external financing.

And so, building on the early success of the JOBS Act, this hearing—the 5th hearing we have had during this Congress—represents another opportunity to explore ways to further reduce unnecessary regulatory burdens and to enhance access to capital for small American businesses.

While the bills we have considered during this Congress address a variety of capital formation issues, they are designed to target regulatory problems in three overarching areas. Let me go through them.

First, some of the bills continue to help small businesses access capital by going public. We call that pre-IPO. Second, some of the bills improve the ability of small companies to access capital and compete after they have gone public. We call them post-IPO. And third, some of the bills help small businesses attract more investment in the private market. We just call them no-IPO.

These three legislative proposals we will be discussing today fit within the third category I just talked about. And the gentleman from North Carolina down at the end here, Mr. McHenry, he has circulated a discussion draft to fix the Senate's burdensome statutory missteps in the crowdfunding title of the JOBS Act by restoring a bipartisan policy authored in this committee last Congress.

Mr. McHenry has also offered a discussion draft to modernize the regulation A section for small companies by updating issuing caps, while striking the right balance between preserving State enforcement and lifting burdensome regulation requirements.

The discussion draft also codifies language that effectively and efficiently facilitates liquidity in the secondary trading of what is called the "restricted securities" among sophisticated investors. So I thank Mr. McHenry for his hard work and thoughtful proposals to make the crowdfunding and Reg A provisions of the JOBS Act more cost-effective and efficient options for issuers and the investors alike.

Finally, I have circulated a discussion draft to ensure that issuers and investors in certain private offerings under Reg D do not face overly complex and burdensome regulatory obstacles. As you all know, last year the SEC adopted a rule lifting the ban on general solicitation and advertising of private offerings under Rule 506 of Reg D, as mandated by Title II of the JOBS Act. Unfortunately, the SEC didn't stop there. Instead of simply removing the ban and opening up this market to new potential investors, the SEC decided to issue a separate rule proposal, not called for by this Congress, that would impose a number of new burdensome regulatory requirements on issuers seeking to use Rule 506, the exemption.

The SEC's selective judgment in deciding when and how to follow clear congressional directives and when not to is, of course, disturbing and disconcerting to me. When members of this committee, outside stakeholders, and even other SEC Commissioners pleaded with the Commission to issue a more pragmatic rule regarding conflict minerals, the Commission refused, stating, "Well, if Congress had intended that a mandate be limited further, we think Congress would have done so explicitly."

Unfortunately, the Commission did not apply this same rationale in a consistent manner when it came to the removal of the ban on general solicitation. As one comment put it, "The JOBS Act on its face does not authorize the Commission to attach new and additional conditions to the use of the exemption. It is not for the Commission to rely on its general rulemaking authority to bring Congress and the President back into line by adding conditions that it believes may enhance investor protection."

However, that is exactly what the Commission did. That the SEC believes it has the authority to alter a clear mandate in the JOBS Act, but not in the Dodd-Frank Act, certainly suggests, as SEC Commissioner Dan Gallagher said, "In the face of a statutory mandate, the SEC only thinks outside the box and uses its expertise when it means adding regulations, no matter the cost."

Indeed, I believe that many of the additional requirements in the SEC's Reg D proposal will, if ultimately adopted, make Rule 506 a less attractive avenue for small business capital formation and, at the same time, harm investors' choice. And this, of course, is clearly at odds with the goals, let alone the text of the JOBS Act.

And so my discussion draft would address some of the more burdensome red tape portions contained in the SEC rule proposal, including, certainly, costly filing requirements and disqualification provisions.

Before I conclude, I want to be clear on a few points regarding what this discussion draft would not do. It would not remove the SEC's existing Form D filing requirements. It would not remove the SEC's existing requirement that issuers take reasonable steps to verify that investors in Rule 506 offerings are accredited. It would not reduce the SEC's existing rules requiring disclosure to investors. And it would not limit the SEC's existing authority to prevent and punish fraud and other misconduct under the Federal securities laws.

I believe this discussion draft will ultimately strike the right balance between helping America's job creators raise much-needed capital and protecting Americans who invest their hard-earned money in these companies at the same time.

I thank you very much for your attention. And at this point, I recognize the ranking member of the subcommittee, Mrs. Maloney from New York, for 4 minutes for her opening statement.

Mrs. MALONEY. Thank you, Mr. Chairman. And welcome to all of the witnesses. I would like to particularly welcome Ms. Tierney, who is from the great State of New York, and I have the privilege of representing you. Thank you for being here today.

The U.S. capital markets are the envy of the world. They offer investors liquidity, transparency, and flexibility. And they offer companies access to capital in the form of a deep pool of investors who stand ready and willing to invest in promising businesses.

In short, the United States is where companies come to raise money. While the system of securities laws in the United States is complex, the central tension underlying our securities law is very simple: Investors want as much information as possible on the companies they are investing in, as quickly and as accurately as possible.

Often the issuing companies, on the other hand, want to keep as much information as possible about their business practices confidential. Companies also want to spend as little time as possible preparing the disclosures that their investors crave. It is the job of public policy to strike the right balance between these competing desires.

But public policy does not run on autopilot. In the securities market, we often entrust the job of properly balancing these competing goals to the regulator, the U.S. Securities and Exchange Commission. I would like to say that in the securities market especially, we need an active and informed regulator to write, enforce, and when appropriate, change the regulations to keep pace with innovation and the market.

Of course, the SEC isn't the only securities regulator in the United States, nor should they be. The State securities regulators play a very important role, as well. And we have one of those State regulators on our panel today, Mr. Bill Beatty from Washington State. Welcome.

State securities regulators are in the best position to provide on-the-ground protection for retail investors who are investing in securities offerings and are too small to merit the SEC's attention, especially given the SEC's lack of resources. The State regulators are also well-positioned to provide investor's education to mom-and-pop retail investors who don't have a fortune to invest, who never worked on Wall Street, and who are most vulnerable to fraud.

Sometimes, of course, Congress has decided that it is necessary to preempt State securities laws in order to reduce the compliance burden for companies seeking to raise capital. But I think that those decisions should be made on a case-by-case basis. Sometimes it will be appropriate to preempt State law, and sometimes it will not.

I hope that we can use this opportunity to have a robust discussion about the proper role of State securities regulators so that we can inform our own thinking about how to maintain and improve our country's capital markets.

I look forward to the hearing today, and thank you very much, Mr. Chairman.

Chairman GARRETT. Thank you, gentlelady. And the gentlelady yields back. We now turn to the vice chairman of the subcommittee, Mr. Hurt from Virginia.

Mr. HURT. Thank you, Mr. Chairman.

Mr. Chairman, thank you for holding today's hearing on these three legislative proposals to further enhance capital formation. I also want to thank our witnesses for being here today.

While we have witnessed the successes of the JOBS Act in the 2 years since it was enacted, more still needs to be done, starting with the SEC completing implementation of the JOBS Act. Additionally, Congress and the SEC must expand on those successes and find practical solutions to increase access to capital for small businesses without sacrificing key investor protections.

Our securities laws are riddled with outdated and burdensome regulations that are hindering small businesses in Virginia's Fifth District, my district, from accessing the capital they need to grow. As our markets and the needs of the participants continue to evolve, it is necessary for our regulatory structure to reflect those new realities.

Chairmen Garrett and McHenry's bills will provide important modifications to key sections of the JOBS Act that enhance the ability of small businesses and start-ups to raise capital. For many of the companies that would take advantage of these improvements, the public markets are not a viable option, and they would otherwise face increased costs and complexity to meet their goals.

I appreciate this committee's continued focus on ensuring that our small businesses and start-ups have the ability to access the necessary capital in order to innovate, expand, and create the jobs that we need.

I look forward to working with my colleagues to advance these proposals and others that will provide growth and opportunity for our constituents in our communities. I look forward to your testimony, and I thank you for your appearance.

And thank you, Mr. Chairman. I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back.

Mr. Scott is recognized for 4 minutes.

Mr. SCOTT. Thank you, Mr. Chairman.

First of all, let me say that I agree with both Chairman Garrett's and Ranking Member Maloney's very thoughtful opening statements. However, we have to look at the big picture. First, we do have to reduce the barriers to capital formation. But most importantly, we have to really identify exactly what these barriers are, be very truthful as to what these barriers are.

Then, we have to increase opportunities to raise that capital. And then, yes, we must address any regulatory impediments or burdens that make it difficult to raise additional capital.

As we know, the Securities and Exchange Commission has a three-part mission: to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation. And nowhere is that needed more than our small businesses. Small businesses are still the heart and the soul of our economy. They produce most of the jobs, especially new jobs.

Recently, the Securities and Exchange Commission's Advisory Committee on Small and Emerging Companies put forth a series of recommendations that we, and ultimately the Securities and Exchange Commission, should provide due consideration, and I believe that this committee will, jointly with the SEC.

Now, whether it is allowing for larger size of increments and bids, or tick sizes, for smaller companies, an option that is currently under consideration by the Securities and Exchange Commission, or more controversial options some of us may not initially care for, but we have to look at the big picture and recognize that we must be open for debate, like, for example, increasing the size of companies exempted from Sarbanes-Oxley's auditor attestment requirements or, another, exempting smaller companies from shareholder advisory votes, yes, on executive pay and compensation, if we have that clear evidence that these are impediments to capital formation. Capital formation must be first. And, of course, we first have to look at it with a very jaundiced eye.

We must also ascertain what significant evidence on small business capital formation exists measuring the impact of the JOBS Act. The JOBS Act is successful. It was signed into law just a little more than a year ago. The fundamental first question is, are we moving too soon? Have we in Congress been given enough to fully implement and evaluate the effects of the JOBS Act before pushing for additional, experimental small business capital formation proposals?

That is the big picture to me. I think we need to look at that. This is a very serious issue. And our small business community certainly deserves that.

And with that, I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back.

Mr. McHenry for 3 minutes.

Mr. MCHENRY. I want to thank the chairman for holding this hearing, and for his leadership on improving our capital markets.

And 3 years ago, this committee undertook a bipartisan, committed effort to update our outdated securities laws. It created new partnerships on this committee and resulted in significant bipartisan votes. With a little luck, our committee's solidarity led to the advancement and passage of the JOBS Act, which President Obama signed into law just over 2 years ago. The Act was arguably the most significant piece of legislation in the last Congress.

Congresswoman Maloney and I authored Title III of the Jobs Act, also known as the equity crowdfunding title. What motivated us was a pledge to cut red tape, as well as strengthen and ensure investor protections and allow start-ups to employ the Internet as a means to solicit small equity investors from everyday investors without triggering costly SEC registration.

Our original bill, passed by voice vote in this committee and by over 400 votes on the House Floor, was the only title within the JOBS Act to get the full and public endorsement from President Obama. That is significant.

But then, the Senate happened. An ill-advised and 11th-hour move resulted in the Senate striking a broadly supported title of the JOBS Act that Congresswoman Maloney and I authored, and hastily substituting an arduous amendment that neutered the promise of equity crowdfunding.

After patiently waiting for the Commission to reveal a crowdfunding rule proposal, and academics and market leaders submitting hundreds of comments, it is now clear that the current statute has failed.

But that does not mean that equity crowdfunding is destined for failure. Today's equity crowdfunding discussion draft not only restores what Carolyn Maloney and I started 3 years ago, this committee's commission to democratizing capital is front-and-center in that. But it also incorporates thoughtful suggestions by commenters who aspire to strengthen the vitality of equity crowdfunding.

Separately, the discussion draft on Regulation A in the resale of restricted securities simply codifies the spirited intent of Title IV of the JOBS Act, reviving the exemption to connect small enterprises and everyday investors. Furthermore, the draft amendment to the 1933 Act also codifies policy that efficiently cultivates liquidity in secondary trading of restricted securities among sophisticated investors. So, we do a lot for both the everyday investor and the more sophisticated investors.

I believe democratizing finance and extending access to America's start-ups are not partisan ideas. In fact, they are anything but. But what motivates each member of this committee is to ensure that we have a bipartisan achievement that helps entrepreneurs and everyday investors. That is what this is all about.

Thank you, Mr. Chairman.

Chairman GARRETT. I thank the gentleman, and I thank the gentleman for his work on these bills. The gentleman yields back.

And for the last word, Mr. Heck is recognized for 2 minutes.

Mr. HECK. Thank you, Mr. Chairman, and Ranking Member Maloney.

It is my privilege, while not a member of this subcommittee, to welcome on its behalf Mr. Bill Beatty from Washington State, who is a constituent of mine. Mr. Beatty is, in fact, the securities administrator for the Washington State Department of Financial Institutions. More importantly, for purposes of today's discussion, he is the president of the North American Securities Administrators Association, and we are so very, very pleased, honored, and grateful that you would come all the way across the country, a trip I know well, to share your insights.

Mr. Beatty is a graduate of the University of Puget Sound and Seattle University's School of Law. There probably is literally nobody in the United States with more expertise in securities law. And I am looking forward to receiving information from him about how it is State securities administrators can play a role in protecting investors, while at the same time helping capital markets perform as efficiently as is possible.

Thank you very much for allowing me to stop by, Mr. Chairman. Mr. Beatty, welcome to Washington, D.C.

Chairman GARRETT. Okay. Thank you. The gentleman yields back.

And now, we will turn to the panel. Again, we thank all the members of the panel, regardless of how far across the country they have flown, for being with us, and we thank you for flying so far. And so we will—for those of you who have not testified before this committee, just a few simple reminders. The little machine in front of you shows your time: green means you have 5 minutes; yellow means you are supposed to be summing up; and red means you are supposed to be done.

Also, we always remind you to pull the microphone closer than it looks like now for each one of you, because it doesn't pick up that well. So when you do speak, pull it close.

You are going to be recognized for 5 minutes to give a summation of your remarks. And without objection, your entire written statements will be made a part of the record.

So with that said, we turn to our first witness, Mr. Miller, cofounder of Fundrise. Mr. Miller, welcome. And you are recognized for 5 minutes.

STATEMENT OF BENJAMIN MILLER, CO-FOUNDER, FUNDRISE, RISE COMPANIES CORPORATION

Mr. MILLER. Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, my name is Ben Miller, and I am the cofounder of Rise Companies Corporation, which owns and operates Fundrise, a real estate crowdfunding platform based here in Washington, D.C. I am honored to be here to testify on my experience using Regulation A to crowdfund the development of local real estate here in the District of Columbia.

Let me spend a moment on my background so you understand how I came to run Fundrise, one of the only companies in the country currently raising equity online from the public, both from accredited and unaccredited investors, in Washington, D.C., Maryland, and Virginia, prior to implementation of Title III of the JOBS Act.

Before starting Fundrise, I ran a real estate company. In that capacity, I led the acquisition and development of more than 2 million square feet of property, such as Gallery Place on 7th and H Streets, NW, a 750,000-square-foot mixed-use development.

As a real estate entrepreneur, I have partnered with some of the largest institutional investment companies in the country, such as MassMutual; Angelo, Gordon, & Co.; and the AFL-CIO. So I understand what it means to raise debt and equity in the capital markets.

But one day, we asked ourselves, why are we raising money from institutions which have no real relationship with the places in which we are investing? What if we raised the money from the people who live there, who care, who are part of the neighborhood? So that is what we are doing and it explains why I am sitting here. We have been raising real investment in increments as affordable as $100 per share from the people who live near our real estate projects.

Since the JOBS Act did not exist when we started our endeavor, we had to work within the existing regulatory framework. Thanks to our outstanding and expensive legal team, we found a way through Regulation A. Our initial Regulation A filings with the Securities and Exchange Commission totaled more than 350 pages, but eventually allowed us to sell equity online at $100 per share to the local public.

To my knowledge, over the past 2 years we are the only ones who have successfully qualified more than one Regulation A offering, having climbed the regulatory mountain associated with Regulation A no less than 3 times. Each Regulation A offering was a serious undertaking, one that did not generally get easier over time.

For example, despite many similarities among our prior offerings, our third regulation offering took us more than 6 months to get through the regulators, which included hundreds of pounds of physical paper—actually, approximately 25 pounds per filing, 8 separate attorneys, more than $50,000 in legal fees, and 2 sets of reviewed accounting and financial statements, all of this to raise $350,000 from the residents of only 3 States.

Yet, we view ourselves as fortunate. Our local regulators in D.C., Virginia, and Maryland understood that we were working to build local places and create a new capital source for local job development and knew that less inclined regulators could have and potentially would have made it impossible for us to move forward.

In our experience, the likelihood that a Regulation A offering becomes effective is primarily dependent upon the jurisdictions in which the offering has to be registered. Given the great uncertainty that places upon an endeavor that requires tens of thousands of dollars and many months to begin, without regard to whether the issuer will actually be successful in its Regulation A offering, we support any proposal that lessens the regulatory burden of Regulation A offerings while simultaneously increasing the regulatory certainty faced by small businesses seeking to raise capital.

In addition, like many in the industry, we have reviewed the proposed Regulation A+, and we support the exclusion of investors in Regulation A+ offerings from the number of holders of record counted under Section 12(g) of the Exchange Act. We do not believe that, given the ongoing reporting requirements already proposed in Regulation A+, requiring small issuers to become subject to the onerous and expensive reporting requirements of the Exchange Act serves either investors or the small business community.

However, we would note that we found the wording contained in the draft bill to be slightly confusing and ask the subcommittee to consider whether there are clearer and simpler ways to accomplish the goal.

We at Fundrise take very seriously our ongoing mission to open up real estate investment to the general population beyond institutional and accredited investors that have predominantly held sway in the market. We believe that the proposals contained in these bills provide substantial, positive steps towards democratizing real estate investment, and we encourage the subcommittee to consider each of these proposals seriously.

I am happy to take any questions that you may have at this time.

[The prepared statement of Mr. Miller can be found on page 66 of the appendix.]

Chairman GARRETT. And I thank you, Mr. Miller.

Next, Ms. Tierney, executive VP and general counsel of SecondMarket. Welcome. And you are recognized for 5 minutes.

STATEMENT OF ANNEMARIE TIERNEY, EXECUTIVE VICE PRESIDENT—LEGAL AND REGULATORY, AND GENERAL COUNSEL, SECONDMARKET HOLDINGS, INC.

Ms. TIERNEY. Good morning, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. My name is Annemarie Tierney, and I am the general counsel of SecondMarket. I am very grateful to be able to testify this morning.

I have been in the securities industry for almost 25 years and have worked in a number of legal roles, including at the SEC, the law firm of Skadden Arps, and NYSE Euronext, before joining SecondMarket in 2010. For those of you not familiar with our company, SecondMarket was founded in New York City in 2004. We are a registered broker-dealer and the leading provider of services to facilitate transactions at private company stock. We have also advocated for regulatory change to help private companies raise capital and facilitate job creation, including changes to the 500-shareholder threshold and the elimination of the ban on general solicitation and advertising included in the JOBS Act.

Today, I would like to express our support for the adoption of proposed Section 4(a)(7) set out in Section 5 of the draft bill to amend securities laws to improve the small business capital formation provisions. I will also share insights on how the current regulatory framework for resales of private company shares imposes significant and unnecessary challenges to private company capital formation and job growth.

Under current laws, the only federally codified safe harbor for resales of private shares is Rule 144. The safe harbor, however, is only available to shareholders who are not affiliates of the company and who have held their common and preferred stock for at least 12 months. This means that Rule 144 is not available to private company founders, many angel investors, and officers and directors. It is also unavailable to employees who own equity in the form of stock options.

Instead, resales by these types of shareholders occur in reliance on a longstanding legal construct referred to as 4(a)(1-1/2), which is a mouthful, and are subject to State blue sky regulations that must be satisfied in every State where potential buyers are located. I would like to provide two examples of the challenges that this legal framework poses for private companies.

In 2012, SecondMarket expanded our business to include private community banks. These banks were looking to provide liquidity to their employees and shareholders. The benefits of that were obvious: Providing community bank shareholders a clear path to liquidity once or twice a year made it easier for the bank to raise capital and attract talented employees. And greater access to capital meant more loans to community and job creation.

The reality, however, is that almost every State other than New York State prohibits broker-dealers from reaching out to their accredited investor clients to identify potential interest in private company stock, a prohibition inconsistent with SEC and FINRA rules which allow broker-dealers to discuss opportunities with clients if there is a preexisting relationship. This restriction ultimately made it impossible for us to create successful liquidity events for these important businesses.

In addition, the other exemptions that are available for resales in the State level are interpreted inconsistently across the States and create a patchwork of regulation that is almost impossible to navigate, even for a registered broker-dealer. It is almost as though you are trying to put together a Rubik's Cube and you are missing one piece. It is almost impossible to make it work across multiple States.

This inconsistent legal framework also creates significant challenges for private company employees seeking to exercise their options and monetize a significant component of equity compensation. Every option has an exercise price that must be paid by the employee in order to convert the option of common stock. In addition, option exercise creates an income tax event for the employee.

Since most rank-and-file employees of private companies don't have sufficient funds to pay these costs out-of-pocket, they often need to simultaneously sell a portion of the common stock underlying their options to cover these costs, so they can't satisfy any hold period, much less a 12-month hold period.

As in the case of community banks, State law restrictions make it extremely difficult for employees or broker-dealers acting on their behalf to find buyers for these shares. As a result, a significant amount of equity of employee options expires every year, resulting in a real economic loss of private company employees.

In my view, proposed Section 4(a)(7) merely codifies a longstanding Federal construct applicable to resales of private company securities by shareholders who cannot rely on Rule 144. In addition, I would note that all of the securities eligible to be resold under proposed Section 4(a)(7) are securities that were originally issued to shareholders in transactions that were themselves exempt from Federal and State registration such as Rule 506 and Rule 701, which provides an exemption for shares issued under certain equity compensation plans.

I would like to note that the proposed legislation also includes important protections, such as that the shares may only be resold to accredited investors and remain restricted after the resale. The proposed legislation also requires verification of accreditation if general solicitation or advertisement is utilized.

Under the current outdated and inconsistent regulatory regime, founders, large angel investors, officers, and a large percentage of start-up employees are put at a legal and economic disadvantage in the post-JOBS Act world. In light of the fact that start-ups are estimated to create an average of 3 million new jobs annually, it is essential that the Federal and State regulatory framework continue to evolve to create an environment in which start-ups can flourish. And providing founders and angel investors greater facility to sell their shares means that more capital will become available to start new companies and create more jobs.

I would also like to note that we agree strongly with Chairman Garrett and support the goals of the draft on the proposed Reg D changes. And in summary, I would like to state that it is absolutely critical that we continue to address regulatory impediments around capital formation and job creation, such as those addressed by the proposed legislation.

Thank you again for the opportunity to participate this morning. I would be happy to answer any questions.

[The prepared statement of Ms. Tierney can be found on page 69 of the appendix.]

Chairman GARRETT. And I thank the gentlelady.

Next, Mr. Beatty from the State of Washington, who was already introduced by Mr. Heck. Welcome, and you are recognized for 5 minutes. Thank you.

STATEMENT OF WILLIAM BEATTY, DIRECTOR OF SECURITIES, SECURITIES DIVISION, WASHINGTON STATE DEPARTMENT OF FINANCIAL INSTITUTIONS, AND PRESIDENT-ELECT, THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

Mr. BEATTY. Thank you, Mr. Chairman.

Good morning, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. My name is Bill Beatty. I am the director of the Washington State Securities Division, and for the past 28 years have served as an attorney in the Division. I am also president-elect of the North American Securities Administrators Association (NASAA), the Association of State Securities Regulators. I have also served as chairman of NASAA's corporation finance section and as a member of the Special Committee on Small Business Capital Formation.

I am honored to testify to you today about proposals to enhance capital formation for small and emerging growth companies.

NASAA has two mandates: promoting grassroots investor protection; and promoting efficient capital formation. In fact, promoting capital formation is also a core mission of my securities department in Washington. We regularly meet with and assist small businesses to help them raise capital in our State.

NASAA shares Congress' goal to improve the economy by encouraging investment in small business. However, we believe this is best achieved through restoring investor confidence in the market. We want to bring investors back to the market, and we want to work with Congress to do so.

My written testimony discusses how States protect retail investors, assist local businesses to raise capital, and oversee small offerings. At the outset today, I want to address an apparent theme running through many of the bills we will discuss today. This is the myth that Federal preemption of State law is the most efficient and quickest way to promote capital formation.

As many of you may recall, on September 13, 2011, NASAA testified that States should play a leading role in establishing a new crowdfunding marketplace. Congress disagreed, and in April 2012 enacted a crowdfunding bill that broadly preempted State authority. At the time, NASAA was already developing a model crowdfunding exemption. This model rule would have been adopted by the third quarter of 2012.

When Congress preempted our authority in this area, our work on this model rule was deferred. Nevertheless, as I appear before you today, seven States have adopted intrastate crowdfunding exemptions, including my own State, and more than a dozen other States are considering similar exemptions. These actions decisively demonstrate that had Congress allowed the States to proceed, there could be a vibrant functioning crowdfunding market today.

Today, we are discussing a draft bill that may once again preempt States from playing a key role in another emerging area that encourages capital formation for small local businesses: Regulation A+. During the JOBS Act debate, we urged Congress to preserve our role as the primary regulator of regulation offerings. Congress agreed, and NASAA supported a GAO study of the factors that affected the use of Regulation A. We committed to address any factor that dealt with State blue sky laws.

Consistent with our goal of capital formation and our pledge to Congress, we undertook a thorough self-assessment of our Regulation A processes and examined blue sky concerns addressed by the GAO. We also solicited public comments and consulted numerous stakeholders, including the American Bar Association.

The culmination of this effort is the NASAA coordinated review protocol, a modernized, efficient system for Regulation A review. Filings are made with one program coordinator and distributed to the other participating States. Only lead examiners communicate with the applicant. Our process is complete 21 business days after the initial filing, assuming no deficiencies in the application and any delay in clearing an application is directly tied to the issuers' response time. Once lead examiners clear the application, the decision is binding on the other States. Our membership approved the new protocol, and as of today, 49 of 53 jurisdictions have implemented it by signing a memorandum of understanding.

We are excited about its potential to help small businesses in our communities. In short, the States are ready to go with Regulation A, provided Congress and the SEC don't short-circuit our efforts through preemption.

You requested that we comment on three draft bills. We are concerned about the overarching deregulatory nature of these bills. As I said, we wholeheartedly share your goal of assisting small businesses and spurring economic growth, but we believe that many of these bills move the goals in the opposite direction. Overregulation did not cause the collapse of our financial markets. America's capital markets are viewed as the gold standard because they are free, transparent, and responsibly regulated. This is the formula for economic growth and job creation.

My detailed comments on these bills are included in my written testimony, along with suggestions for how they might be improved. Some members of this committee requested our comments on related bills discussed in an April 9th hearing, and my written testimony offers brief comments on those, as well.

In conclusion, State securities regulators share your goals, and we appreciate your interest in our perspective. My hope, and NASAA's hope, is to work with Congress to pursue policy reforms that reflect smart regulation.

Thank you. I will be happy to answer any questions you may have.

[The prepared statement of Mr. Beatty can be found on page 32 of the appendix.]

Chairman GARRETT. Thank you very much.

Finally, last but not least, Mr. Lynn, CEO of Seedrs Limited. Good morning. Welcome. And you are recognized for 5 minutes.

STATEMENT OF JEFF LYNN, CHIEF EXECUTIVE OFFICER, SEEDRS LIMITED

Mr. LYNN. Good morning, Chairman Garrett, Ranking Member Maloney, and honorable members of this subcommittee. My name is Jeff Lynn, and I am the chief executive officer and cofounder of Seedrs.

I want to thank you for inviting me to testify today in connection with the discussion draft of the Equity Crowdfunding Improvement Act of 2014, which I will refer to as the "Improvement Act."

By way of background, Seedrs is one of the leading equity crowdfunding platforms in Europe. We launched in the United Kingdom in July 2012, and we opened to investors and entrepreneurs across Europe in November 2013. Since our launch, we have completed 92 financing rounds, with a total of approximately 8.4 million pounds, or $14.1 million, invested. We have financed businesses ranging from mobile app developers to theater productions to traditional manufacturers to financial services firms to a cheesemaker.

Seedrs is authorized and regulated by the U.K. Financial Conduct Authority. When we received our authorization 2 years ago, to our knowledge, we were the first equity crowdfunding platform anywhere in the world to obtain regulatory approval.

My own background is as a U.S. securities and corporate lawyer. I practiced with the international law firm of Sullivan and Cromwell in New York and London before founding Seedrs.

Seedrs conducts its activities under the laws of the United Kingdom. I have detailed in my written testimony how U.K. law applies to equity crowdfunding. And in the interest of time, I will say here simply that there is general consensus that the British approach represents a reasonable and workable balance between investor protection and commercial viability and that it is probably the best equity crowdfunding regime in the world today.

Turning to the United States, Title III of the JOBS Act provides the legislative framework for an equity crowdfunding regime here. I have come before you today because I believe, based on the extensive experience I have gained in the equity crowdfunding space, that Title III as enacted is an unworkable law that will stifle equity crowdfunding in the United States before it ever begins.

At the time the legislation which turned into Title III was first being discussed and introduced by Congressman McHenry and Congresswoman Maloney, my team and I actively considered bringing Seedrs into the U.S. market. As Title III emerged into its final form in the Senate, however, we decided not to enter the United States because we did not think it would be possible to conduct a viable equity crowdfunding business under the regime.

We would very much like to provide American entrepreneurs and investors with the opportunity to participate in this important and effective new form of finance, but we simply cannot do so under Title III as it now stands.

There are I believe five core problems with Title III, and the Improvement Act goes a long way toward addressing each of them. I do not have time to address all five of these issues in detail here, and for my views on the fundraising caps, the financial statement requirements, the maximum amounts that investors can invest, and curation, I would respectfully ask you to refer to my written testimony.

However, I do want to take this opportunity to address the final issue, which I believe is the most profound. Title III provides an exemption from the registration requirements of Section 5 of the Securities Act of 1933, but it does not address the equivalent provisions of the Investment Company Act of 1940. This means that while a platform may facilitate the direct issuance of shares by an issuer to investors under Title III, there is no scope for the platform to aggregate those investors into a special purpose vehicle or nominee structure.

While this may seem a technical point at first glance, it is actually one of the most important issues in equity crowdfunding. If a small, growing company issues shares directly to hundreds of individual shareholders, that poses significant risks both for the issuer and for investors. Such a structure can kill a company by preventing it from raising additional capital or being sold and it can deprive investors of the entirety of the appreciation to which they are entitled due to lack of critical contractual protections.

The solution to this problem is the use of aggregation, allowing all investors to be grouped together in one SPV or nominee structure. The Improvement Act proposes to include aggregation structures used for crowdfunding under the list of exemptions in Section 3(c) of the Investment Company Act. I believe this is a hugely important provision and is essential to making equity crowdfunding work.

To conclude, Mr. Chairman, equity crowdfunding has the potential to be a transformative tool for small businesses and for investors. If implemented correctly, it can create some of the most productive flows of capital an economy can ever see, bringing willing investors together to finance the businesses that will create the most jobs, wealth, and productivity.

However, this cannot happen if the regulatory regime is not fit for the purpose, which Title III simply is not. The Improvement Act makes significant strides in addressing the problems with Title III, and I believe that if this legislation is enacted in the form proposed, there is a substantially greater likelihood that equity crowdfunding will be able to flourish in the United States.

Mr. Chairman and members of the subcommittee, thank you for the opportunity to appear before you today, and I would welcome the chance to respond to your questions or to amplify or clarify these statements at any time.

[The prepared statement of Mr. Lynn can be found on page 59 of the appendix.]

Chairman GARRETT. I thank you, Mr. Lynn. And I thank the entire panel. We will now turn to questioning, so I recognize myself for 5 minutes.

I guess I will start with Ms. Tierney. Some of you folks got into this a little bit, but maybe you can dig a little bit deeper for me. Reg D, can you run down, however you want to explain it, some of the most troublesome, some of the most burdensome aspects of complying with the additional reg requirements that SEC is proposing with regard to Reg D?

Ms. TIERNEY. Of course. SecondMarket, as I noted at the beginning of my comments, is very active in the private company space. And we actually support a significant number of private companies raising capital under 506(b) and 506(c).

We know from our own experience as an issuer of an investment trust that is utilizing 506(c) that the facility to generally solicit has made it much simpler for us to get access to investors to whom we would not otherwise have access. So we think that the rules as currently in place work really well, but the proposed rules—I can tell you from experience—have created a real overhang on the market for other companies that want to utilize 506(c). And I think the most significant issues with the proposed rules, in my mind, are the multiple requirements to file Form Ds, an advanced Form D, the current Form D, and a final Form D.

An advanced Form D, as proposed currently 15 days in advance of filing, is completely unworkable for private companies. We raise money on a continuous basis. There is no start or stop. I think the proposed rules were really drafted for a Wall Street investment opportunity model, not the way that private companies in Silicon Valley—

Chairman GARRETT. Isn't there a—there has to be a start period, right, when you start doing it?

Ms. TIERNEY. My CEO, when we were a start-up, was constantly raising capital. He could be at a cocktail party—and I am sure you know this, as well—you are at a conference, you are anywhere and needing every single day looking for investors in your offering.

Chairman GARRETT. Okay.

Ms. TIERNEY. So it is continuous. To have to stop that for 15 full days and potentially trip it up is just unworkable. And I know that NASAA wrote a very good comment letter to the SEC, noting—I think, Bill, you didn't support the 15-day advanced filing. I think you came out at, if I recall, 2 to 3 days in advance. Is that right? But I know that the idea of any stop in capital raising is problematic for private companies.

I think also the concept of having to file a final Form D, whether or not you have raised capital, can be a death knell for private companies. Nobody wants to go out and tell people that they failed to raise capital. That is not a good message to send if you are a start-up.

And Form Ds are difficult to file. You have to file one with the SEC, and you have to file one in every State where you actually sell securities. And I know the States are working very hard to get a uniform Form D filing system in place, but that doesn't exist right now. And every State has a different approach to Form D.

Chairman GARRETT. Can you just go on to what Mr. Beatty was talking about as far as what they are trying to do in this area? Is that a solution to the problem or is the legislation a solution to the problem? Why is one better than the other, if it is, in your opinion?

Ms. TIERNEY. I think that a concept of filing one Form D in a consistent manner that would apply to every State in which you sell would be a massive step forward for Reg D filings. But having to do three of those—

Chairman GARRETT. Yes, I get that.

Ms. TIERNEY. —and having to file, I would assume, if the SEC adopts the proposed rules, that the States will follow and require that those additional forms be filed in every State, as well. So that is expensive. We have to pay our outside counsel to file these Form Ds for us—

Chairman GARRETT. So, in other words, even if the States do what Mr. Beatty was talking about and come up with a, sort of like a common multi-State arrangement is what you were suggesting there, that doesn't solve the problem, is what you are saying?

Ms. TIERNEY. I think it makes—it lessens the impact of the problem, but I think that my proposal and SecondMarket's proposal would be one Form D filing at the time that you commence capital-raising—

Chairman GARRETT. Okay.

Ms. TIERNEY. —not the form—not the 15-day after, not a final—

Chairman GARRETT. Got you.

Ms. TIERNEY. —so we would support one filing. I would support a filing that had to be done at the State level if it is consistent and a one-stop shop kind of approach.

Chairman GARRETT. We took all this time on this one question. So what about the 1-year suspension that—I will let you start, and then we will get—

Ms. TIERNEY. I think that is a death knell for private companies.

Chairman GARRETT. Why is that?

Ms. TIERNEY. Because people make mistakes. So if the rules were adopted as proposed, say you have a cease conversation for 15 days, but maybe your CEO says something by accident, and now you haven't filed your Form D 15 days in advance or you forget to file your final—there is a lot of—these are small companies. They don't have expensive outside legal counsel. They are trying to do this themselves, and people make mistakes.

The current requirements for Form D filings specifically state that the failure to file a Form D does not preclude you from relying on the exemption. To go from a structure where that is not a necessary item in order to comply with the requirement to you are out of the market for 12 months if you fail to file seems—I just don't understand how that is justifiable or how that helps the market.

Chairman GARRETT. Got it. My time has expired, but thank you for answering those couple of questions.

The gentlelady from New York is recognized for 5 minutes.

Mrs. MALONEY. Thank you to all of the panelists for your statements today.

Mr. Beatty, during the time that we debated the passage of the JOBS Act, there was a great deal of debate over the State securities laws, and should they be exempted for offerings under Regulation A? Some people argued that the burdens of complying with State regulations was one of the reasons why companies didn't use Regulation A anymore. And as many of us recall, we reached a deal on the Floor to remove most of the State preemption, although we allowed it in some circumstances.

Can you describe the work that the State securities regulators have done since the JOBS Act was passed to streamline their compliance for Reg A+ offerings?

Mr. BEATTY. Thank you, Congresswoman Maloney. Yes, we have done a fair deal of work—as some of it was highlighted in my oral comments—what we have done—we recognized, I think, that with the GAO study that we could be better at doing these types of offerings. We could be more consistent, we could be more timely.

We put in place a coordinated review system that, as I said, would result in the initial determination of clearance or need for additional work within 21 business days. This is something that we have signed an MOU on. We are committed to this. We believe this provides excellent service to the companies in our State and other States that want to raise capital.

I think that what has been described here by Mr. Miller and the fact that he had jurisdictions that understood what he was trying to do is an important concept. We understand what companies are trying to do when they raise capital in our States. We want them to succeed. We think it is very important.

The days of a regulator trying to find a way to deny offerings are over. We don't do that. We need these companies in our State. The system that we propose is very timely, it is a one-stop filing, and it is a filing that will be made via e-mail with our State initially. Eventually, it will go up on our electronic filing system that we are developing and will be available for Form D filings in November of this year.

This is something that, given the timelines—and I would note that at the back of my written testimony, we have the timeline laid out in a table that I think is pretty easily understandable. But quick decisions, decisions that are based on one set of guidelines, this results in certainty, I think, for the filers and is a good thing for the filers and is a good thing for the States.

Mrs. MALONEY. Can you discuss the areas where you think State security regulators can play a role that the SEC can't play? Is it mostly protecting the mom-and-pop retail investors or regulating small securities offerings?

Mr. BEATTY. I think we do both.

Mrs. MALONEY. What do you think you offer that the SEC does not offer?

Mr. BEATTY. I think we do—as the initial question—I think we do both. As I said, the mandate that I think most States have is to protect investors and foster capital formation in our States. I think the role that we can play that the SEC doesn't play is that we are local and we are available.

We understand that if somebody has a problem with an offering in our State, an investor, that the call was going to come to us, whether it is a Federal offering or a State offering, it is not going to Washington, D.C. We also understand that from the standpoint of an issuer, if there is a problem and we are deemed to be intransigent or otherwise not responsive to an issuer, that we are going to hear about it not only from the issuer, but probably from our governor, as well. So we are very responsive, and we understand the needs of these small companies.

Mrs. MALONEY. Okay. Ms. Tierney, could you talk about your company's experience in verifying that investors are, in fact, accredited investors? There was a lot of debate over accredited investors when we debated this earlier. And do you think it is important to require verification that an investor is sophisticated or an accredited investor before selling them an unregistered security?

Ms. TIERNEY. I apologize to Chairman Garrett for having to disagree on this point, but we do this for a business, so I have to be objective—or not objective. We have done a verification, I think, on about 1,200 to 1,500 investors, mostly in the context of angel companies raising company through 506(c) offerings.

There are some points of friction in the existing rules that create problems. For example, they are drafted for U.S. investors and don't anticipate foreign investors who can't provide a credit report. So there are some frictions that the securities bar is working through right now.

But I can tell you, from our experience, people have been generally willing to provide the information. We try to be rational and reasonable. We are a registered broker-dealer, so people know that their information is going to be safe.

Mrs. MALONEY. Very quickly, do you find that investors claim to be accredited investors when they are not? Do you have examples like that—

Ms. TIERNEY. We have found that, Representative Maloney. We have found that people—not a large percentage, I would say a very small percentage of angel investors who had done multiple angel investments based on checking a box on their accreditation questionnaire, when having to provide actual documentation weren't able to show that they had made $200,000. They weren't far off, but they weren't over the requisite threshold.

But I would say that the vast majority easily satisfy the rules. We have very few investors who come through who make $201,000 a year, so it is—but I know that a lot of investors that we are not seeing are saying that it is problematic for them to provide confidential personal information. So I think there are arguments on both sides.

Chairman GARRETT. Thank you.

Mr. Hurt, the vice chairman of the subcommittee, is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman. Thank you all again for your appearance and testimony today.

My question is for Mr. Miller and for Mr. Beatty. In talking about Reg A, I think the evidence is clear that historically only a limited number of issuers have taken advantage of the Reg A exemption for public offering stacks, that is public markets.

Mr. Miller, and then Mr. Beatty, why do you think it is that issuers have avoided using the Reg A exemption in the past? And do you believe—what do you think the effect would be of raising the exemption proffering from $5 million to $10 million? What benefit would that give to small companies looking to raise capital? And then from Mr. Beatty's standpoint, what are the investor protection concerns that are posed, if any?

Mr. MILLER. I think that the primary challenge with Regulation A is actually the speed. The first offering we did took us 9 months, and I had O'Melveny & Myers, former General Counsel of the SEC, actually leading the process with us. And that is—partly as a result of the fact that it is not frequently used, it is a very human process. People—the regulators aren't familiar with Regulation A. The regulators aren't familiar with real estate investment. And so, you have a learning curve.

And I do think that when you think about the process, the SEC spent 6 months, 9 months, 8 months in each one of our offerings, and I do sometimes wonder—the SEC obviously is sophisticated, knows what they are doing, has to do it multiple times. We did it basically 4 times, because each State is sovereign, although coordinated, and so there is a question of what does the additional—sort of basically repeating of the process—how does that benefit the investor? It doesn't necessarily benefit the fundraiser, even though the States are sophisticated in many cases.

The other issue is that we—it is not just—everybody focuses on preemption, but there are other requirements State by State. In Maryland, we had to file as an exempt broker-dealer. Each State has—there are a lot of rules beyond the ones we are focused on that each State requires. And so it is a patchwork quilt. It is very—and the Internet now makes it possible to raise nationally—so there is an efficiency that is possible nationally in order to get to scale that—I can imagine interfacing with—we had hundreds, we had hundreds of questions from the States, hundreds, about our offering, and if I were potentially getting questions from 50 State regulators, I can only imagine we would get more.

So I think that the question is, is the SEC, as a sophisticated body, not sufficient? Why would I need to do it twice, essentially? That is the question that I think needs to be addressed in this Regulation A preemption issue.

Mr. HURT. Thank you. Mr. Beatty?

Mr. BEATTY. I think, to answer your first question about why it wasn't—while Reg A was not used widely, I think it had to do partially with the offering amount. I think it had to do with—as Mr. Miller said—the speed associated or lack of speed associated with the review of the offering, particularly at the Federal level. I think that it was not used widely, at least in our area, in multi-State offerings, again, because it was not that large.

Also, at least in our area with our local bar, there was a perception essentially that perhaps because it wasn't used widely, that good companies didn't use Regulation A. And so they were reluctant to try and do a Regulation A offering. I don't know if that is pervasive throughout the country, but that is what our local bar told me when I asked them about it.

As far as the—I would note that the system that we have put in place would address many of the concerns addressed by Mr. Miller in terms of inconsistent State comments and those types of things. As far as the investor protection element, I think what States bring to the table is that, particularly for local companies, we know these people, we know what the issues are going to be, we are familiar with these companies, and we are better able to, perhaps, address some of the questions.

I see my time is running out, so I will conclude my remarks there. Thank you.

Mr. HURT. And then I guess my question—just going back to Mr. Miller for a second, so the JOBS Act, of course, increases the cumulative Reg A offerings by an issuer from $5 million to $50 million. Do you have a sense of what an appropriate threshold would be? And how—would increasing that further, would that aid a small business?

Chairman GARRETT. Very briefly.

Mr. MILLER. Yes, absolutely. I think that you will see small, regional investment banks actually enter the space of Regulation A where—and also start seeing real institutional block sales, if Regulation A becomes available at larger amounts.

Mr. HURT. Thank you. Thank you, Mr. Chairman.

Chairman GARRETT. I now recognize Mr. Scott.

Mr. SCOTT. Thank you very much. Thank you very much, Mr. Chairman.

I said in my opening statement that we need to look at the big picture of this, and where there are regulatory impediments, we need to really examine it. And, Ms. Tierney, I really think you have hit on something here with the 506(c) and the Form D. And I do notice, Mr. Chairman, on our memo, we do have a mention of that, but we don't have any sponsorship on it. I don't know if that could be incorporated in that.

But if so, I would be delighted to work with you on that, because, Ms. Tierney, I would like for you to go into a little more detail of exactly what we need to do, because I agree with you. If one form can do, and if these repeat forms of Form D is causing very difficult—a difficult obstacle to capital formation, then obviously we certainly need to address that. Mr. Chairman, I would like to work with you on that.

And with that, Ms. Tierney, can you just share with the committee what you actually would like to see us do, succinctly?

Ms. TIERNEY. I think that the absolute best outcome, in my mind, would be that every private company that is raising capital under 506 would file one Form D at the commencement of the offering to put the States on notice on which—whether they are using B or C, so that the States have the information they need to regulate fraudulent activity. Those forms will be filed one time, be available across all 50 States, say how much the intent was to raise, and potentially what the use of—the expected use of proceeds will be, but that would be it. And they would file that at the commencement of the offering. And then the States and the Federal Government would have the information they need.

Right now, you have to file a Form D at the point in time that you sell your first—from the first time you have somebody invest, you have to file a Form D 15 days after the sale with the Federal Government, with the SEC. Then you have to file a Form D in every single State where you sell. So you may sell one week to somebody in Utah and the next week to somebody in Washington State, so you have to file a form in every single State the first time you sell. That doesn't seem sensible to me. I don't understand why that is beneficial to the States, the SEC, or to investors.

Mr. SCOTT. And what does that cost the small business? What is the hardship there? Is there a cost?

Ms. TIERNEY. It is the cost of preparation. Not every State—it is a patchwork, as Ben and I have been saying. And I know the States are working hard to address that, but under the current regime, there are States that allow you to file a Form D electronically. There are States that require you to file in hard copy. There are States that require a fee that is significant. There are States with a minor fee. There is a fee in every State, I would note, so this is a cash-generating business for the State.

Mr. SCOTT. Could you share with us what that fee might be, if you have that knowledge?

Ms. TIERNEY. I am so sorry, Representative. I don't know off the top of my head.

Mr. SCOTT. Okay.

Ms. TIERNEY. I think it is as high as $2,000 in some States and as low as $100 in others, but you have to have—you really have to have either a registered broker-dealer or a law firm do this for you, or else you are going to get it wrong.

And the implications for doing it wrong under the proposed rules are that you can't rely on Reg D 506 for an entire 12-month period, which for a start-up means you are going to shut your doors and lay off all of your employees. That is just the reality of it.

Mr. SCOTT. That is something very reasonable I think that we could really look at, Mr. Chairman. The other point I wanted to raise with you, Ms. Tierney, in your testimony, you mentioned safe harbor. Could you share with us what—I was trying to follow you on that, but you were going very rapidly there. Tell us about the safe harbor.

Ms. TIERNEY. Of course. And I'm sorry I talk so rapidly, but I only get 5 minutes and I was watching the clock.

Mr. SCOTT. No, it is fine. It is more my not being able to keep up with you.

Ms. TIERNEY. Okay, thank you. So the way that the securities laws work around resales of private company stock under the current regime are there is a clear safe harbor under Section 41 of the 1933 Act, if you have held your common stock for 12 months. At the end of the 12-month period, you can sell into the market, you can sell to anyone, you can generally solicit. There are no restrictions whatsoever.

That exemption, however, is only available to shareholders who have held the stock for 12 months, and it is not available to offices or directors, founders, or large angel investors who have made sizable investments in the company, so more than a 10 percent ownership stake.

Then, you have publicly registered securities where people can sell as they will on the NYSE or on Nasdaq. So you have, in between those two events, this delta of shareholders and employees. Most of us working for private companies get a significant amount of our compensation in the form of options.

Mr. SCOTT. And so, tell us, how would you like to see this—what would be the best way of seeing this exemption applied?

Ms. TIERNEY. I think it would be a transaction exemption for resales of securities or founders, angel investors, employees who hold options. When we were working with the community banks, it is the officers and directors of community banks. They are middle-income Americans who just happen to work for a private company. They couldn't sell their securities without worrying about the State law.

And we have been working with NASAA on this issue. They are very well aware of our position. And I think we all have the goal of making capital formation and job creation simpler, and I think having to deal with the patchwork of blue sky law every time you go to sell securities in this delta shareholder group makes it extremely unworkable.

Mr. SCOTT. Thank you.

Ms. TIERNEY. And the implications are significant for private company shareholders.

Mr. SCOTT. Thank you very much.

Chairman GARRETT. Thank you. The gentleman yields back.

Mr. Mulvaney?

Mr. MULVANEY. With the permission of the Chair, I would like to yield my time to the gentleman from North Carolina.

Mr. MCHENRY. I certainly appreciate my colleague yielding.

And, Mr. Lynn, I wanted to talk to you about crowdfunding. As I stated in my opening statement, Carolyn Maloney and I worked diligently to make sure we had investor protection and the ability of folks to raise equity online.

You said that before the regulations were written, you viewed the law as "unworkable." Is that correct?

Mr. LYNN. That is absolutely correct.

Mr. MCHENRY. Okay, so describe to me how crowdfunding leaders around the world view the American crowdfunding equity law?

Mr. LYNN. I think that my view represents the consensus view, both outside the United States and inside, that Title III, no matter how it had been implemented by the SEC, simply wasn't going to work. I know many of my colleagues in Europe have made the same decision that we have not to look at the U.S. market as a result of it, and I know that many platforms in the United States that have relied solely on 506(c) or other forms of accredited investor only rules had initially considered using Title III, but upon seeing its final form, decided not to do so.

Mr. MCHENRY. Okay. So you mention also about the need for a special purpose vehicle. Explain how that actually lessens crowdfunding remorse, if you will, with investors and issuers.

Mr. LYNN. Absolutely. So one of the often misunderstood, but absolutely essential aspects of investing in a private company as opposed to a fully publicly traded company is that there are complexities around minority shareholder protections and other issues that get addressed by contract.

So when an angel or a venture capitalist invests in a start-up, they uniformly enter what is called either a shareholders' agreement or a subscription agreement, which sets out a series of protections for investors. That works perfectly fine when there are 2, 3, 5, or even 10 investors. When you have hundreds, though, the whole process falls apart, and you wind up with essentially the following scenario: No contract is entered into, the result of which is investors have effectively no protection against the various things that can happen to a minority shareholder in a privately held company, while at the same time the company is forced to deal with the administrative overhead and the liabilities that come from having hundreds of direct shareholders, making it significantly less likely that later, State investors will want to deal with them.

Mr. MCHENRY. Okay. So this idea of a special purpose vehicle is for investor protection?

Mr. LYNN. It is absolutely for investor protection.

Mr. MCHENRY. Okay. Now, the ability—the other question is for portals—the question of liability, sound liability provisions. I saw hundreds of comments about this with the SEC. Can you address that?

Mr. LYNN. I think that there are a number of issues around liability, the most important of which is that there needs to be a very, very clear delineation of where liability sits as between an issuer and a portal. One of the very frank aspects that makes working in European markets advantageous over the United States in many aspects of securities law is the lack of strike suits and the lack of frivolous litigation. When you are dealing with very small businesses, that becomes even more profound. That can be minimized significantly by making very, very clear what actions and what omissions a platform or an issuer can be liable for—

Mr. MCHENRY. But this is twofold. So the portal—if they remove someone because they believe they are fraudsters, would they be subjected to liability under the current law?

Mr. LYNN. Yes, sorry. That is right.

Mr. MCHENRY. Okay, so if they remove someone, they perhaps could be sued, right?

Mr. LYNN. Yes, sir.

Mr. MCHENRY. So it is a twofold, those coming and going, the liability provisions, right?

Mr. LYNN. It is. And that particular issue, which I have called curation, is one that comes up under the fact that portals are not allowed under the current law to provide investment advice, but that can very easily be construed and has been construed as preventing them from taking down businesses or refusing to deal with businesses that they feel may be fraudsters or otherwise inappropriate for their platforms.

Mr. MCHENRY. Thank you for your comments. Mr. Miller, we view you as the lone wolf of Reg A offerings in the United States. How many Reg A offerings were there in the United States in the year 2010?

Mr. MILLER. 2010?

Mr. MCHENRY. How about 2011?

Mr. MILLER. I think that over the last 3 years, there have been approximately 19.

Mr. MCHENRY. And how many of those are you responsible for?

Mr. MILLER. Three of them, approximately 20 percent.

Mr. MCHENRY. Okay. And what year were you the only Reg A offering in the United States?

Mr. MILLER. I believe in 2012, we were—

Mr. MCHENRY. 2012, okay. So prior to—it has been basically viewed as a dead letter of the law. Is that correct?

Mr. MILLER. Effectively.

Mr. MCHENRY. Okay. So thank you for mentioning that, but I do want to mention that in our view, you are the lone wolf in terms of your boldness for this. So, thank you, Mr. Chairman. And thank you.

Mr. MULVANEY. I yield back the balance of my time.

Chairman GARRETT. Thank you.

Mr. Carney is recognized for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman, and thank you to each of the witnesses for coming today.

I just have a couple of really quick questions. Just following up on Mr. Scott's line of questioning about the need to file in multiple States, Mr. Beatty, I thought there was an effort going on by the North American Securities Administrators Association to develop kind of a one-stop filing process. Is that not accurate?

Mr. BEATTY. That is completely accurate, Congressman. The States have been working diligently to establish what we call an electronic Form D filing system. It is in development right now. It is scheduled to go live in November of this year. It will allow one-stop filing. It will allow the payment of fees at one place. So I think the question about—or the concern about having to send paper filings to all 50 States will soon be a thing of the past.

I would also note that the Form D itself, it is an eight-page form. I think it has like 16 items on it. It is not a big form. I think—I heard Annemarie say that one filing as the commencement of the offering and why the States maybe need to see the filing. These forms are incredibly important for us to see early on, because we are the ones who get the questions from potential investors such as, "I got pitched this offering, and what do you know about it?"

And if we don't get the filing shortly before the offering starts, as we proposed in our comment letter, then what happens is, we are forced to say something like, we don't have any record of this filing. You should be careful and ask a lot of questions.

We don't know, quite frankly, whether the offering is a legitimate exercise by a company to try and raise capital privately or, God forbid, some scam artist out there trying to take somebody's money. So it is an incredibly important piece of information. It is a relatively small form. And we certainly would appreciate the opportunity to do that.

Mr. CARNEY. Do you have any sense of what—in this world we live in, it is kind of amazing that we wouldn't have that now. Do you have a sense as to what the timing of that is?

Mr. BEATTY. I am not sure I completely follow you, but—

Mr. CARNEY. The timing of the development of the one-stop—when will it happen?

Mr. BEATTY. Oh, in November of this year, it goes live. We have been working on it for a while, but in November of this year, it is scheduled to go live. It is on schedule to go live.

Mr. CARNEY. Okay. Let me use the remainder of my time to get any feedback from any of you. As you may know, I worked with Mr. Fincher, who was here a few minutes ago—he has since left—on the IPO onramp part of the JOBS Act. And I don't know if any of you have had any experience with that, but I would be interested in any comments that you might have about how the IPO onramp has worked in practice, whether you are aware of any intended or unintended consequences.

We know that the data shows that IPOs are up quite a bit. Now, Mr. Fincher and I are taking full credit for that, and everybody else who supported it, of course. Whether that is the reason, I am sure there are lots of different reasons, but just any thoughts that anybody might have on that?

And I guess, Mr. Beatty, if you think there are problems with that from your perspective. Ms. Tierney, I know you have some Blue Hen connections, so why don't we start with you?

Ms. TIERNEY. I am a proud Blue Hen. We are not a public company, but we work with a lot of private companies that go public. And almost every single one of them is utilizing the IPO onramp bill in order to facilitate becoming a public company.

Mr. CARNEY. Any feedback about which provision in particular has been most helpful?

Ms. TIERNEY. Again, not out of my own experience, but I think the ability to file confidentially is a huge benefit to private companies.

Mr. CARNEY. I have heard that from a lot of people.

Ms. TIERNEY. Yes—

Mr. CARNEY. There was a lot of—and, by the way, there was a lot of difference of opinion on that particular aspect of it, but that is the one thing that keeps coming back that has been really helpful.

Mr. Miller, you are shaking your head. Would you like to share some thoughts, as well?

Mr. MILLER. There is no doubt that is true. I have heard that from—I work with some public real estate companies and small public real estate investment trusts. And across-the-board, to be able to file confidentially, you can withdraw without basically having a punitive result in the market, it is very, very material to the consideration of going to the public markets.

Mr. CARNEY. Great. Mr. Beatty, any comments from the other side?

Mr. BEATTY. I think I would agree with my co-panelists about the feature, the confidentiality feature. It is the one that I hear about the most, as well. I think from a regulatory standpoint, we have some concerns, not just with that particular feature, but the trend for less transparency in the markets. We believe that—as mentioned in my opening remarks—the transparency is an important feature for our public markets and it is just one of the several things that we have seen that have kind of decreased that transparency.

How that will play out—we certainly haven't gotten any complaints about it or anything like that, but how that will play out long term does give me some concern.

Mr. CARNEY. All right. Thank you all very much for what you do. And thanks for being here today.

Chairman GARRETT. The gentleman yields back.

The gentleman from Texas, Mr. Neugebauer, is recognized.

Mr. NEUGEBAUER. Thank you, Mr. Chairman, for holding this important hearing.

Mr. Lynn, what I heard you saying is that basically, with Title III the way it is now, the crowdfunding is difficult. And I think you used the word "impossible."

Mr. LYNN. "Impossible" is the word I would use, sir.

Mr. NEUGEBAUER. And so the question is—a lot of times, we have good ideas that we get, really, from the private sector, and we massage them up here, and we try to codify them, and then we send them over to the Executive Branch and the Executive Branch massages them. And then when they come out the other end, they don't always end up being like we thought they were going to be.

So I think one of the questions I wanted to ask you is, when it comes to that section, was the structure of the law flawed? Or are the rules the problem? Or is it a little of both?

Mr. LYNN. I believe it was primarily the structure of the law in the form adopted by the Senate. While the version adopted initially by the House I think has been improved upon by Congressman McHenry's proposed draft, the core structure was there. By the time it came out of the Senate and went to committee, I think that was where the main failure was—the SEC rules could not have been saved, no matter what they said.

Mr. NEUGEBAUER. And so, basically what you think is that it is going to take a legislative fix and not necessarily an administrative fix?

Mr. LYNN. I think that is absolutely the case, and I can tell you, sir, that I have spoken with a number of staff members at the SEC who have, on an off-the-record or nonattribution basis, at least, acknowledged that they felt that their hands were tied in trying to address many of the concerns, because the legislation was written the way it was.

Mr. NEUGEBAUER. What would you say are the one or two most burdensome pieces of it, that really would have an impact?

Mr. LYNN. I think if I can identify the three top ones, it is the levels—the thresholds for financial statements. Financial statements are something of a red herring when you are dealing with very early-stage businesses. They don't say anything, because the company hasn't done anything yet. And requiring an audit or even an accountant review for very, very small businesses is hugely disproportionate and simply makes it impossible or virtually impossible for businesses to rely on.

I think the issue I addressed in Mr. McHenry's question regarding curation and the inability to select which businesses go on the platform in a subjective way is a huge flaw. And the points around the lack of ability to use an SPV or nominee structure is the third.

Mr. NEUGEBAUER. One of the things that I understand in the proposed rule is that, for example, if you own 20 percent of the company, you are subject to a look-back of 3 years of your personal tax returns. Is that necessary? And if I am part of a start-up, does that keep me from participating?

Mr. LYNN. I think it is one of a number of perhaps secondary-level burdens that is unnecessary. I think it is an example of the type of rule that was designed with much larger publicly traded companies in mind that simply does not apply or does not have a whole lot of utility when you are dealing with a "two man in a garage" start-up.

Mr. NEUGEBAUER. And, Mr. Miller, I was amused by your comment about the legal fees that small businesses are having to pay in order to come into compliance. Is that just because there is so much risk out there of—if you don't comply with all of the—if you don't check all of the boxes, is it the complexity? Or what do you think is driving most of that?

Mr. MILLER. I think it is primarily driven by complexity. You can be a software engineer or a bioscientist, but the regulatory knowledge to make sure that you maintain compliance—and in particular, if you want to grow—the compliance is critical to your next round, right? If you raised $500,000 and you violated securities law, your business is dead, even if it is successful in the underlying merits.

So the complexity is outside the knowledge base of a normal entrepreneur, and so you have to rely on legal counsel, and that basically—the complexity of the law and the number of regulators involved drives the amount of legal fees.

Mr. NEUGEBAUER. One of the things we hear from people all across the broad spectrum now about—in their businesses is the term regulatory risk, that—whether it is compliance or other areas of government—one of the things that is really stifling a lot of businesses is regulatory risk that is out there and how to price it into your product. Does anybody disagree that there are regulatory risks that have increased over the last few years?

Ms. TIERNEY. I would completely agree. For a long period of my career, I was involved in taking companies public in the United States. This is the first job I have had where I worked for a private company and worked with private companies. And in the time that I have been a securities lawyer, the scales have tipped. There are not a lot of good reasons to be a public company in the United States of America right now when you do a cost-benefit analysis around the risk, the costs, and the burdens of being a public company.

There are a lot of good reasons to go public that will always be there, but I think for a lot of private companies, with the facility now offered with the 2,000 registration threshold and the ability to more easily raise capital under Reg D, under 506, they are really going to be deferring those IPOs for a very long time. And I think that is the right regime, but it is sad to me as a former SEC attorney and an NYSE attorney just to see companies not want to go public.

Chairman GARRETT. We are going to have to—

Mr. NEUGEBAUER. Thank you.

Chairman GARRETT. We are going to have to cut it there. And we will have, I think, our last word on it. Mr. Kildee, you are recognized for 5 minutes.

Mr. KILDEE. Thank you, Mr. Chairman.

I will be brief. I was talking to Mr. Carney, and I just want to say, I don't know what a Blue Hen is, except that I know that I have never been served one. I assume that they are very good.

Ms. TIERNEY. You are missing out.

Mr. KILDEE. I will just have one question. If it is redundant, if it has already been asked, I apologize for that. But I would just like to follow up on some of the comments that I made in part I one of this hearing that was held earlier this month, that while these proposals ostensibly are intended to increase capital formation for small and emerging companies, we have yet to fully realize the impact of the JOBS Act. Trends in the future may prove that there are some shortcomings in the JOBS Act, for which a cohesive legislative fix might be required, but now the House would have to address this with a legislative solution.

Specifically, though, I am interested in the area of capital formation. It seems like to me, anyway, the mortgage market, in ensuring that people have the ability to purchase a home, might be a better place to start this conversation. And if we are looking to have additional sources of capital for small and emerging companies, we might focus on reauthorization of the Ex-Im Bank, which I know in my State has been a really significant player in helping to get small companies moving and to reach additional markets.

But my main concern with these proposals and the ones from today and earlier this month is that they specifically, in some cases, preempt State regulator oversight. And specifically, just the other day, we had SEC Chair White here and we had, I think, a good exchange. But one of the questions that I posed to her and that I am concerned about is that we have the SEC that is already fairly thinly stretched.

And with increasing obligations continuing, we could have a debate about whether those obligations are appropriate, and we have had a substantial debate on that subject, but I don't think we should try to dial back on whether the regulations in place should be enforced by limiting the resources. But I am concerned about the sort of combined effect of reducing State regulatory responsibility or roles in this particular space while we have an SEC that seems already challenged in meeting its obligations.

Starting with Mr. Beatty, I would certainly like to get your observations, but if the rest of you could also make a comment, I would certainly appreciate it. And that would be the only question I would have today.

Mr. BEATTY. I share similar concerns. I note that there was a recent BNA article that talked about Regulation A+, and it noted that the—I am sure I have the number wrong—but the average review time for a Reg A offering before the SEC was something in the—over 100 days, anyway.

We are proposing with our Reg A coordinated review proposal to have an initial decision back to the issuer within 21 business days. So I think we share your concern about diminishing resources. A strong and healthy SEC is important, but we also think that we have something to bring to the table, and that this is not the time to take regulators off the table in terms of providing services.

Mr. MILLER. We have proposed to the SEC that for the offerings below $5 million, they actually would leave it to the States, rather than requiring the SEC and the States for an offering that is less than $5 million under Regulation A. And as a proposal, it would lessen the burdens on the SEC, while giving the States a purview to succeed inside, I think, what would be more likely a smaller local offering of less than $5 million.

Mr. LYNN. I think—if I could just take a slightly different view, I have no doubt that in many ways individual State regulators may be more efficient or more effective than the SEC. The problem is that a majority of offerings, particularly—I appreciate real estate may be a bit different—for small and growing businesses, the fact that they are small does not correlate with them being local. They tend to have Internet-based offerings, supporters, and people who want to invest in them from across the country, and often internationally.

And I think that the more barriers you put up and the more differentials you put up across borders, the more difficult that becomes. Whether the locus of regulation sits in one or the other, I think, is less of an important question than whether we are dealing with potentially 50 different, slightly altered regulatory regimes versus a unified one, and I think that if we get into that situation, that is the real problem.

Chairman GARRETT. And having had the last word, Mr. Lynn, I thank you, and I thank the entire panel for all your very good testimony. It was very helpful, both your written testimony and the testimony today. And I thank the members of the subcommittee.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

With that, again, I thank the panel and wish you a good day. And this hearing is adjourned.

[Whereupon, at 11:05 a.m., the hearing was adjourned.]

A P P E N D I X

May 1, 2014

Written Testimony of William Beatty

Washington Securities Division Director and

President-Elect of the North American Securities Administrators Association, Inc.

House Committee on Financial Services

Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on "Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies, Part II"

May 1, 2014

Introduction:

Good Morning Chairman Garrett, Ranking Member Maloney, and members of the Subcommittee. My name is Bill Beatty. For the past 28 years, I have worked as an attorney in the Securities Division of the Washington State Department of Financial Institutions, and since 2010 I have served as the Department's Securities Director. I am also the President-Elect of the North American Securities Administrators Association, Inc. ("NASAA"),[1] the association of state and provincial securities regulators. Prior to my election to be NASAA President, I served as the Chairman of NASAA's Corporation Finance Section, and as a member of NASAA's Special Committee on Small Business Capital Formation.

I am honored to testify before the Subcommittee today about legislative proposals to enhance capital formation for small and emerging growth companies.

State securities regulators have protected Main Street investors for the past 100 years, longer than any other securities regulator. Ten of my colleagues are appointed by Secretaries of State, five are under the jurisdiction of their states' Attorneys General. Some, like me, are appointed by their Governors and Cabinet officials and some of my colleagues work for independent commissions or boards. We are responsible for enforcing state securities laws by pursuing cases of suspected investment fraud, conducting investigations of unlawful conduct, licensing firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, and providing investor education programs and materials to your constituents.

States are also the undisputed leaders in criminal prosecutions of securities violators. In 2012 alone, state securities regulators conducted nearly 6,000 investigations, leading to nearly 2,500 enforcement actions, including 339 criminal actions. Moreover, in 2012, 4,300 licenses of brokers and investment advisers were withdrawn, denied, revoked, suspended, or conditioned due to state action. State securities regulators continue to focus on protecting retail investors, especially those who lack the expertise, experience, and resources to protect their own interests.

In addition to serving as "cops on the beat" and the first line of defense against fraud, state securities regulators serve as the primary regulators of most small size offerings. As such, state securities regulators regularly work with and assist small and local businesses seeking investment capital. Moreover, state securities regulators, acting within NASAA, have a long history of working closely with the U.S. Securities and Exchange Commission ("SEC" or "Commission") to affect greater uniformity in federal-state securities matters, including meeting annually as required by section 19(d) of the Securities Act of 1933.

State securities regulators share Congress' desire to improve the United States economy by, spurring private investment for small businesses. However, we believe this goal is best achieved through restoring investor confidence in the markets and market participants, and it is our hope that

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. (NASAA) was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

Congress and the state securities regulators can work together to pursue balanced and sensible policy reforms that reflect smarter regulation.

State Regulators and Small Business Capital Formation

State regulators provide a level of accessibility to local small business issuers and investors that is unavailable from the Commission. For example, the Washington Securities Division routinely presents to entrepreneurs, small business development centers, and other local groups regarding vital information that businesses need to know if they are contemplating raising capital. We provide this assistance through all stages of a growing company's business operations, from formation through the issuance of securities, and helps to ensure that small businesses have access to the capital needed to start or grow their business in a manner consistent with both state and federal regulations.[2]

State securities regulators are accountable to residents of their states, including both investors and local businesses that seek to raise capital. This accountability factors into our review of applications for registration, including the adequacy of disclosures to prospective investors. We must answer questions from investors, businesses, local legislators, and the local media regarding offerings that have been registered, as well as those that have not been granted registration. Such a level of accountability is essential to investor protection in these smaller public offerings.

States Are Leaders in Modernizing Capital Formation

My testimony today discusses in considerable detail the important role states play in protecting retail investors, working with emerging and local businesses to help them raise investment capital, and providing oversight of small sized offerings. However, at the outset of my testimony, I would like to address one of the apparent themes running through a number of the bills before the Subcommittee today, which is the notion that federal preemption of state law is the most direct and expeditious way to promote capital formation. As state securities regulators have testified in the past, and as I believe the implementation of the JOBS Act has perhaps underscored, this is simply not true.

Two areas where states have undertaken actions that illustrate this point relate to legislation pending before the Subcommittee today. While I discuss this more extensively later in my testimony , I want to state at the outset that these serve as concrete examples of states' initiative and capability, and of the potentially severe and counterproductive impact of federal preemption.

(1) Crowdfunding

One of the discussion drafts before the Subcommittee today would make substantial revisions to the federal exemption for crowdfunding, enacted under Title III of the JOBS Act.

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[2] For example, a group of local businesspersons from a small town in Washington contacted our staff to discuss requirements for raising capital before filing with the Division. Our staff regularly corresponded with these individuals and when they subsequently filed their application for registration, our staff reviewed the company's offering materials to ensure that all material information was disclosed and that the offering was not abusive of investors. We registered the offering within three months of filing the application and the company successfully raised over $650,000 from Washington investors. It is doubtful that this issuer would have received the same level of support and attention from Commission staff in Washington, D.C.

As some members of the Subcommittee may recall, on September 13, 2011, NASAA testified that states should be permitted to play the leading role in establishing a new marketplace for raising capital through crowdfunding.[3] Congress disagreed, and in March of 2012, enacted a federal crowdfunding bill that broadly preempted state authority.

At the time the JOBS Act was enacted, NASAA was in the midst of promulgating a model crowdfunding exemption. The NASAA model exemption, which was drafted by a NASAA committee comprised of regulators from seven states, and on which I served, was broadly supported by state regulators.[4] In December 2012, NASAA estimated that the model rule was on course to likely be finalized and adopted by the third quarter of 2012.[5]

The enactment of the JOBS Act unfortunately precluded the states from playing a leading role in crowdfunding; following enactment of the law work on the NASAA model rule was deferred. Nevertheless, as I appear before you today, seven states have adopted crowdfunding exemptions under the intrastate offering exemption of the Securities Act of 1993, and more than a dozen other states are actively considering adopting exemptions to facilitate crowdfunding. *Such actions demonstrate decisively that, had Congress allowed the states to proceed with our efforts, there would be an emerging, vibrant, and functioning crowdfunding market operating today.*

(2) Regulation A+

A second discussion draft before the Subcommittee addresses Regulation A Plus, which, like crowdfunding, is awaiting the completion of rulemaking by the SEC.

During Congress' consideration of the JOBS Act, state securities regulators urged Congress to preserve the states' role as primary overseers of Regulation A offerings. Congress concurred, and NASAA agreed to support a proposed Government Accountability Office ("GAO")[6] study of impediments

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[3] Testimony of A. Heath Abshure, Arkansas Securities Commissioner and Chairman of the Corporation Finance Section Committee North American Securities Administrators Association, Inc. before the House Subcommittee on Capital Markets and Government Sponsored Enterprises at a hearing entitled "Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation." September 21, 2011.
http://financialservices.house.gov/uploadedfiles/092111abshure.pdf

[4] As then-NASAA President Jack Herstein explained in a letter to House Financial Services Committee:
"On October 18 [2011], NASAA's Board of Directors met in Washington and voted to establish a special Small Business Capital Formation Committee to examine and propose steps that may be taken collectively by state securities regulators to promote and facilitate the formation of small business capital. I have directed that the Committee's first order of business be the development of initiatives, including a model rule, which state securities regulators may adopt to responsibly encourage small business capital formation through crowdfunding... In the case of crowdfunding, state securities regulators are not only capable of acting, but indeed, are acting, and Congress should allow them the opportunity..." See Letter from NASAA President Jack Herstein to the Chairman and Ranking Member of the House Financial Services Committee. October 21, 2011. http://www.nasaa.org/wp-content/uploads/2011/07/2930_Letter102111.pdf

[5] When the JOBS Act was enacted on April 5, 2012, NASAA's model crowdfunding rule was in the midst of an internal comment period. Following the completion of such comment period, the model would have been posted for public comment for a period, after which a final rule could have been adopted by NASAA.

[6] U.S. GOV'T ACCOUNTABILITY OFFICE, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS, GAO-12-839 (2012).

to the use of Regulation A, and committed to undertake concrete steps to address any impediments associated with Blue Sky laws.

Consistent with our desire to promote capital formation in our communities and our pledge to Congress to promptly undertake steps to remedy inefficiencies in the state processes for reviewing Regulation A offerings, state securities regulators conducted a thorough self-assessment of existing state processes and examined the concerns expressed in the GAO's study of offerings conducted under current Regulation A. In 2013, NASAA commenced a year-long effort to address inefficiencies in the state review process while continuing our essential mandate of protecting investors. As part of this process, NASAA consulted numerous stakeholders, and solicited public comments.[7]

The culmination of the states' effort to modernize our processes for reviewing Regulation A offerings is the NASAA Coordinated Review Protocol.[8]

Under the new Protocol, Regulation A filings will be made in one place and distributed electronically to all states, and "lead" examiners will be appointed as the primary point of contact for both the disclosure and merit review states. Each state in which registration is sought is permitted ten business days to review an application for registration and submit comments or concerns to the lead examiners, but the lead examiners alone will interact with the issuer to resolve any deficiencies, streamlining the process Importantly, once a lead examiner clears the application, the decision is binding on all other states.

The NASAA Coordinated Review Protocol has been approved by the NASAA membership and 49 of 53 NASAA jurisdictions have implemented the Protocol by signing the requisite memorandum. We are excited about the new Protocol, and its potential to help small and emerging businesses in our communities.

In short, with respect to the implementation of Regulation A Plus, the states are ready-to-go, provided that Congress and the SEC don't short-circuit our efforts by preempting our role.

NASAA Comments on Three Legislative Proposals Before the Subcommittee

The Subcommittee has requested that NASAA comment on three draft legislative proposals intended to promote capital formation and reduce unnecessary regulatory burdens, and NASAA's views regarding the impact (or lack thereof) that the enactment of such proposals may have on the economy and the capital markets. The three proposal are: (1) discussion draft legislation proffered by Representative Patrick McHenry of North Carolina entitled "The Startup Capital Modernization Act of 2014"; (2) discussion draft legislation proffered by Rep. McHenry entitled "The Equity Crowdfunding Improvement Act of 2014"; and (3) a discussion draft, without an identified sponsor, "to direct the

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[7] In designing the Coordinated Review Program and its protocols, members of NASAA's Small Business/Limited Offerings Project Group met with and collected feedback from the American Bar Association's Business Law Section's working group on Section 3(b)(2) offerings. We also engaged and received detailed comment from stakeholders such as the Biotechnology Industry Organization (BIO).

[8] The full text of the NASAA Multi-state Coordinated Review Protocol may be found on the NASAA website at www.nasaa.org. Please see Addendum #1 for an illustrated guide outlining the NASAA Multi-state Coordinated Review Protocol.

Securities and Exchange Commission to revise its proposed amendments to Regulation D, Form D, and Rule 156, as contained in Release Number 33-9416."

State securities regulators are broadly concerned about the overarching deregulatory nature of these proposals, the primary impact of which would be to weaken various federal securities laws and reduce state and federal oversight of initial public offerings and small public companies. While we wholeheartedly share the Subcommittee's stated goal of promoting capital formation, assisting small businesses, and spurring economic growth, we believe that many aspects of the drafts before the Subcommittee today would shift policies in the wrong direction. Over-regulation did not cause our financial markets to collapse. A weakened regulatory system has not contributed to our capital market system being viewed as the "gold" standard. Investor confidence in our system is what fuels economic growth and job creation.

I. Comments on Discussion Draft Legislation entitled "The Startup Capital Modernization Act of 2014"

The overall impact of the Startup Capital Modernization Act of 2014 would substantially and further weaken investor protections, in several important ways.

Preemption of State Authority to Review Regulation A Offerings

Securities offerings must either be registered with the appropriate government authorities or be subject to an available exemption from the registration requirement. Offerings under federal Regulation A have long been capped at $5 million. Title IV of the JOBS Act directed the SEC to adopt rules to provide an exemption from the registration process for certain offerings up to $50 million. Due to its similarity to the current Regulation A, this new exemption is commonly referred to as Regulation A+. These offerings will be exempt from SEC registration under the new Section 3(b)(2) of the Securities Act of 1933, but will be subject to registration at the state level unless listed on a national securities exchange or sold to "qualified purchasers" as that term is defined by the Commission.

The proposed Startup Modernization Act would raise the offering limit of "traditional" Regulation A from $5 million to $10 million and expand the scope of possible state preemption.

Given the inherently risky nature of the offerings, and the primacy of the states' role in policing small offerings, NASAA believes that state oversight is critically important for investor protection and responsible capital formation. As I recently explained in a comment letter filed with the Commission regarding Regulation A offerings:

> State regulation [of Regulation A offerings] is essential to capital formation and investor protection in these offerings. Given the relatively small size of these offerings and the low probability of attracting the attention of national broker-dealers to distribute them, these offerings are likely to be local in nature. Companies that are successful in raising funds in Regulation A offerings will likely be raising funds from local investors who have some level of familiarity with the company and/or its promoters.
>
> State regulators provide a level of accessibility to local small business issuers and local investors that is unavailable from the Commission. In addition to responding to inquiries from local investors questioning the legitimacy of offerings, state regulators regularly field inquiries from

entrepreneurs, small business owners, and local counsel regarding options for raising capital. We are easily accessible via telephone, e-mail, and even provide in-person consultations. This assistance is provided through all stages of business operations, from formation through issuance.[9]

At the same time, state securities regulators also understand that that dealing with multiple states may be burdensome for some small companies. As explained above, over the past 18 months, in anticipation of the SEC's implementation of Title IV of the JOBS Act, states, working within the framework of NASAA, have successfully undertaken unprecedented steps to modernize and streamline our processes for reviewing Regulation A offerings.

State regulators want offerings under the new Regulation A+ to be an attractive alternative to offerings conducted under Rule 506 of Regulation D. Although the GAO did not single out Blue Sky laws as the sole or even the primary reason for disuse of Regulation A,[10] we recognize that Regulation A+ will involve larger and more broadly dispersed offerings that elevate the need for uniformity in the states' rules. [11] For that reason, NASAA undertook a year-long effort to address and respond to the points raised in the GAO report. The result was a new coordinated filing and review program created with active industry input.

The states embraced this opportunity for change and modernization and voted overwhelmingly in March to support the NASAA Coordinated Review Program for Regulation A offerings. Within three weeks of approving the program, nearly all U.S. NASAA members officially signed a Memorandum of Understanding demonstrating their agreement to participate, signaling broad support for the program.

NASAA will continue to work with all of its U.S. members over the coming weeks to secure additional approvals and to deploy the program so that issuers may begin realizing its benefits.

The Coordinated Review Program for Regulation A offerings will provide greater efficiencies in the state review process, maintain important investor protections, and facilitate responsible capital formation.

NASAA's Coordinated Review Program for Regulation A offerings

With the potential for more Regulation A offerings as a result of the JOBS Act, we understand that the creation of an efficient filing and review process for multi-state securities offerings is critical. NASAA has designed and is ready to implement a streamlined multi-state review program for Regulation A filers. Key features of this process include:

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[9] Comment letter from William Beatty. Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act; Release Nos. 33-9497, 34-71120, 39-
2493; File No. S7-11-13). March 24, 2014. http://www.sec.gov/comments/s7-11-13/s71113-76.pdf

[10] According to the GAO Report, "Multiple factors appear to have influenced the use of Regulation A[, including] the type of investors businesses sought to attract, the process of filing the offering with SEC, state securities laws, and the cost-effectiveness of Regulation A relative to other SEC exemptions." Id.

[11] United State Government Accountability Office Report to Congressional Committees, Securities Regulation: Factors That May Affect Trends in Regulation A Offerings, July 2012.

- The program coordinator will be the State of Washington. Issuers desiring coordinated review will email an electronic copy of the application and required exhibits to Washington.
- The program coordinator will distribute the documents to states selected by the issuer on the application form.
- An electronic filing system is under development and is scheduled to be available for Rule 506 offerings in November of this year. Once operational, the system will be expanded to accommodate Regulation A and other filings. This one-stop electronic filing system will take the place of the email based system described above.
- Timelines for review:
    - Within three days after receipt of the application the program coordinator will select two lead examiners—one for merit review and one for disclosure review.
    - No later that ten business days after the lead examiners are selected, they will drat and circulate a proposed comment letter to the other participating states.
    - The participating states the have 5 business days to communicate any suggested changes to the lead examiners.
    - Within an additional 3 business days, the lead examiners will finalize the initial comment letter and send it to the issuer. If there are no comments, the offering will be cleared, 21 business days after filing.
    - If there are outstanding deficiencies, the lead examiners will work with the issuer and participating jurisdictions to get them resolved. Whenever the issuer files a response to any deficiency, the lead examiners will reply within 5 business days.

  On the day the lead examiners clear the offering, all participating states will clear the offering.

- Adjustment of NASAA Statements of Policy for Regulation A filers. Merit states use various NASAA Statements of Policy (SOPs) to review offerings. In response to comments NASAA received from representatives of issuers, NASAA has made adjustments to these policies to better accommodate Regulation A filers. For example:
    - The SOP regarding promoter's equity investment requires promoters contribute a certain percentage of capital to the issuer. This helps align the interests of the promoters with those of the investors. Recognizing that promoters contributions to small business typically consist of "sweat equity" or other non-monetary contributions and that such contributions are difficult to value, this SOP will not be applied to Regulation A offerings.
    - The SOP regarding Promotional Shares requires that some discounted shares acquired by promoters with 5 years of the offering escrowed or subjected to a lock-in agreement. The maximum period for this lock-in or escrow is 5 years. These requirements will be modified for Regulation A filers to allow half of the escrowed

shares to be leased after one year, with the remainder to be released at the end of year two.

State regulators have particular strengths that uniquely qualify us to effectively oversee Regulation A+ offerings. As noted, we are geographically close and accessible to both investors and local businesses, putting us in a better position than the Commission to communicate with them about the offering to prevent abuse and improve the overall quality of the deal for investors and business alike. Our proximity to investors also puts us in the best position to deal aggressively with securities law violations when they do occur.

We cannot do our job – protect investors or help small businesses access capital and grow their companies – where Congress attempts to prohibit our review, as contemplated by the discussion draft proposal.

Exclusion of Regulation A-acquired securities from the reporting thresholds of the Securities Exchange Act of 1934

Under Section 4 of the discussion draft, holders of securities acquired pursuant to both 3(b)(1) and 3(b)(2) offerings would be excluded from the definition of "holders of record" for purposes of triggering the mandatory reporting requirements of the Securities Act of 1934. The JOBS Act increased the threshold for the 1934 Act ("'34 Act") reporting from 500 to 2,000 shareholders and excluded investors in crowdfunding offerings from this calculation. This proposal would expand the category of excluded investors by defining "holder of record" to exclude Regulation A and Regulation A Plus investors.

One of the fundamental tenets of securities law is that an investor is protected when the seller of securities is required to disclose sufficient information so that an investor can make an informed decision. Sufficient information also encourages a robust, transparent and legitimate secondary market. Section 12(g) of the '34 Act was enacted to ensure that as companies grew in size and complexity, so did their investor disclosures. Rather, companies could not avoid becoming public reporting companies once their shareholder base reached a certain threshold (currently, 2,000 shareholders, and over $10 million in total assets). Requiring companies of this size to become public reporting companies ensures that investors have sufficient information to make informed decisions.

Already the current "holder of record" definition creates confusion and allows many small and large private companies to avoid reporting requirements by creative shareholder recording methods. For instance, the current "holder of record" (or, rather holder of title) definition bears little correlation to actual shareholder qualifications as most shareholders rely on brokers, banks and other intermediaries to conduct transactions on their behalf. These "title" holders bear little resemblance to the actual "beneficial owner" of the shares.

Investors should be entitled to the same disclosures (current, quarterly and annual reports, audited financial statements, insider transaction notifications, etc.) from all companies meeting the shareholder threshold requirement regardless of the use of intermediaries. Excluding Regulation A, A Plus and crowdfunding investors from the calculation of "holder of record" will encourage companies to remain private and reduce the amount of information available to investors in the primary and secondary marketplace. This was not the intention of Section 12(g), and arguably not the intention of

Congress which has been actively seeking to increase the number of companies conducting IPOs and participating in the public marketplace.

Finally, unaccredited, retail investors that are participating in Regulation A or crowdfunding offerings are most directly impacted by a lack of sufficient information about small businesses and startup companies in which they are investing. These investors would benefit the most from reporting company disclosures—particularly when they are attempting to sell their shares in the secondary market. Not including these investors will also be difficult and time-consuming for issuers from a logistical standpoint as companies will need to track beneficial holders, title holders and shares held in a street name, stocks sold in the secondary market, etc. Expending resources on this exercise cannot be in the best interest of companies trying to raise capital and create jobs.

Secondary Market Sales to Accredited Investors

Section 5 of the proposal would add a new transactional exemption in Section 4 of the 1933 Act ("'33 Act") for secondary market sales by any person other than an issuer, underwriter, or dealer. Purchasers must be accredited investors and general solicitation would be permitted provided the seller took reasonable steps to verify that the seller meets the definition of an accredited investor. Securities acquired under this new exemption would be considered securities acquired in a transaction under section 4(a)(2) of the Securities Act and, therefore, like rule 506 offerings, preempted from state registration. In sum this exemption would allow an individual investor to resell securities to any accredited investor in a preempted securities transaction. While NASAA is sensitive to the desire for increased liquidity for holders of unlisted securities, we believe that investor protection may be significantly compromised by this proposal.

Exempt transactions are subject to the antifraud provisions of the Securities Act which generally make it unlawful to offer or sell a security without fully disclosing all material facts. With respect to nonpublic companies, we are concerned that it will be very difficult for a selling security holder to obtain and provide to a purchaser the information required to fulfill this requirement. Traditional sources of information such as 10-K and 10-Q reports would be unavailable. The disclosure document the selling security holder received when he/she acquired the security will likely be significantly out-of-date. The issuer may not have, or be willing to reveal, material information about the company to a purchaser that it is not familiar with.

II. Comments on Discussion Draft Legislation entitled "The Equity Crowdfunding Improvement Act"

During the debate surrounding the JOBS Act, NASAA asked Congress to leave the regulation of small investments in small companies to the states because the federal government has neither the inclination nor the resources to regulate effectively in this area. In testimony during consideration of the Act, we stated:

> NASAA firmly believes that the states should be the primary regulator of small business capital formation, including crowdfunding offerings. Based on the small size of the offering, the small size of the issuer, and the relatively small investment amounts, it is clear that the states have a more direct interest in these offerings. The states are in a better position to communicate with both

> the issuer and the investor to ensure that this exemption is an effective means of small business capital formation. The states will be most familiar with the local economic factors that affect small business and have a strong interest in protecting the particular investors in these types of offerings. Further, requiring the SEC to regulate these small, localized securities offerings is not an effective use of the agency's limited resources.[12]

Before the JOBS Act was even introduced, three states allowed crowdfunding in intrastate offerings,[13] and during the debate on the Act, NASAA was working on a model exemption that would apply to multi-state offerings. The model rule envisioned a one-stop filing mechanism and the application of uniform review standards. Unfortunately, those efforts were halted when Congress enacted a federal exemption for crowdfunding that preempted state authority.

Ironically, many crowdfunding advocates that have grown frustrated with the pace of federal rulemaking and, in some cases, dissatisfied with the federal exemption itself, are again seeking state-level crowdfunding exemptions. Bills have been introduced in over 20 states—and have passed in 7 states—to allow intrastate offerings that involve equity crowdfunding.[14] A number of other states are considering this type of legislation. This underscores why Congress should let the states innovate and be creative in striking a reasonable balance between investor protection and capital formation for smaller offerings.

The JOBS Act was enacted into law on April 5, 2012. Title III allows issuers to raise no more than $1 million per year through the new crowdfunding exemption and limits individuals from investing no more than $2,000 or 5-10% of their annual income, whichever is greater, per year, based on applicable net worth and income thresholds.[15] While much of the new federal crowdfunding structure and compliance requirements were articulated by Congress in the JOBS Act itself, the SEC was given 270 days to promulgate rules to implement the new offering exemption. The SEC released their rule

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[12] Written Testimony of Jack E. Herstein, President of the North American Securities Administrators Association, Inc. and Assistant Director of the Nebraska Department of Banking & Finance, Bureau of Securities before the Senate Committee on Banking, Housing, and Urban Affairs at a hearing entitled "Spurring Job Growth Through Capital Formation While Protecting Investors." December 1, 2011.
http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=255a1e89-30b9-4036-9560-b4a0db5def80

[13] Two states – Kansas and Georgia – adopted exemptions before the JOBS Act was even introduced. See the "Invest Kansas Exemption," Kan. Admin. Reg. 81-5-21 (adopted Aug. 12, 2011) and the nearly identical "Invest Georgia Exemption," Ga. Rule 590-4-2-.08 (adopted Dec. 2012). Idaho adopted an exemption by order on January 20, 2012, which imposes similar conditions upon crowdfunding as the Kansas and Georgia regulation.

[14] As of May 1, 2014 the following states have passed equity crowdfunding bills into law: Alabama Act No. 2014-376 (bill SB 44) became law on April 8, 2014; Indiana Public Law 106 (bill SB 375) became law on March 25, 2014; Maine Chapter 452 (bill LD 1512) became law on March 2, 2014; Maryland HB 1243/SB 811 became law on March 13, 2014; Michigan Public Act 264 (bill HB 4996) became law on December 26, 2013; Washington Chapter 144 (bill HB 2023) became law on March 28, 2014; and Wisconsin Public Act 52 (bill AB 350) became law on November 7, 2013.

[15] The United States Securities and Exchange Commission has proposed further restricting the five percent (5%) and ten percent (10%) individual investor limitation to a $100,000 total cap in its crowdfunding rule proposal. See SEC Release Nos. 33-9470; 34-70741 (October 23, 2013), available at http://www.sec.gov/rules/proposed/2013/33-9470.pdf. The SEC proposed expanded the restriction in another sense, however, by allowing investors to utilize the higher of either net worth or income standards in applying the 5% and 10% limitations

proposal on October 23, 2013[16] and formal comments were due on February 3, 2014.[17] We would expect the final rules to be forthcoming.

The "Equity Crowdfunding Improvement Act of 2014," proposed by Representative McHenry (R-NC), repeals the existing crowdfunding framework and replaces it with a new version of Title III that is "[i]n response to comment letters received by the SEC and concerns with the underlying statute that may make crowdfunding difficult to implement."[18] While NASAA has strong concerns with a number of the provisions outlined in the new draft, we also recognize that there may be provisions in Title III that may limit its utility for certain issuers. Until the final rules are implemented and issuers are able to participate in crowdfunding, however, it is impossible to evaluate the impact Title III will have on capital formation, job creation and investors' willingness to invest through crowdfunding. We caution that a number of the changes proposed by the draft bill would decrease protections that were central provision Congress included to minimize severe investor risk, and that are vital to encouraging their participation and confidence in crowdfunding.

The expressed rationale for Title III of the JOBS Act was to provide small, startup businesses access to capital from "the crowd" that may otherwise not be available. However, because low net worth and less sophisticated investors would be able to participate in these offerings, and because of the high risk nature of investing in start-up ventures, Congress determined certain investor protections crucial forsuccess.[19] We are concerned that the higher individual and aggregate offering limits, and the ability of an issuer to conduct parallel offerings above the aggregate threshold set forth in the bill, would critically undermine the potential success of equity-based crowdfunding. In fact, Congress viewed $1 million as a sufficient boost for small businesses using crowdfunding to get their start. As Senator Jeff Merkley (D-OR), the author of the Senate amendment containing the relevant language, explained: "[T]he amendment allows existing small businesses and startup companies to raise up to $1 million per year. That is a substantial amount for a small business."[20] Senator Merkley also stated, "Without

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[16] SEC Release Nos. 33-9470; 34-70741 (October 23, 2013), available at http://www.sec.gov/rules/proposed/2013/33-9470.pdf

[17] *See* NASAA Comments in Response to [SEC] Release Nos. 33-9470 and 34-70741 (File No. S7-09-13), "Crowdfunding"; *available at*: http://www.sec.gov/comments/s7-09-13/s70913-286.pdf.

[18] *See* Memorandum From House Financial Services Majority Staff To Members of the Committee on Financial Services, Subject: *May 1, 2014, Subcommittee on Capital Markets and Government Sponsored Enterprises Hearing Entitled "Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies, Part II"* (April 28, 2014). *Available at*: http://financialservices.house.gov/uploadedfiles/050114_cm_memo.pdf.

[19] The SEC's Investor Advisory Committee ("IAC") recently issued a recommendation regarding the SEC's crowdfunding regulations. The proposal notes that implementing crowdfunding presents "a significant regulatory challenge" to balance the cost of compliance with the risk of investor loss. It makes the following preliminary observation: "[O]ne of the benefits of the current financing model is that either a skilled investor, a close-knit family or community, or a third party institution such as a bank providing debt financing, is reviewing, investing and then monitoring the investment. In contrast, crowdfunding enables a broad and diverse investing community where there may or may not be a person or entity that has the means or the interest to engage in such pre-investment or post-investment monitoring." The IAC outlines several areas where the SEC can "strengthen" its proposed rules "to better ensure that investors understand the risks of crowdfunding and avoid unaffordable financial losses." *See* "Recommendation of the Investor as Purchaser Subcommittee: Crowdfunding Regulations" (April 10, 2014), *available at* http://www.sec.gov/spotlight/investor-advisory-committee-2012/crowdfunding-recommendation.pdf.

[20] 158 CONG. REC. S1829 (daily ed. Mar. 20, 2012).

aggregate caps, someone could in theory max out a per-company investment in a single company and then repeat that bet ten, a hundred, or a thousand times, perhaps unintentionally wiping out their entire savings."[21]

A loss of up to $5,000 or 10% of annual income or net worth, as proposed in the bill, could be a crippling loss for many investors. A 2013 survey indicated that 57 percent of American households had less than $25,000 in total savings and investments.[22] The typical retail investor, unlike the traditional small business financier, also does not have the ability to conduct a reasonable investigation of a start-up or development-stage entity. In fact, small businesses start-ups tend to have little or no operational history or experience. The company's business model, intellectual property, technology and other assets are untested, and the company may require additional rounds of financing, thus diluting early investors' shares. In fact, failed businesses are often considered a badge of honor for entrepreneurs.[23]

We are also concerned about a number of other provisions in the bill, including (i) reducing required financial disclosures that an issuer must provide to investors; (ii) reducing important disclosure requirements for both issuers and intermediaries; (iii) removing any disclosure requirements for issuers that are selling shares directly to accredited investors; (iv) removing any civil liability provisions against an issuer for rescission for material misrepresentations or omissions; (v) preempting states from regulating crowdfunding offerings, reducing the amount of information required to be disclosed to states and removing any requirement that the SEC consult with the states during rulemaking[24]; (vi) removing the mandatory securities enforcement regulatory check on control persons and other insiders of the issuer; and (vii) reducing the breadth of issuer and intermediary disqualifications.

We would be happy to work with the Subcommittee in addressing any areas that may make crowdfunding impractical after the SEC issues its final rules. Many state bills contain some of the changes addressed in this draft bill, including allowing an intermediary to avoid federal broker-dealer registration so long as they do not (1) offer investment advice or recommendations; (2) explicitly solicit purchases, sales, or offers to buy particular securities offered or displayed on its website or portal; (3) directly compensate employees, agents, or other persons for the direct sale of securities displayed or referenced on its website or portal; or (4) manage, possess, or otherwise handle investor funds or securities. Moreover, we note that the draft bill only requires an intermediary when issuers sell to unaccredited investors; thus, issuer-based transactions are allowed. Some state bills also contemplate issuer-based transactions. While NASAA has not taken a position on this aspect of intrastate

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[21] 158 CONG. REC. S5476 (July 26, 2012).

[22] According to the Employee Benefit Research Institute's 2013 Retirement Confidence Survey, 57% of workers in the U.S. have less than $25,000 in total savings and investments; *available at* http://www.ebri.org/pdf/surveys/rcs/2013/Final-FS.RCS-13.FS_3.Saving.FINAL.pdf.

[23] Statistics show that unfortunately, roughly 50 percent of small businesses fail within the first five years. U.S. Small Business Administration. http://indus.sba.gov/smallbusinessplanner/plan/getready/SERV_SBPLANNER_ISENTFORU.html Statistics also show that from 1994-2005, on average, only 48.8% of new business establishments survived beyond five years. U.S. Bureau of Labor Statistics. *Available at*: http://www.bls.gov/bdm/entrepreneurship/bdm_chart3.htm.

[24] States, as the primary regulator of small business offerings, have a direct interest in the SEC's rulemaking and implementation of the JOBS Act. Moreover, as the undisputed leaders in investigating and enforcing securities violations and fraud, we believe it is essential that the SEC and state regulators work together in crafting rulemaking.

crowdfunding, our longstanding position is that for crowdfunding to be successful, less sophisticated and less experienced investors must be adequately protected.

In conclusion, we recognize the need for small businesses to access capital in innovative ways that reflect modern realities; however, we urge this Subcommittee to analyze crowdfunding as a tool for capital formation after the legalization of crowdfunding. Finally, we ask that the Subcommittee consider the important role that states play in helping small, local businesses succeed and grow, and the success that states have had in implementing intrastate crowdfunding alternatives. If Congress determines to rewrite the federal crowdfunding rules, states should be an important part of the process and allowed to review and regulate these small offerings.

III. Comments on Discussion Draft of legislation seeking to revise the SEC's existing and proposed amendments to Regulation D, Form D and Rule 156

NASAA has been asked to comment on the unnumbered discussion draft that states its purpose as "to direct the Securities and Exchange Commission to revise its proposed amendments to Regulation D, Form D, and Rule 156, as contained in release number 33-9416," issued on July 10, 2013.[25] The nature of the revisions specified by the draft reveal it as an assault on the authority of the SEC to provide basic, reasonable investor protection. Specifically, the legislation's primary purpose appears to be to eviscerate the few investor protection components the SEC has either adopted or proposed adopting in connection with the JOBS Act requirement to lift the ban on general solicitation for Regulation D Rule 506 offerings.

State securities regulators, pursuant to their antifraud authority, are the primary regulators of offerings conducted under Regulation D, Rule 506, and we are deeply concerned about the negative impact these recently implemented changes will have on investors in our states. In 2012, for instance, state regulators took 130 enforcement actions related specifically to Rule 506 offerings. Moreover, in 2012 the states pursued nearly 200 investigations of Rule 506 offerings likely leading to more enforcement actions reported for 2013.[26] Regulation D Rule 506 offerings were the violation most reported by the states in 2013. It is the fourth consecutive year that has topped NASAA's list of investor traps.

State securities regulators strongly oppose the policies contemplated by the draft, as indeed we would be opposed to any actions by Congress that might diminish the ability of the SEC to undertake prudent steps to attenuate the significant potential risks to investors that has arisen due to the lifting of the ban on general solicitation pursuit to Section 201 of the JOBS Act.

Discussion Draft Section I. – Prohibition on the Exercise of SEC Authority to Require Advance Filing of "Form D" for Rule 506 Offerings Relying on General Solicitation

In order to conduct actions and investigations of fraudulent Rule 506 offerings, state regulators routinely review Form D filings (i.e., a notice filing to the SEC after the first sale of securities pursuant to

[25] It is notable that the scope of the draft exceeds Release Number 33-9416, as Section (3) of the draft would constitute revisions of existing Regulation 506(c), as amended on July 23, 2013 and effective September 23, 2014.
[26] Many states do not maintain statistics for the various types of offerings that result in enforcement actions. As a result, the number of state enforcement actions and investigations related to Rule 506 offerings are likely to be significantly higher than the reported statistics.

the Rule 506 exemption, which informs both the SEC and state regulators that a company is conducting a "private" offering in reliance on the exemption). Unfortunately, the SEC does not conduct a substantive review of these offerings, or their corresponding Form D filings – however, for state regulators, the information captured by the Form D is often the first and only indication that an offering being advertised and sold to investors in their state is being conducted under the Rule 506(c) exemption.[27]

Prior to removal of the long-standing ban on general solicitation and advertising, state securities investigators could be assured that any securities offering relying on general solicitation was registered with the SEC. State securities regulators commonly encourage investors in their states to "investigate before they invest." Typically this results in communications by state regulators with investors—notably, many local "mom and pop" investors—who are seeking information about issuers and potential investments.

With the removal of the general solicitation and advertising prohibition, state investigators no longer have any way to determine whether the issuer is advertising an unregistered, and non-exempt, offering to the general public or engaging in a compliant Rule 506 offering.

To address this major impediment to effective state oversight of Rule 506 offerings, the SEC, on July 10, 2013, proposed a two-part Form D filing requirement for issuers performing a securities offering and using general solicitation. Under the proposed rules, issuers would be required (1) to file a Form D no later than 15 days in advance of the first use of general solicitation in a Rule 506(c) offering, and (2) to file a closing Form D amendment within 30 days after the termination of a Rule 506 offering. The SEC's decision to propose Form D pre-filing requirements for Rule 506 offerings being advertised to the general public was undertaken both in order to improve the SEC's understanding of the Rule 506 market, and in direct response to pleas from state securities regulators.[28]

This single, modest adjustment to the Form D filing requirements for Rule 506 offerings, which are advertised to the general public, would go a very long way in addressing the practical realities that state enforcement personnel now confront. Indeed, adoption of a prefiling requirement could ensure that state securities regulators, and the SEC, are able to determine an issuer's intent to rely on general solicitation and advertising; enable state regulators to respond to questions from investors in their states about publicly advertised offerings; and permit local investors – who can also access Form D filings – to access basic background information about "legitimate" offerings before they invest.

As NASAA explained in a comment letter filed with the Commission, in connection with its rulemaking to implement Section 201 of the JOBS Act:

> [I]t is essential for state regulators and prospective investors to have access to the information disclosed in Form D at or before the time an issuer begins to advertise to

[27] As described in SEC Inspector General Report No. 459, "Regulation D Exemption Process" (March 31, 2009), the Commission conducts no substantive review of Form D filings to determine whether an issuer actually complies with Rule 506. See http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf

[28] The SEC's Proposing Release notes that the prefiling requirement is intended, in part, to enhance the SEC's understanding of the Rule 506 market by improving compliance with Form D filing requirements. See, *SEC Release 33-9416, 34-69960, IC-30595, Amendments to Regulation D, Form D and Rule 156 (July 10, 2013), 78 Fed. Reg. 44806 (July 24, 2013). http://www.gpo.gov/fdsys/pkg/FR-2013-07-24/html/2013-16884.htm*

> the general public. With the Commission's recent lifting of the ban on general solicitation, we anticipate a substantial increase in the number of investors who will want this type of information. However, without a requirement that the Form D be filed prior to the use of general solicitation, there is no way for state securities regulators to respond to these basic questions. An investor that contacts a state securities regulator to ask about an offering is simply being diligent, and state regulators should have the information necessary to respond to such inquiries.
>
> In addition, the lack of a pre-solicitation filing makes it impossible for state enforcement personnel to easily determine whether an offering is being conducted in accordance with the securities laws.
>
> We do not believe a fifteen day advance filing requirement is unduly burdensome to an issuer who wishes to seek investments from the general public...[t]he critical issue is that the Form D should be publicly accessible before an issuer begins to publicly solicit investors.[29]

Unfortunately, Section (1) of the draft would prevent the SEC from effectuating this sensible and badly needed reform by short-circuiting the SEC's rulemaking in this critical area, and would eliminate the least burdensome and most effective step the Commission might take to improve oversight of Rule 506 offerings in the post-JOBS Act era.

Discussion Draft Section II. – Prohibition on the Exercise of SEC Authority to Improve Compliance with Form D Filing Requirements

For far too long, the Commission has failed to address a glaring problem in Rule 506 offerings. Currently, Rule 503 of Regulation D imposes a Form D filing requirement of no later than 15 calendar days after the first sale of securities in the offering, but issuers failing to meet this requirement do not face meaningful consequences under Regulation D.[30] As reported by the SEC Inspector General in 2009, "there are simply no tangible consequences when a company fails to file a Form D."

The voluntary nature of Form D has significant repercussions for state regulators. States are preempted from requiring registration of securities that are sold in compliance with Rule 506, and, as already explained, state regulators routinely review Form D filings to ensure that the offerings actually qualify for an exemption under Rule 506 and to look for "red flags" that may indicate a fraudulent offering. The absence of a Form D filing complicates our efforts to protect the investing public. In addition, a promoter who has no intention of complying with Rule 506 may attempt to assert it as a defense to a state-level enforcement action by filing a Form D long after the fact.

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[29] NASAA Comments in Response to Release Nos. 33-9416, 34-69960, IC- 30595 (File No. S7-06-13), "Amendments to Regulation D, Form D and Rule 156 under the Securities Act." September 27, 2013. http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-re-Form-D.pdf

[30] Rule 507 removes the availability of Regulation D to an issuer in circumstances that would be unlikely to occur absent litigation:

> No exemption under §230.505, §230.505 or §230.506 shall be available for an issuer if such issuer, any of its predecessors or affiliates have been subject to any order, judgment, or decree of any court of competent jurisdiction temporarily, preliminary or permanently enjoining such person for failure to comply with §230.503.

To remedy the deficiencies arising from the "voluntary" nature of the filing requirement currently prescribed by Rule 503, the SEC's Proposing Release on July 10, 2013 proposes to amend Rule 507 to disqualify an issuer from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with all the Form D filing requirements in a Rule 506 offering.

Section (2) of the discussion draft would prevent the SEC from taking action to adopt this vital component of its proposal, which the Proposing Release notes is necessary to improve compliance with Form D filing requirements. Just as in the case of the prohibition contemplated under Section (1) of the draft, Section 2 would, without any cogent or valid policy basis, serve to deprive investors and regulators of the ability to reliably access basic information they require to understand and make informed decisions regarding the Rule 506 marketplace.

Discussion Draft Section III. – Elimination of Accredited Investor Verification Provisions Mandated by Section 201 of the JOBS Act and Implemented Effective Sept. 23, 2013.

Section 201(a)(1) of the JOBS Act mandated that the SEC's amendments to Rule 506 require issuers using general solicitation in Rule 506 offerings "to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission." When the SEC amended Rule 506 in 2013 to permit an issuer to engage in general solicitation or general advertising in offering and selling securities pursuant to Rule 506, this amendment included the provision that all purchasers of the securities be accredited investors and that the issuer take reasonable steps to verify that such purchasers are accredited investors. In its Regulation D Amendments Adopting Release,[31] the SEC emphasized that the requirement that the issuer take reasonable steps to verify the accredited investor status of purchasers be separate from and independent of the requirement that sales be limited to accredited investors, and must be satisfied even if all purchasers happen to be accredited investors, noting that "this [separate and apart requirement] will avoid diminishing the incentive for issuers to undertake the reasonable verification steps envisioned by the statute [the JOBS Act]."[32]

The amendment to Rule 506 also included a non-exclusive list of methods that issuers may use to satisfy the verification requirement for purchasers who are natural persons, which the SEC noted would maintain the flexibility of the verification standard while providing additional clarity and certainty that this requirement has been satisfied if one of the specified methods is used. The SEC also noted that availability of the Regulation D Rule 506(c) exemption for an issuer would remain in circumstances where a non-accredited investor may invest in the offering, as long as an issuer has taken reasonable steps to verify that a purchaser is an accredited investor. Therefore, availability of the exemption would not be jeopardized by a sale to an unaccredited investor, provided the issuer maintains reasonable controls and compliance.[33]

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[31] SEC Release 33-9415, 34-69959, IA-3624, Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings (July 10, 2013), 78 Fed. Reg. 44771 (July 24, 2013) ("Regulation D Amendments Adopting Release").

[32] See Footnote 101 at 78 Fed. Reg. 44778.

[33] "...it is possible that a person nevertheless could circumvent those [verification] measures. If a person who does not meet the criteria for any category of accredited investor purchases securities in a Rule 506(c) offering, we believe that the issuer will not lose the ability to rely on Rule 506(c) for that offering, so long as the issuer took

Once again, notwithstanding broad and bipartisan consensus that general solicitation under Rule 506 offerings should be limited to non-accredited investors, Section (3) of the discussion draft proposes to prohibit the SEC from acting consistent with the interests of investors – in this case, by barring the Commission from adopting rules requiring issuers to verify the accredited status of investors to whom they sell securities under the exemption. Section (3) would effectively eliminate completely the investor protection provisions included in the JOBS Act to ensure the retention of investor protections in the lifting of the ban of general solicitation for Rule 506 offerings.[34]

NASAA strongly opposes Section 3 of the draft on the grounds that it would substantially increase the risks associated with allowing general solicitation of Rule 506 offerings, and the likelihood that it would increase the likelihood that securities offered under Rule 506 would be sold to unsophisticated "mom and pop" investors.

NASAA further objects to Section (3) as it appears to be contrary to the bipartisan commitment reached in Congress, and articulated publically, by members of the Financial Services Committee, without which Title II of the JOBS Act may never have been enacted. Indeed, Section (3) of the draft would effectively prevent implementation of critical amendments offered by Ranking Member Maxine Waters (D-CA) during the Subcommittee markup of the JOBS Act, in October 2011.[35]

Discussion Draft Section IV. – Prohibition on Exercise of SEC Authority to Provide Guidance to Private Funds in Developing Sales Literature that is Neither Fraudulent nor Misleading.

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reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor at the time of sale." See, 78 Fed. Reg. 44783.

[34] Section (3) of the draft provides: "(3) An issuer's obligation under section 201(a) of the JOBS Act and under Rule 506(c) of Regulation D (17 C.F.R. 230.506(c)) to take reasonable steps to verify that purchasers of the securities are accredited investors shall not be a condition to the availability of the exemption under such Rule. The Commission shall not condition the availability of any exemption for an issuer under Rule 506 of Regulation D on the steps taken by issuers to verify that purchasers of the securities are accredited investors, as required under section 201(a) of the JOBS Act and under Rule 506(c) of Regulation D 2 (17 C.F.R. 230.506(c))."

[35] During the Subcommittee's consideration of Title II of the JOBS Act, then-Ranking Democratic Member, Rep. Maxine Waters (D-CA), appeared to condition support for the legislation on SEC rulemaking to ensure that such securities would only be sold to accredited investors. **Section 3 of the discussion draft would prohibit precisely such a rulemaking.** *See, House Financial Services Committee markup of H.R. 2940, the Access to Capital for Job Creators Act. October 4, 2011. Amdt. #1, offered by Ms. Waters. (H. Rept. 112-263).* *http://financialservices.house.gov/uploadedfiles/100511hr2940watersam.pdf*.

> **Ranking Member Waters**: *"I feel that I can only tentatively support [this] bill, which would remove the prohibition on general solicitation or general offers of securities made under rule 506 of Regulation D, if those securities were only sold to accredited investors. My amendment would require the SEC when issuing a rule to...include a provision mandating that issuers take reasonable steps to verify investor status as an accredited investor."*
>
> **Chairman Garrett (R-NJ)**: *"I know that [Ms. Waters] just referred to the SEC, [which] will then be required to promulgate rules...I believe that it is a good amendment. I also encourage support of the amendment."*

See, House Financial Services Committee markup of H.R. 2940, the Access to Capital for Job Creators Act. October 4, 2011. Amdt. #1, offered by Ms. Waters. (H. Rept. 112-263). *http://financialservices.house.gov/uploadedfiles/100511hr2940watersam.pdf*

Finally, the discussion draft includes a provision that appears intended to prevent the SEC from providing guidance on the types of information in Regulation D, Rule 506 general solicitations that could be misleading. The SEC has proposed that Rule 156, which provides guidance on the types of information in investment company sales literature that could be misleading, apply to marketing materials for Rule 506 securities. The utility of providing guidance to issuers regarding the advertising of Rule 506 offerings is self-evident—not only from the standpoint of investors in Rule 506 offerings, but also issuers.

Once again, as elsewhere, Section (4) of the discussion draft appears to eschew the possibility of an optimal or balanced approach to the lifting of the ban on general solicitation in favor of policies that jeopardize basic protections for investors. In this case, state securities administrators consider that the most likely consequence of handcuffing the SEC in this manner would be the undermining of protections for investors and the viability of the marketplace for Rule 506 offerings sold through general solicitation. NASAA strongly urges Congress to reject such a course of action.

NASAA Comments on Additional Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies

In addition to the three discussion drafts that comprise the immediate focus of today's hearing, state securities regulators have been asked by a number of members of the Subcommittee to comment on other, related bills, pending before the Subcommittee that were the focus of a hearing before the Subcommittee on April 9, 2014, and which the Financial Services Committee may be considering in the near future.

H.R. 2629, "The Fostering Innovation Act of 2014"

This bill reduces the number of companies that would qualify as accelerated filers. Currently, companies with a public float over $75 million qualify as accelerated filers. Were this bill to be enacted, firms with public floats of less than $250 million or revenue of less than $100 million would no longer qualify as accelerated filers. Interestingly, the addition of the revenue exception means that a 50-year-old, stale company might still avoid being an accelerated filer. The JOBS Act exempted "emerging growth companies" (EGCs) from the audit obligation for a maximum of five years; this bill would do the same for older companies that did not qualify under that legislation, but the exemption would continue indefinitely.

The principal requirements that non-accelerated filers avoid are accelerated filing requirements, e.g. having a full 90 days to file the annual report rather than the 75 days available to an accelerated filer, and certain other audit-related requirements, i.e. that management must include in the annual report a statement as to the adequacy of the company's internal controls and that the company's outside accountants must file an attestation regarding the management's assurance.[36]

Neither slower filing requirements, nor the lack of an outside auditor review of company financial controls, contribute to strengthen investor protection. Investors will be adversely impacted in

[36] Section 404(b) of the Sarbanes-Oxley Act, which requires accelerated filers to obtain an annual audit of their internal controls.

that they will receive information about companies somewhat slower (i.e. the annual report may be filed up to 15 days later) and thus, will not have the assurances and/or improved internal controls that might result from a required annual internal controls evaluation by an outside auditor.

On the other hand, the degree to which this legislation may negatively impact investors is likely to be mitigated by a number of factors: (1) annual and quarterly reports are still required, albeit slightly less quickly; (2) non-accelerated filers are still required to comply with the SEC's rigorous reporting requirements, including audited financial statements; (3) state authority will remain in place; and (4) the legislation's "internal-controls" requirement, while required under federal law, is not required by most, if not all, states unless it is also required by federal law.

Ultimately, the primary impact of H.R. 2629 is likely to be that it will save companies money by reducing compliance costs on businesses. A 2009 SEC study indicated that the median total compliance cost for non-accelerated filers was $439,000, most of which were auditors' fees.[37] For this reason, Congress exempted non-accelerated filers from the annual independent auditor evaluation; H.R. 2629 further expands the universe of companies that benefit from this cost savings.

H.R. 4200, the "SBIC Advisers Relief Act of 2014"

H.R. 4200 would amend the Investment Advisers Act of 1940 to expand the registration exemption under §203(l) (which exempts venture capital fund advisers) to cover persons who are advisers to both venture capital funds and small business investment companies ("SBICs"), and would exclude SBIC assets from the SEC registration threshold calculation. H.R. 4200 would also exclude SBIC assets from the SEC registration threshold calculation and would preempt state regulation of SBIC fund advisers.

State securities regulators appreciate that, on its face, H.R. 4200 does not appear to directly threaten retail investors. However, we are concerned that the preemption of state law would exempt advisers of SBICs from all state and federal registration focused on investor protection. The removal of all forms of state and federal oversight of persons acting as the adviser of SBIC funds, under this bill, may have unforeseen downstream effects on the securities markets which will negatively impact retail investors. NASAA recommends that Section four of H.R. 4200 be amended to permit states the option of requiring the registration of any person acting solely as an adviser to an SBIC.

SBICs are exempt from the Dodd-Frank Consumer Protection and Wall Street Reform Act's "Volcker Rule," which prohibits banking entities from engaging in most forms of proprietary trading, and prohibits them from acquiring an ownership interest of more than 3% of any private equity or hedge fund. Because SBICs are exempt from the Volcker Rule, banking institutions can acquire ownership in an SBIC in excess of 3% of an SBIC's total equity. As a result, banking institutions and fund managers may seek to form, manage, and invest in SBICs as an alternative to bank-sponsored private equity and hedge funds, which were widely used before the Dodd-Frank Act was enacted.[38] Although banks and fund

[37] Office of Economic Analysis, U.S. Securities and Exchange Commission, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements*. (September 2009).

[38] Bank-sponsored funds were attractive to investors because such funds had the imprimatur of the investment bank's substantial investment, and because the investment bank could call upon a vast network of advisers and investment opportunities, thus increasing the funds' likelihood of success. The Columbia Business Law Review.

managers that elect to form SBICs will still need to satisfy various requirements under the Small Business Act, given the uncertainty of precisely how SBICs may be utilized going forward, it is premature to conclude that Congress should remove all means for subjecting advisers to such funds from any prospect of direct oversight.[39]

Discussion Draft entitled "The Disclosure Modernization and Simplification Act of 2014"

This draft legislation proposes that the SEC permit issuers to submit a summary page as part of a Form 10-K filing, in order to make annual disclosures easier to understand for current and prospective investors. It would also direct the SEC to reform Regulation S-K and tailor its disclosure rules as they apply to smaller issuers and EGCs.

In his April 9, 2014 testimony to the Subcommittee, Professor John C. Coffee, Jr. stated that he had no "conceptual objections" to such a cross-reference sheet, primarily because he believes cross-referencing is currently in place and thus, legislation is not unnecessary.[40] In reviewing the SEC website, it does appear that Form 10-K cross-referencing by hyperlink is already widely used on the Electronic Data-Gathering, Analysis, and Retrieval ("EDGAR") system.

However, NASAA does have some concerns about Section (3) of the discussion draft, which directs the SEC to revise Regulation S-K to "further scale or eliminate" disclosure requirements that are perceived as burdensome to smaller issuers and EGS and "duplicative, overlapping, outdated, or unnecessary" as to all issuers. Similarly, Section 4(a)(3) of the discussion draft proposes that the SEC engage in studies that "explore methods for discouraging repetition and the disclosure of immaterial information." This language suggests that the bill's proponents consider that some of the information that is currently required to be reported on Form 10-K is immaterial, and that a study may serve as a precursor to eliminating some categories of "boilerplate" information that are currently reported on Form 10-K.

In fairness, there has been bipartisan dialogue and scholarly debate about whether a one-size-fits-all reporting requirement makes sense for all issuers, especially those reporting requirements that may be cost-prohibitive or inapplicable for issuers of smaller size (i.e. some environmental impact disclosures).

Thus, state securities regulators do not oppose the "Disclosure Modernization and Simplification Act of 2014". We do, however, believe that it could be improved by adding language to Section (3) that is consistent with Section (4)'s requirement that any changes to Regulation S-K disclosures are made

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Frydman, David. Sidestepping the Volcker Rule: The Emergence of SBICs as a Viable Replacement for Bank-Sponsored Investment Funds. November 17th, 2012. http://cblr.columbia.edu/archives/12417

[39] While it is not yet clear precisely how adoption of the Volker Rule will impact the activities of SBIC, the financial and academic literature suggest there is at least a potential for it to have a significant impact, and thus, such absence of such clarity is in-and-of itself a basis for caution in considering deregulation of this area. See: "SBIC Revival: Why Interest From Banks Is Way Up, As The Volcker Rule Looms." By Kite, Shane. *American Banker*. April 28, 2014. http://www.americanbanker.com/magazine/124_04/volcker-rule-brings-sbics-back-in-vogue-1066822-1.html

[40] Statement of Professor John C. Coffee, Jr. at p. 10, "Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies" (April 9, 2014). http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-jcoffee-20140409.pdf

17 C.F.R. 229.10 et seq.

"while still providing all necessary material information." Such a provision would ensure that there is a balancing between reducing costs and burdens on smaller issuers, while maintaining transparency for investors.

Discussion Draft legislation entitled "The Small Company Freedom to Grow Act of 2014"

The "Small Company Freedom to Grow Act of 2014" would expand the use of Form S-1 to allow for incorporation by reference; allow for the expanded use of Form S-3; and most significantly, instruct the SEC to submit a report to Congress recommending an amendment to Section 18 of the Securities Act of 1933 that would make securities issued by smaller reporting companies and emerging growth companies not listed on a national securities exchange covered securities.

State securities administrators are deeply concerned about this discussion draft, and NASAA would be strongly opposed to the legislation if it were introduced in its present form.

As a general matter, state securities regulators do not support Congressional preemption of state authority to protect investors. However, while NASAA opposes unwarranted federal preemption in all forms, we recognize that there are valid and legitimate rationales for policies that preempt state laws in connection with listed securities. Specifically, in the case of listed securities, the registration statement is reviewed by the SEC; the exchange typically has stringent listing standards and active market monitoring; and, especially in the case of a large listed security, there is generally ample information about the company accessible to retail investors, and such information is frequently filtered through analysts that follow the stock. In short, there are a number of regulatory eyes watching the issuers combined with ample disclosure, which collectively provides investors with some security regarding the legitimacy of the issuer.

By contrast, in the case of non-listed companies, these safeguards simply are not present. Even if these companies file registration statements, non-listed issuers are not subjected to any listing standards or scrutiny from the listing exchange, nor are they typically monitored by investment analysts.

There is absolutely no cogent reason to preempt state regulators for companies that can't achieve a listing. Quite to the contrary; if an issuer can't satisfy the criteria for a listing on even one of the smaller national exchanges, the states' role in performing oversight of their offerings is essential.

The policies embodied in the proffered draft legislation would reduce disclosure, and provide few if any prospective benefits to investors or small businesses seeking access to capital, while raising a host of concerns about the effective oversight of small and unlisted securities offerings. State securities regulators strongly urge Congress to reject this ill-advised legislation.

Discussion Draft legislation to require the SEC to increase the threshold amount for requiring issuers to provide certain disclosures relating to compensatory benefit plans.

Rule 701, adopted pursuant to Section 3(b) of the Securities Act of 1933, provides an exemption from the registration requirements of the Securities Act for securities offered to employees or consultants pursuant to a written compensatory employee benefit plan or a written contract by an issuer that is a non-reporting company (a non-public issuer) under the Exchange Act.[41] The purpose of Rule 701 is to facilitate the use of securities for compensation to employees for private companies, including start-ups. Rule 701 is not available for other purposes, such as raising capital. Securities issued pursuant to plans or schemes designed to evade the registration requirements of the Securities Act, although in technical compliance with Rule 701, are required to be registered.

Under current Rule 701, an issuer can offer any amount of securities. The aggregate sales price or amount sold in any consecutive 12-month period is limited to the greatest of either $1 million, 15 percent of the company's assets, or 15 percent of the outstanding securities of the class. The issuer must always provide a copy of the plan or contract to the investor. Additionally, if the amount of securities sold during any consecutive 12-month period exceeds $5 million, the issuer must make certain additional disclosures to the employees, including: 1) a copy of the summary plan description required by the Employee Retirement Income Security Act ("ERISA") or, if the plan is not subject to ERISA, a summary of the material terms of the plan, 2) information concerning risks associated with the securities sold, and 3) unaudited financial statements required by Regulation A (unaudited financials are acceptable).

The Rule 701 exemption is available only to the securities offered or sold by the issuer, and the employee must find another exemption for their resale. Such securities are deemed restricted securities as defined by Rule 144 of the Securities Act of 1933. Therefore, the securities can be resold pursuant to a registration statement, in a private transaction (Section 4(1½) exemption), or pursuant to Rule 144. Section 501 of the JOBS Act raised the threshold for mandatory registration under Section 12(g) of the Exchange Act from 500 to 2,000 shareholders of record, and shareholders "of record" now exclude persons who receive securities pursuant to an employee compensation plan.

The discussion draft legislation proffered by Rep. Hultgren (R-IL) directs the SEC to amend Rule 701 to increase the amount of securities that may be sold from $5 million to $20 million in a 12-month period before the additional disclosures must be made. It is important to note that Rule 701 relates only to the registration requirements of the Securities Act, and issuers have an obligation to provide investors with disclosures adequate to satisfy the anti-fraud provisions of the federal securities laws.

Securities sold pursuant to the Rule 701 exemption are not sold to retail investors, and thus NASAA does not consider the policy changes contemplated by the draft as likely to directly threaten or materially impact "mom and pop" investors. Nevertheless, on balance, NASAA does not believe it would be prudent for Congress to mandate raising the disclosure for the Rule 701 threshold in an effort to spur capital formation. In the first instance, the purpose of Rule 701 is to compensate employees, not to raise capital.[42] In addition, the SEC has expressed concerns that raising the threshold for additional disclosures to $20 million would create investor protection concerns. Indeed, when the SEC, in 1999,

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[41] The Rule 701 exemption is not available to companies which are investment companies or reporting companies under the Exchange Act.

[42] The SEC and the text of Rule 701 are clear on the purpose of the rule. The SEC has stated, "[Rule 701] is specifically designed not to raise capital," while the text of Rule 701 states, "The purpose of [Rule 701] is to provide an exemption from the registration requirements of the Act for securities issued in compensatory circumstances. [Rule 701] is not available for plans or schemes to circumvent this purpose, such as to raise capital." See 17 C.F.R. § 230.701 (2014).

considered the implications of amending Rule 701 to remove the $5 million aggregate offering price ceiling, the staff expressed concerns regarding investor protection, stating:

> We would have investor protection concerns if we removed the $5 million ceiling without imposing specific disclosure requirements.... In contrast, we believe that disclosure requirements are not needed for offerings below the $5 million threshold at this time. We have not witnessed abuse below this threshold, and therefore the burden of preparing and disseminating the new disclosure does not justify the potential benefits to employee-investors.[43]
>
> In view of the substantial amounts of securities that may now be issued under Rule 701, we believe that a minimal level of disclosure consisting of risk factors and Regulation A unaudited financial statements is essential to meet even the lower level of information needed to inform compensatory-type investors such as employees and consultants.[44]

Further, because companies already have prepared the type of disclosure required by Rule 701, the disclosure requirements should not create an additional burden. Indeed, as the SEC observed:

> [A] number of commenters told us that this information is commonly maintained by this class of issuer (generally not small entities) in order to satisfy requirements for securities issuance exemptions (such as for private placements), loans and other purposes such as regulatory and internal ones, [and] the amendments will not increase reporting, recordkeeping or compliance burdens, and may reduce those burdens for some companies.[45]

Moreover, allowing small startups to compensate key, early-stage employees with stock is sensible because these employees likely have access to the same kind of information that the Act would make available in the form of a registration statement. However, if companies are allowed to issue up to $20 million in a 12-month period without making any disclosures to investing employees, it is foreseeable that a company could become relatively large without making any disclosures. The larger a company is, the less likely it is that employees will have access to the type of information necessary to make an informed investment decision, especially since Rule 701 does not limit which employees may invest. Thus, the very basic disclosures provided at $5 million are necessary to protect investing employees.

Finally, raising the disclosure limit to $20 million under Rule 701 may incentivize companies to substitute stock for traditional employee compensation. This increases the risk to employee investors and, in turn, increases the need for additional disclosure.

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[43] Rule 701—Exempt Offerings Pursuant to Compensatory Arrangements, 64 FR 11095-01 (Mar. 8, 1999).

[44] *Id.*

[45] *Id.*

Discussion Draft legislation to amend the securities laws to improve private market offerings, and for other purposes.

This discussion draft legislation (1) amends Rule 144 to reduce from 6 to 3 months the mandatory holding period before restricted securities by an SEC reporting company may be resold; (2) allows public resale of restricted securities originally issued by a shell company starting two years after the company files a Form 8-K disclosing that it is no longer a shell; and (3) amends Section 18(b) to include in the definition of "covered securities" any securities offered or sold in compliance with Rule 144A (i.e., sales to Qualified Institutional Buyers).

This bill effectively bypasses the protections in Rule 506 of Regulation D. As proposed, an issuer could generally advertise an offering and sell to accredited investors. In as little as three months, that accredited investor could then sell those securities to unaccredited investors. It has generally been held that holding securities for six months, or for twelve months in the case of non-SEC reporting companies, would negate the inference that the buyer purchased with a view to distribute (rather than hold those securities for investment). We question whether a holding period of only three months would effectively eliminate this well-established position. Moreover, it is in an issuer's best interest to issue shares to as few initial investors as possible. If an issuer can avoid selling those shares to unaccredited, retail investors, and sell only to large institutional investors (i.e., mutual funds, hedge funds, investment banks, etc.), an issuer will choose that route. With the changes proposed by this bill, the large investor could buy the shares at a healthy discount and three months later, dump the stock on average, unaccredited retail investors. We are concerned that the legislation will flood the market with Rule 506 offerings that are unloaded by large sophisticated investors on less sophisticated "mom and pop" investors. Because these are resale transactions, if the business fails or becomes insolvent, the business will have already received the initial money from the large investors, those investors will have received a quick profit, and the retail investors will be left holding worthless shares.

Finally, most states already have an exemption for institutional investors, making the Rule 144A preemption proposed in this draft unwarranted. Moreover, if there are unforeseen problems in this area, preempting the states would eliminate our ability to revise or amend that exemption if necessary. We also have not heard from any of these large investors that state regulation of 144A transactions, if in fact required, has proven problematic.

Discussion Draft legislation to require the SEC to revise the definition of a well-known seasoned issuer to reduce the worldwide market value threshold under the definition.

This discussion draft legislation would require the SEC to revise its definition of well-known seasoned issuer ("WKSI"), to reduce the public float requirement from $700 million to $250 million. This may allow most issuers to bypass the quiet period restrictions of Section 5(c) of the Securities Act of 1933. Under Section 5 of the Securities Act, all issuers must register non-exempt securities with the SEC; Section 5 also regulates the timeline and distribution process for issuers who offer securities for sale.

The discussion draft would significantly reduce investor protection by preventing the SEC from conducting any pre-offering review of registrations for companies that qualify as WKSIs. It may also prove problematic for issuers who will no longer have the time to conduct a pre-offering "due diligence" review of the registration statement's contents, and thus may be subject to later litigation.

As explained by Professor Coffee, in his testimony before this Subcommittee, this proposed legislation could position EGCs into a status where they simultaneously qualify as a WKSI. This seemingly contradictory—and troubling—result would allow a new Emerging Growth Company ("EGC") to qualify as a well-known seasoned issuer and not be subject to any pre-offering review.

Professor Coffee also suggested that were this bill to become law, WKSIs would be able to register securities for sale for the account of selling shareholders without separately identifying the selling security holders or the securities to be sold by such persons until the time of the actual sale. This facilitates secondary sales by large shareholders, and essentially, according to Prof. Coffee, creates a "bailout by insiders."

NASAA echoes the concerns articulated by Professor Coffee with respect to the proffered discussion draft, and strongly urges Congress to refrain from consideration of such legislation.

Conclusion

As regulators, states are guided by the principle that every investor deserves protection and an even break and has the right to not be cheated or lied to. As we saw with the passage of National Securities Markets Improvement Act (NSMIA) in 1996, state securities regulators have been handcuffed from reviewing certain offerings before they were sold to members of the public. Since then, a regulatory black hole has emerged to expose investors to high-risk investments offered by companies with little or no financial stability or regulatory scrutiny.

In the 18 years since NSMIA became law, it has become painfully clear that capricious preemption of state review of offerings is a failed experiment. We must not let history repeat itself by creating more regulatory black holes and exposing investors to unacceptable levels of risk and outright fraud, or further dislocating states from our central role in the oversight and stewardship of small business capital formation.

State regulators understand the complex challenges faced by small business issuers. We also understand that a reasonable balance of the issuers' interests and the investors' interests is in the best interest of both groups. It protects the investors, and it facilitates the market for the issuers' securities. If the investors do not trust the small business issuer market, they will not invest.

The states are ready to play an active role in balancing these two interests, and indeed, we are already striving to play such a role.

Thank you again, Chairman Garrett, and Ranking Member Maloney, for the opportunity to testify before the Subcommittee today. I would be pleased to answer any questions you may have.

Addendum #1

NASAA Multi-state Coordinated Review Program

NASAA has developed streamlined multi-state review protocols for Regulation A+ offerings to ease regulatory compliance costs on small companies seeking to raise capital. With this new program, Regulation A+ filings will be made in one place and distributed electronically to all states. Lead examiners will be appointed as the primary point of contact for a filer and each state will be given 10 business days for review. The lead examiners alone will interact with the issuer to resolve any deficiencies. On January 30, the NASAA Board of Directors approved the Proposed Coordinated Review Program for membership vote by electronic ballot with a March 7 deadline.

Filing Process	Review Process				
Day 1	3 business days	10 business days	5 business days	3 business days	Day 21
Issuers desiring coordinated review will e-mail an electronic copy of the application and required exhibits to the program coordinator (State of Washington). The exhibits include Form 1-A & financial statements. The program coordinator will distribute the documents to the states selected by the issuer on the application form. Filing fees paid directly to each state.	Within three business days after receipt of the application, the program coordinator will select a lead disclosure examiner and lead merit examiner (assuming registration is sought in both types of jurisdictions).	Within an additional 10 business days, the lead examiners will draft and circulate a proposed comment letter to the other disclosure states and/or merit states.	Within an additional five business days, the participating jurisdictions may communicate any concerns or comments to the lead examiners.	Within an additional three business days, the lead examiners will make any necessary revisions and send the initial comment letter to the issuer.	**If there are no deficiencies** in the application, no comments will be necessary and the registration will be cleared by the lead examiners within 21 business days after it is filed. **If there are deficiencies**, the lead examiners will communicate with the applicant and the participating jurisdictions to resolve deficiencies. Whenever an issuer files a response to any deficiency, the lead examiners will reply within five business days. When a lead examiner determines that the application satisfies all substantive review standards, the examiner will clear the application and provide same-day notice to participating jurisdictions. The lead disclosure examiner and lead merit examiner may clear the application at different times. Each participating jurisdiction agrees to clear the application upon clearance by the lead examiner.

Written Testimony of
Jeff Lynn
Chief Executive Officer, Seedrs Limited

Before the
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

May 1, 2014

Chairman Garrett, Ranking Member Maloney, honorable Members of this Subcommittee, my name is Jeff Lynn, and I am the Chief Executive Officer and a co-founder of Seedrs, one of the leading European equity crowdfunding platforms. I want to thank the Subcommittee for inviting me to testify today in connection with the discussion draft of the Equity Crowdfunding Improvement Act of 2014 (the "Improvement Act").

Background

Seedrs

Seedrs is an equity crowdfunding platform for European startups and investors. We allow investors to invest as little or as much as they like in the businesses they choose, and we allow seed and early-stage startups to raise capital from friends, family, their communities, angel investors, institutions and the crowds, all through a simple, online process.

We launched in the United Kingdom in July 2012, and we opened to investors and entrepreneurs across Europe in November 2013. Our 20-person team is based in London, UK and Lisbon, Portugal

Seedrs is authorised and regulated by the UK Financial Conduct Authority (FCA, formerly the Financial Services Authority). When we received our authorization in May 2012, to our knowledge we were the first equity crowdfunding platform anywhere in the world to obtain regulatory approval.

Since our launch in July 2012, we have completed 92 financing rounds (including those that have reached their targets and are currently pending due diligence and execution), with a total of approximately £8.4 million ($14.1 million) invested. Of this, 43 financing rounds, representing nearly £6 million ($10.1 million) of investment, have completed in the slightly over five months since our Europe-wide expansion. We have financed businesses ranging from mobile app developers to theatre productions to traditional manufacturers to financial services firms to a cheesemaker; and we have seen investments ranging from £10 ($16.80) from recent college graduates taking their first steps into the investment world to institutional investors investing well in excess of £100,000 ($168,000).

Personal

As CEO of Seedrs, I have overall managerial responsibility for the business. I hold day-to-day oversight over the commercial, corporate and legal aspects of our work, while my co-founder, Carlos Silva, oversees the technological and web development aspects of our work.

My background is as a U.S. securities and corporate lawyer. I received my J.D. from the University of Virginia School of Law, I am a member of the New York Bar (inactive), and I practiced with the international law firm of Sullivan & Cromwell LLP from 2004 to 2008 in New York and London.

I left the active practice of law in 2008 in order to pursue a career working with early-stage businesses, which I firmly believe are becoming the greatest source of wealth and job creation in economies throughout the world. As part of my career transition, I enrolled in the MBA program at Saïd Business School at the University of Oxford, where I met Mr. Silva and began working on what has become Seedrs.

UK Law

Seedrs conducts its activities under the laws of the United Kingdom. While I am not a UK-qualified lawyer, my work over the past few years has made me intimately familiarity with the application of UK law to equity crowdfunding. The following is a very high-level summary of how the UK regime works.

Prior to April 1, 2014, the UK had no rules expressly addressing equity crowdfunding. Instead, equity crowdfunding fell under existing financial services legislation and regulation. Under that existing system, an investment in the equity of a business could be offered to the public without an approved prospectus (that is, without complying with the UK equivalent of Section 5 of the Securities Act of 1933) if four conditions were satisfied:

1. The arrangement of the transaction, and certain other activities in connection therewith, was conducted by a regulated financial services firm;

2. The offering materials used by the issuer were approved by a regulated financial services firm as "fair, clear and not misleading";

3. The regulated financial services firm managing the transaction determined that the investment was "appropriate" for each investor, meaning that the investor had the experience, expertise and knowledge to understand the risks and considerations of the investment and make his or her own investment decisions; and

4. The issuer did not raise more than €5 million[1] ($6.9 million) over the course of a 12-month period except in reliance on a separate exemption or pursuant to an approved prospectus.

Seedrs designed the approach to complying with these conditions which ultimately became the industry standard. This approach is summarized briefly as follows:

Condition	**Approach**
1. Regulated platform	All equity crowdfunding platforms must be authorized by the FCA, or come under the regulatory umbrella of another authorized firm, before they may conduct business.
2. Approval of offering materials	Platforms conduct a straightforward verification and review process on each crowdfunding campaign.

This maximum figure is derived from European Union law, which is why it is denominated in euros rather than sterling.

Condition	Approach
3. Appropriateness	Platforms implement a multiple-choice quiz on the main risks of investing in early-stage businesses, and only those investors who pass the quiz to a sufficient standard are permitted to invest (this requirement does not apply to investors who are the UK equivalent of accredited investors, as these investments are automatically deemed appropriate for them).
4. €5 million cap	The issuer agrees to this with the platform contractually, and compliance with it is the issuer's responsibility.

The foregoing is something of an oversimplification but outlines the material points of how existing UK law applied to equity crowdfunding.

On April 1, 2014, the FCA adopted a set of rules specific to equity crowdfunding. The full text of the rulemaking document can be accessed at http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-04 (with the relevant provisions in Section 4 and Annex D). These rules codified the existing practice and made only one material change: investors who do not fall under certain exemptions must agree to invest no more than 10% of their net assets through an equity crowdfunding or equivalent platform in any given 12-month period.

Notwithstanding that the new rules changed little in practice, they represented the FCA's (and the UK government's) first official policy on equity crowdfunding, and in doing so they provided clarity and reduced uncertainty for the market. The new approach has been strongly welcomed by the equity crowdfunding community—including platforms, issuers and investors—and the general consensus is that the UK now has in the place the world's most advanced and effective regulatory regime for equity crowdfunding.

Equity Crowdfunding in the United States

Title III of the JOBS Act provides the legislative framework for an equity crowdfunding regime in the United States. The SEC has proposed, but not yet adopted, rules implementing Title III.

I have come before you today because I believe, based on the extensive experience I have gained in the equity crowdfunding space, that Title III as enacted is an unworkable law that will stifle equity crowdfunding in the United States before it ever begins.

The intentions behind Title III were good ones: finding the right balance between the reduction of administrative burdens for issuers and platforms on the one hand, and protecting investors on the other, is not an easy task, and the various iterations that led up to the finalization of Title III were aimed at striking that balance as best as possible. Unfortunately, it has been clear to many of us who are on the ground in this industry that the balance chosen was not a viable one, and that if equity crowdfunding is to have a chance in the United States, a substantial overhaul is needed.

To make this point as explicitly as I can, at the time that the legislation which turned into Title III was first being discussed, my team and I actively considered bringing Seedrs into the U.S. market. As Title III emerged into its final form, however, we decided not to enter the U.S. market because we do not think it would be possible to conduct a viable equity crowdfunding business under this regime. We would very much like to provide American entrepreneurs and investors with the opportunity to participate in the important and effective new form of finance that is equity crowdfunding, but we simply cannot do so under Title III as it now stands.

The remainder of my testimony explains where I believe the core problems with Title III lie, and why I believe the Improvement Act goes a long way toward addressing them.

Fundraising Caps

Title III limits the amount an issuer can raise through equity crowdfunding to $1 million in any 12-month period.

While this cap will be sufficient for some small businesses, it is significantly too low for many of the early-stage, high-growth firms that have the greatest potential to create jobs and investor returns. As venture capital firms increasingly move toward later-stage deals, and the oft-discussed "Series A crunch" prevents early-stage, fast-growing businesses from obtaining the capital they need to get to their next stage of development, equity crowdfunding has the potential to play a major role.

The revised cap of $5 million proposed by the Improvement Act much more closely aligns with where venture capital tends to become more available, and it is therefore a more sensible cut-off point for equity crowdfunding. At this level, businesses not only in their seed stages but also in their critical early growth phases will be able to use equity crowdfunding—and investors will have the opportunity to access not only the very earliest businesses but also those that have made more progress—while still limiting the exemption to what are fundamentally very small businesses. A $5 million cap also more closely aligns with the European approach.

Issue Financial Statement Requirements

Under Title III, an issuer raising less than $100,000 must provide income tax returns financial statements that have been certified by its CEO; an issuer raising between $100,000 and $500,000 must provide financial statements reviewed by a public accountant; and an issuer raising over $500,000 must provide audited financial statements.

This set of requirements, and in particular the audit requirement, is one of the most burdensome aspects of Title III and one of the main reasons it is unworkable. It is worth saying at the outset that a focus on financial statements is something of a red herring in crowdfunding: the vast majority of businesses that will use equity crowdfunding will be sufficiently early in their development that historic financial statements will contain minimal information of relevance; far more valuable to investors will be qualitative disclosures about what the business and team have accomplished (which is why the UK rule that the whole of the offering materials be reviewed and declared fair, clear and not misleading is so important). But even if there is a desire to impose specific financial statement requirements, forcing a business seeking $100,000 (which in many cases will be just a team of two or three people and some initial prototypes or concepts) to have an accountant sign off on their financials, and to make a business seeking $500,000 (which in many cases will be a small operation that has just begun generating revenues) have a full audit, is hugely disproportionate to the size and stage of the business. These types of requirements add no value for investors and simply make the conduct of an equity crowdfunding round prohibitively expensive for entrepreneurs.

The proposal set forth in the Improvement Act is significantly more sensible. A $500,000 minimum for an accountant's involvement to be required, and a $3,000,000 minimum for an audit to be required, ensures that these requirements will not be disproportionately expensive relative to the size of the fundraising round while also aligning much more closely with the levels at which financial statements start to play a role in an investor's investment decision.

Investor Caps

As currently enacted, Title III limits the amount an individual can invest through equity crowdfunding in any 12-month period to (1) the greater of $2,000 or 5% of the investor's annual income or net worth, if his or her annual income or net worth is less than $100,000; and (2) 10% of the investor's annual income or net worth, if his or her annual income or net worth is greater than $100,000. Significantly, the burden of ensuring that investors comply with these caps falls on the platforms.

I believe that the principle of caps on the amount an investor can invest has an unnecessarily paternalistic element to it, especially where other safeguards (such as ensuring the investor understands the risks of this type of investing) are in place. That said, I appreciate that a cap like this may provide a reasonable safety net—and will not cause meaningful harm—if set at the right level Any level is going to be somewhat arbitrary, but in my view 5% is simply too low to allow smaller investors a meaningful opportunity to participate in equity crowdfunding. The 10% minimum that would apply across the board under the Improvement Act (and which is used in UK law) is a more reasonable threshold, giving investors of all sizes the chance to access this form of investing while ensuring that no one will suffer major financial hardship if the money is lost.

More important than the level of the cap, however, is the approach to enforcement. The requirement under Title III that platforms be responsible for enforcing the cap is deeply problematic. While a platform may be able to prevent an investor from investing beyond a given level through that particular platform, it has no way of knowing how much he or she has invested through other platforms—which is precisely what the Title III rules could be interpreted to require. In order to make this work, a complex data-sharing system would need to established among all platforms, and the implications both for cost and for investor privacy would be tremendous. The Improvement Act would allow platforms to rely on self-certification, which is a substantially more reasonable approach.

Curation by Platforms

One the issues raised by Title III that has received significant attention from commentators is the issue of curation. This is about a platform's ability to choose which issuers it works with, both at the time an issuer seeks to conduct an offering and also after the offering commenced but before the investment has been completed. While not expressly addressed in Title III, the issue arises from the prohibition on funding portals providing investment advice. It has been observed that a platform which exercises curation over its listings could be construed to be advising investors to invest in those listings it makes available. To avoid this, a platform would need to accept all submitted listings (or at least all those that meet a set of pre-defined, objective criteria such as location or industry), and not to terminate any transaction where the offering has already commenced.

Curation is an essential part of running an equity crowdfunding platform. Any platform needs to be able to choose which businesses it works with and which is does not. Part of this is for commercial reasons: a platform may want to work only with issuers whose branding is aligned with theirs or who have a particular type of growth objective. But the ability to reject businesses that a platform feels are not suitable for its investor customers—or about which adverse issues come to light during or after the period when the listing is live—is also a key part of investor protection. The exercise of curation does not mean, as a substantive matter, that the platform is actually recommending investment in the issuers it does accept—simply that, as is the prerogative of any business, it has chosen not to work with certain issuers.

UK law addresses this issue by separating the concept of "promotion" from "advice". An equity crowdfunding platform is seen to be promoting the issuers it lists and completes transactions with but not advising investors to invest in them, and so while UK platforms are not allowed to give advice, they can choose which issuers they wish to promote and which they do not. The Improvement Act achieves a similar outcome by expressly permitting platforms to select and terminate transactions, and that is an essential change in order to make the equity crowdfunding regime functional.

Use of Special-Purpose Vehicles and Nominee Arrangements

The final, and perhaps most profound, problem with Title III relates to the use of special-purpose vehicles and nominee arrangements (together, "SPVs") to aggregate investments. Title III provides an exemption from the registration requirements of Section 5 of the Securities Act of 1933, but it does not address the equivalent provisions of the Investment Company Act of 1940. This means that while a platform may facilitate the direct issuance of shares by issuer to investors under Title III, there is no scope for the platform to aggregate those investors into a single holding vehicle.

While this may seem a technical point at first glance, it is actually one of the most important issues in equity crowdfunding. If a small, growing company issues shares directly to hundreds of individual shareholders, that poses significant risks both for the issuer and for investors. From the issuer's perspective, it will be very difficult to raise additional capital from institutional investors or to sell the business down the road, as the coordination of action by shareholders that is required for these transactions is often not feasible when there are so many of them. Meanwhile, from the investors' perspective, it is generally not possible to give investors the benefit of a shareholders agreement or subscription agreement—which contains the key protections that any angel investor or venture capitalist would require—when so many investors are involved, meaning that investors must take the shares on an unprotected basis. There are a number of consequences to this lack of protection, the most significant of which is aggressive dilution: in the absence of a shareholders agreement or subscription agreement, the issuer may be able to issue very large numbers of shares to its founders or other connected parties for virtually no consideration, thereby wiping out the value of the crowdfunding investors' holdings (which, in the case of a highly successful company, could mean a loss to investors in the tens or hundreds of millions of dollars).

The solution to these problems is the use of aggregation, allowing all investors to be grouped together in one structure. For the issuer, this means it only has the single SPV as a shareholder instead of all the individual investors, thereby making future capital-raising and sale significantly easier. And for investors, the SPV can easily enter into a shareholders agreement or subscription agreement that provides the exact same types of protections that angels and venture capitalists get when they make investments. There are several choices as to the exact form of the SPV, as well as who administers it (which may be the platform, a lead investor or a designated third party), but so long as the aggregation is in place in some form, the core issues can be addressed.

The Improvement Act addresses this in exactly the right way by including SPVs used for crowdfunding under the list of exemptions in Section 3(c) of the Investment Company Act.

Conclusion

Equity crowdfunding has the potential to be a transformative tool for small businesses and for investors. If implemented correctly, it can create some of the most productive flows of capital an economy can ever see, bringing willing investors together to finance the businesses that will create the most jobs, wealth and productivity. However, this can only happen if the regulatory regime is fit for purpose, and in the absence of an effective set of rules, there is no prospect for equity crowdfunding to achieve its potential.

Title III was a major step forward in making equity crowdfunding a reality, but it did not get all the way there. The flaws that I have outlined mean that, as currently enacted, Title III is not a regime that is fit for purpose. The Improvement Act makes significant strides in addressing that, and I believe that if this legislation is enacted in the form proposed, there is a substantially greater likelihood that equity crowdfunding will be able to flourish in the United States.

I hope the thoughts and insights I have provided today are helpful in your evaluation of this legislation, and I would be happy to amplify or clarify these statements, or to provide additional detail about the Seedrs approach and our views on crowdfunding, both now and at anytime in the future.

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

FUNDRISE

Testimony to the Subcommittee on Capital Markets and Government Sponsored Enterprises
"Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies Part II," May 1, 2014
Benjamin Miller, Co-Founder of Rise Companies Corp.

Chairman Garrett, Ranking Member Maloney, and members of the Subcommittee – my name is Ben Miller, and I am the co-founder of Rise Companies Corp., which owns and operates Fundrise, a real estate crowdfunding platform based out of Washington, DC. I am honored to be here today to testify on my experience using Regulation A to crowdfund the development of local real estate here in the District of Columbia. Let me spend a moment on my background so that you understand how I came to run Rise Companies, one of the only companies in the country currently raising equity online from the public—both accredited and unaccredited investors—in Washington, DC, Maryland and Virginia, prior to implementation of the JOBS Act. We are legally crowdfunding real investment today, through currently existing regulations, and have been doing so since 2012.

Prior to starting Fundrise, I ran a real estate company. In that capacity, I lead the acquisition and development of more than 2 million square feet of property. We built some of the more iconic projects in Washington DC, such as Gallery Place on 7th and H Streets NW -- a 750,000 square foot mixed-use development. As a real estate entrepreneur, I have partnered with some of the largest institutional investment companies in the country, such as Mass Mutual, Angelo Gordon, and the AFL-CIO. I understand what it means to raise debt and equity.

After the 2008 financial crisis, I began to focus on real estate in emerging neighborhoods. Neighborhoods filled with new energy and growth driven by the millennial generation, and a reinvigorated desire from people of all ages to move into cities. When I went to my traditional capital partners, they didn't understand the dynamics of these neighborhoods—neighborhoods such as Washington's H Street NE, Greenpoint, Brooklyn, Lowertown, Minneapolis, or the Los Angeles Arts District. It was striking to me how little they understood local neighborhoods, where new growth is, as compared to traditional core downtown markets.

I would speak to local people in the communities where I was building and they would get very excited about what we were doing. They understood why we were investing there. They cared deeply about the places we were changing and how we were changing them. They wanted to participate in building their city too.

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So one day we asked ourselves, "Why are we raising money from institutions which have no real relationship with the places in which we are investing? What if we raised money from the people who live there, who care, who get it?"

So that's what we're doing, and explains why I am sitting here. We have been raising real investment, in increments as affordable as $100 per share, from the people who live near our real estate projects. Anyone and everyone locally can invest--even if they are not accredited investors, as defined by the SEC. Thousands of people have been investing millions of dollars through Fundrise, purchasing shares of their neighborhoods through our web platform.

Since the JOBS Act did not exist when we started our endeavor, we had to work within the existing regulatory framework. Thanks to our outstanding (and expensive) legal team, we found a way through using Regulation A. Our initial Regulation A filings with the Securities and the Exchange Commission (SEC) totaled more than 350 pages, but eventually allowed us to sell equity online at $100 per share to the local public. To my knowledge, over the past two years, we are the only ones who have successfully qualified more than one Regulation A offering, having climbed the regulatory mountain associated with Regulation A no less than three times.

Each Regulation A offering was a serious undertaking, one that did not generally get easier over time. For example, despite many similarities to prior offerings, our third Regulation A offering took us six months to get through the regulators, which included hundreds of pounds of physical paper filings with the SEC and states, eight attorneys (generating fees of approximately $50,000) to get through the regulatory process, and two sets of reviewed financial statements. All of this to raise $350,000 from the residents of only three states. Yet, we view ourselves as fortunate. Our local regulators in DC, Virginia and Maryland understood that we were working to build local places and create a new capital source for local job growth, and know that less inclined regulators could have, and would have, made it impossible for us to move forward.

In our experience, the likelihood that a Regulation A offering becomes effective is primarily dependent upon the jurisdictions in which the offering has to be registered. Given the great uncertainty this places upon an endeavor that requires tens of thousands of dollars and many months to even begin, without regard to whether the issuer will actually be successful in its Regulation A offering, we support any proposal that lessens the regulatory burdens of Regulation A offerings while simultaneously increasing the regulatory certainty faced by small businesses seeking to raise capital.

In addition, like many in the industry that have reviewed the proposed Regulation A+, we support the exclusion of investors in Regulation A+ offerings from the number of holders of record counted under Section 12(g) of the Exchange Act. We do not believe that, given the ongoing reporting requirements already proposed in Regulation A+, requiring small issuers to become subject to the onerous and expensive reporting requirements of the Exchange Act serves either investors or the small business community. However, we would note that we

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found the wording contained in the draft bill to be slightly confusing and ask that the Subcommittee consider whether there are clearer and simpler ways to accomplish this goal.

We at Fundrise take very seriously our ongoing mission to open up real estate investing to the general population beyond the institutional and accredited investors that have predominantly held sway in the market. We believe that the proposals contained in these bills provide substantial, positive steps towards democratizing real estate investment, and encourage the Subcommittee to consider each of these proposals seriously.

I am happy to take any questions that you may have at this time.

Written Testimony

of

Annemarie Tierney

Executive Vice President – Legal and Regulatory, General Counsel

SecondMarket Holdings, Inc.

to the

Committee on Financial Services,

Subcommittee on Capital Markets and Government Sponsored Enterprises

U.S. House of Representatives

"Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation, Part II"

MAY 1, 2014

Good afternoon Chairman Garrett, Ranking Member Maloney, and Members of the Committee. My name is Annemarie Tierney. I am the Executive Vice President – Legal and Regulatory, General Counsel of SecondMarket. I am grateful for the opportunity to testify this morning regarding these important subjects that pose significant challenges to our country. The issues raised in my testimony directly impact startup growth, job creation and American global competitiveness.

First, I'd like to describe SecondMarket and the important role that SecondMarket plays in facilitating the growth of private companies. Next, I will describe the regulatory barriers that currently pose challenges to private companies seeking to raise capital and to provide liquidity for their shareholders. Finally, I will suggest passage of the legislation that is the subject of today's hearing, particularly the bills that address these regulatory barriers, while also maintaining a high level of investor protection.

My Background and SecondMarket's History

I was born and raised in New Jersey, attended college at the University of Delaware, where I received degrees in Finance and International Relations, and law school at the Columbus School of Law at the Catholic University of America, where I focused on securities law. After graduating law school in 1990, I started my career as an attorney in the Division of Corporation Finance at the Securities and Exchange Commission. I subsequently spent six years as a senior associate with the law firm of Skadden, Arps, Slate, Meagher and Flom, LLP in their London and New York offices, followed by six years as Assistant General Counsel at NYSE Euronext. Just prior to joining SecondMarket, I was the General Counsel of NYFIX, Inc., a Nasdaq-listed registered broker dealer. I joined SecondMarket in 2010.

SecondMarket was founded in New York City in late 2004, and we opened for business as a registered broker dealer in 2005 focused on trading restricted securities of public companies. Since launching the first asset class in 2005, our business has refocused to provide markets for fixed income securities (*e.g.*, auction-rate securities, mortgage-backed, etc.), private company stock and bitcoin. These asset classes have unique characteristics, meet distinct objectives and attract different investors. However, they share the common thread that they are illiquid, alternative investments that benefit from a centralized marketplace.

Our technology has also substantially evolved as we have invested millions of dollars into our online platform, which provides a central market and greater efficiency, an improved user experience, and a streamlined sales process for transactions in these asset classes. Moreover, SecondMarket now employs over 50 people in New York City, and we are hiring new employees every month. I should also note that SecondMarket is a FINRA registered broker-dealer.

Over the years, SecondMarket has emerged as an innovative solution provider. We have helped retirees obtain liquidity when their auction-rate securities (which were often marketed as a cash equivalent) turned out to be long-term, illiquid investments. We were part of the sales team that worked in conjunction with Deutsche Bank to help the U.S. Treasury Department sell TARP warrants. And we've helped dozens of private companies raise capital and also provide liquidity for their shareholders, many of whom reinvested their money into other startups.

SecondMarket is the leading provider of services to facilitate transactions in private company stock. Our original approach with respect to this market was to match buyers and sellers of private company stock in privately negotiated block trades or through a competitive Dutch auction format. We completed these types of trades in over 60 different companies, including

Facebook and Twitter. To provide a sense of our trading volume, in 2008, when we entered the private company secondary liquidity market, we completed $30 million in private company secondary transactions; in 2010, we completed $524 million in private secondary transactions; and in 2012, we completed $312 million in private secondary transactions. In 2011, we pivoted our private company secondary business to provide shareholder liquidity solely in the context of company-sponsored and/or supported liquidity programs, working closely with private companies to facilitate orderly sales of stock by their existing shareholders. Although we also provide support for private companies raising primary capital, I'd like to focus today on our insights regarding the challenges faced by private company shareholders seeking liquidity for their shares and how these challenges negatively impact private companies.

Need for Private Company Secondary Liquidity

Based on our considerable experience with private company shareholder transactions described below, I strongly support Section (5) of the proposed legislation referred to as "A bill to amend the securities laws to improve the small company capital formation provisions, and for other purposes" to adopt Section 4(a)(7) of the Securities Act of 1933 and to make securities sold pursuant to that exemption covered securities for purposes of Section 18 of the Securities Act of 1933. In my view, this legislation merely codifies a long-standing legal framework applicable to resales of private securities by shareholders who cannot meet the requirements of Rule 144 as described below. In addition, I would note that all of the securities eligible to be resold under Section 4(a)(7) are securities that were originally issued in transactions that were themselves exempt from registration, such as Rule 506(b), Rule 506(c) and Rule 701 (which exempts from registration issuances of securities to employees under certain equity compensation plans), and preempted from state law registration. It seems sensible to put these securities on equivalent legal footing in both the primary and secondary sale context for the reasons outlined below.

Rationale for Codifying Existing Legal Practice

The average time a company remains private has essentially doubled in recent years. Based in part on the provisions of the Jumpstart Our Business Startups (JOBS) Act of 2012, a private company now has the ability to defer an IPO and Securities Exchange Act of 1934 reporting and remain private longer than it might have done in the past. Moreover, the profile of companies going public has changed dramatically. Today, only the very largest companies are undertaking IPOs, and receiving the sales and equity research support needed to succeed as public companies.

It may be commonly understood that venture-backed companies fuel job growth in this country,[1] but most people do not appreciate the staggering extent to which this statement is true. In its 2010 study entitled *The Importance of Startups in Job Creation and Job Destruction*, the Kauffman Foundation noted that startups create an average of three million new jobs annually and the most new net jobs in the United States.[2] The study bluntly states: "Put simply...without startups, there would be no net job growth in the U.S. economy." [3]

Thus, it is essential that the regulatory framework responds to this dynamic and creates an environment in which startups can flourish. Every member of Congress is concerned about job

[1] Venture-backed companies in the United States account for approximately 12 million jobs, or 11% of total private sector employment. *Venture Impact: The Economic Importance of Venture Backed Companies to the US Economy*, National Venture Capital Journal and IHS Global Insight, 2011.

[2]*The Importance of Startups in Job Creation and Job Destruction*, Kauffman Foundation Research Series: Firm Formation and Economic Growth, July 2010. Significantly, the study notes that even during poor economic conditions, "job creation at startups remains stable while net job losses at existing firms are highly sensitive to the business cycle."

[3] *Id.*

creation. It is the foremost concern of President Obama and of virtually all Americans. Policymakers need to understand that any serious job creation effort must address the concerns of entrepreneurs. The Kauffman study concludes by noting that "States and cities with job creation policies aimed at luring larger, older employers can't help but fail, not just because they are zero-sum, but because they are not based on realistic models of employment growth. Job growth is driven, essentially entirely, by startup firms that develop organically…effective policy to promote employment growth must include a central consideration for startup firms." [4]

I'd like to explain why facilitating shareholder liquidity is so important to the overall success of private companies. We were first approached about facilitating sales of private company stock in late 2007. A former Facebook employee contacted us and asked if we could help him sell his stock. He had read that we facilitated transactions in restricted stock of public companies. Since Facebook was not a public company, the stock had never been registered for public sale and Facebook did not have any IPO plans. We facilitated the transaction but then spent nearly a year conducting diligence to assess the viability of the market. Once we understood that companies were remaining private much longer than they had in the past, and that systemic changes in the public markets had made it increasingly difficult for companies to go public, we were convinced that we could help provide liquidity opportunities for private companies.

The SecondMarket approach is premised on the notion that there is not a "one-size-fits-all" model for private companies. Each company has its own goals and objectives when creating a liquidity program for shareholders. Some companies value flexibility, while others are more concerned with valuation. In the context of the liquidity services that we provide, companies

[4] *Id.*

control the parameters regarding how and when liquidity is provided to their shareholders, including identifying and approving the potential buyers, establishing the number of shares eligible to be sold, and setting the frequency of transactions. Most of the transactions that we facilitate today take the form of private company share buybacks or third party tender offers. In the context of these transactions, we act as depositary, paying and information agent, handling all of the administrative aspects of the transactions, from capitalization table management, to online access to the transaction data room, to electronic execution of deal documents, and fund flows.[5]

As a result of our experience, SecondMarket has become an important part of the capital formation process. By helping a company provide a liquidity opportunity for its early stage investors, former and current employees, and other shareholders, we operate as a bridge either to an IPO for a company that eventually wants to go public, or as an alternative liquidity opportunity for a company that wishes to remain private. Importantly, we have found that private companies find it much easier to raise primary capital when prospective shareholders understand that interim liquidity will be available to them, particularly in the case of private companies that wish to remain private and defer their IPOs.

We have also found that private companies are better able to attract and retain talented employees if those employees have the ability to monetize at least part of their equity compensation via a centralized liquidity event held on an annual or semi-annual basis. The pay structure at startup companies generally relies heavily on stock-based compensation in the form

[5] When a company uses SecondMarket to conduct a liquidity program, we require the company to provide robust disclosures to eligible buyers and sellers, which generally include audited financial statements and company risk factors. Companies are increasingly comfortable with the requirements of our market as they recognize that the information they provide is only available to the companies' selected buyers and sellers in a secure, online data room administered by SecondMarket.

of options representing common shares that vest over several years. The options provide an economic incentive that allows employees to realize the financial upside of contributing to a successful startup. Startup companies prefer to give equity in lieu of cash compensation because startups generally need to conserve capital in order to grow the business, so making equity compensation more attractive to prospective employees will facilitate job creation and startup growth.

Options granted as part of a private employee's compensation package typically vest over a four year period and expire (a) a specified number of years after grant (*e.g.*, five to seven years after grant date) or (b) at a point in time after the employee leaves the company (*e.g.*, 60 or 90 days after employment ends). Exercise of employee options, however, requires that the employee pay the option exercise price at the time of exercise and also triggers an income tax event for employees resident in states that impose an income tax.

A minority of private company options are exercisable on a cashless basis, meaning that the employee forfeits options in an amount equal to the cost of the exercise price and any applicable taxes in order to exercise the remainder. Most options, however, require that the employee go out of pocket to pay the applicable exercise costs, which can be significant. The significant consequence of this requirement for rank and file employees cannot be understated. Most employees cannot fund these exercise costs; they must structure an exercise and immediate sale of common shares to order to cover these costs. Under the current legal framework, it is very difficult, if not impossible, for employees to navigate the federal and state requirements applicable to the exercise of their options and resell of the common shares on their own, and engaging legal counsel to do the analysis on their behalf can be cost prohibitive. As a result, a substantial amount of private company employees' options may not be exercised and, thus, expires, resulting in the forfeiture of economic value and loss of potential income.

Challenges Presented Under Current Legal Framework for Private Company Shareholder Liquidity

As a general matter, in order for a private company shareholder to sell his shares, the shareholder must engage his own legal counsel and pay them to provide an opinion confirming that the shares were sold pursuant to valid federal and state exemptions from registration. The legal opinion is delivered to the company's transfer agent, along with a transfer fee that may be as high as $7,500, in order for the sale to be finalized. To the extent that the shareholder is not an affiliate of the private company and can demonstrate that he has held the shares being sold for at least 12 months, the opinion letter will be based on an analysis of the seller's compliance with the conditions of the Rule 144 safe harbor promulgated under Section 4(a)(1) of the Securities Act of 1933, which provides a federal, state preempted, exemption for the resale transaction.

The challenge comes into play, however, where the shareholder cannot rely on Rule 144 because they are an affiliate of the company, as is the case for officers, directors and control persons, or where the shareholder has not held the shares to be sold for the requisite 12 month period, as in the case of a private company employee who holds options, but not the common stock underlying the options. In either case, the shareholder needs to identify both a federal and state exemption from registration for the resale transaction since the transaction is not preempted from state blue sky laws.

On the federal level, no specific statutory safe harbor exists for these types of resale transactions. Instead, a legal construct referred to as Rule 4(a)(1 ½) has developed as a result of case law and legal analysis over the past 60 years.[6] The basic requirement of Rule 4(a)(1 ½) is that the transaction satisfy certain elements of both Section 4(a)(1), the non-issuer exemption, and 4(a)(2), the issuer exemption, such as that there is no public offering and that all buyers are accredited investors. While the SEC has never acted to codify the Rule 4(a)(1 ½) construct, it has acknowledged the validity of the exemptive theory in an interpretive release[7] and in several no-action letters, the latest of which was issued in 1972. The SEC has declined, however, to provide any additional clarification on the requirements necessary to satisfy the construct. Unfortunately, the SEC Staff even declined to consider a no-action letter request that we submitted two years ago in the context of the exercise of employee options and the immediate sale of the underlying common shares in order to cover the option exercise costs. Despite the lack of formal guidance, the legal bar is generally comfortable providing legal opinions that affirm that these transactions are exempt from SEC registration under a Rule 4(a)(1 ½) analysis (assuming the essential conditions for a private placement have been met) and multiple law firms do so for hundreds of private company secondary share transactions each year.

The most significant disadvantage of the lack of a specific federal safe harbor for these transactions is that each transaction must also satisfy the blue sky laws of the state of residence of every potential accredited investor buyer. The difficulties imposed by this obligation are clearly understood when you consider our efforts to provide liquidity for shareholders of private community bank shares. Starting in 2011, SecondMarket attempted to create an efficient secondary market for private community banks across the country. Many of these were private bank holding companies, subject to the same level of bank regulation as bank institutions whose

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[6] See *The Section "4(1 ½)" Phenomenon: Private Resales of "Restricted" Securities*, 34 Business Law 1961 (1978-1979).
[7] Securities Act Release 6188, footnote 178, 45 Federal Register 8962, February 1, 1980.

securities issuances are exempt under Section 3(a)(2) of the Securities Act of 1933. These community banks, however, were initially structured as bank holding companies to take advantage of the ability to issue trust preferred securities which counted toward their Tier 1 regulatory capital requirements, an advantage that was eliminated under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. As a result of being organized in holding company form, primary and secondary securities transactions in community bank shares are subject to the same requirements and restrictions of the Securities Act of 1933 as any other private company.

The community banks that we worked with throughout 2011 and 2012 were generally focused on providing liquidity to their existing shareholders in a forum where individual accredited investors, rather than institutions, would buy their shares. The banks saw a tremendous benefit in attracting new shareholders who were members of their communities or surrounding areas and expressed the belief that providing regular secondary share liquidity events would make it easier for them to raise primary capital and, subsequently, lend more money to local businesses. Most of the banks' shareholders are account holders or employees, including officers and directors, so allowing those shareholders the opportunity to monetize even a portion of their shareholdings on an annual or semi-annual basis would also inject additional capital into the community in the form of discretionary income, capital gains taxes and additional income taxes.

Before launching our community bank initiative, we conducted an in-depth analysis of the various private company selling shareholder transaction exemptions provided by all 50 states. We found that state regulations relating to these transactions are generally inconsistent, which made it very difficult to establish a nationwide approach to implementing liquidity programs for shareholders looking to sell their shares. Since private company secondary transactions have the potential to generate significant income and capital gains tax revenues at the state level, the lack of clarity as to the availability of these exemptions across the states may limit a shareholder from transacting in a particular state, resulting in lost revenue for that state.

Our nationwide analysis demonstrated that most states provide for one or more variations of four non-issuer transaction exemptions. The specific requirements of these exemptions, however, vary significantly across the states, creating confusion and increasing the costs associated with obtaining liquidity in situations where the shareholder in a single liquidity program seeks to sell shares to accredited investors located in more than one state.

The variability of the requirements relating to each exemption also make it extremely difficult, if not impossible, for an intermediary, such as a broker-dealer, to assist a private company in locating buyers to provide liquidity for its shareholders. For example, forty-four states provide an exemption for transactions effected through a broker-dealer resulting from an unsolicited offer from a buyer interested in purchasing private company shares from an existing shareholder. In the case of this exemption, individual states impose a wide variety of limitations and restrictions on the use of the exemption. For example, some states require that a purchaser acknowledge or confirm in writing that the bid for the security was unsolicited. In addition, some states limit the use of this exemption by affiliates of an issuer.

The following chart represents the patchwork of state blue sky laws applicable to the unsolicited broker transaction exemption as of January 2012. There were similar inconsistencies across the other three non-issuer transactions – the manual exemption, the institutional exemption and the isolated non-issuer exemption – that make it virtually impossible for a private company shareholder to resell his shares without significant and costly assistance from legal counsel.

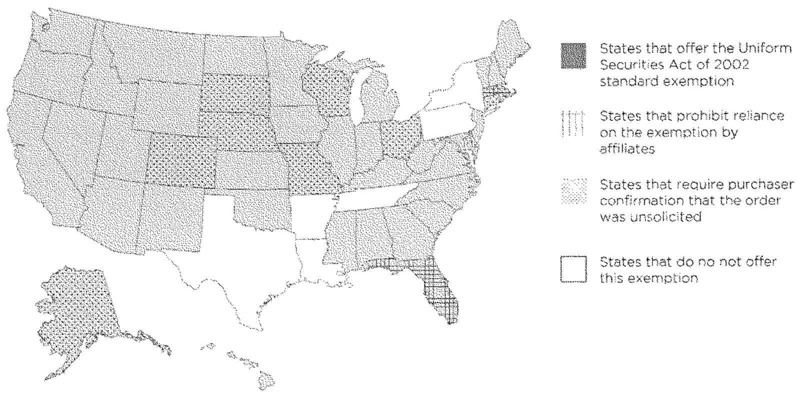
Unsolicited Broker Transactions

44 STATES
have adopted the Uniform Securities Act of 2002 standard form of exemption.

2 STATES
prohibit reliance on the exemption by affiliates.

12 STATES
require purchaser confirmation that order was unsolicited.

6 STATES
do not offer this exemption.



To make matters even more difficult, this exemption generally prohibits broker-dealers from soliciting customers that were previously known to the broker-dealer, an approach that is inconsistent with FINRA rules and regulations and the guidelines applicable to primary offers made under Rule 506(b) of Regulation D. State regulations that require that bids be unsolicited unnecessarily restrict the ability of broker-dealers to identify potential accredited investor buyers for private company shareholders even among a broker's existing client base.[8] As a result,

[8] In 2012, we submitted an interpretative request to the State of California Department of Corporations requesting guidance on whether a process by which potential buyers logged onto the SecondMarket platform, successfully completed our background check and accreditation processes, indicated that they were interested in being contacted regarding private company secondary share buying opportunities, and further indicated that they were interested in a specific industry, such as community banks, or in shares of companies located in the State of California would be sufficient steps on the buyer's part to enable us to contact that potential buyer regarding a specific opportunity without constituting a "solicitation". The State took the position that, even in this instance, any action on our part to notify a SecondMarket member that a specific company's shares were available for sale would constitute a solicitation and, therefore, not satisfy the requirements of the exemption that the bid be unsolicited.

shareholders and broker-dealer intermediaries acting on their behalf have greater difficulty finding liquidity for their shares.

In light of the state law limitations on our ability to efficiently locate potential buyers for the shares of private community banks across multiple jurisdictions, even within our membership base of over 25,000 accredited investors, we ultimately ceased our efforts to create efficient liquidity events for community banks.

In 2013, I participated in the SEC's Government - Business Forum on Small Business Capital Formation on a panel entitled "Crystal ball: Now that you raised the money, what's next for the company and the markets?" I discussed the difficulties inherent in the patchwork of state laws applicable to private company shareholder transactions and highlighted the need for codification of a federal, state preempted exemption for private company shareholder transactions that do not satisfy the conditions of Rule 144. In addition, the Forum's participants recommended adoption of the same exemption to the SEC as part of the plenary session recommendations.[9]

Conclusion on Proposed Section 4(a)(7)

In light of the specifics provide above, I strongly support Section (5) of the proposed legislation referred to as "A bill to amend the securities laws to improve the small company capital formation provisions, and for other purposes" to adopt Section 4(a)(7) and to make securities sold pursuant to that exemption covered securities for purposes of Section 18 of the Securities Act of 1933.

[9] Final report pending.

Proposed Regulation D Legislation

I would also like to comment on the draft legislation referred to as "To direct the Securities and Exchange Commission to revise its proposed amendments to Regulation D, Form D and Rule 156" regarding the SEC's proposed amendments to Regulation D. While I support the underlying goals of minimizing investor fraud and enabling the SEC to evaluate market practices in Rule 506 offerings, I strongly believe that many of the SEC's proposed changes are unworkable for startups raising capital in today's electronic world.

Consider the reality of how most startup businesses actually raise capital. Early and mid-stage startup private companies are under constant pressure to raise capital in order to grow and expand their businesses. Capital is generally sought by the company's CEO on a continuous basis. The company seldom prepares a formal private placement memorandum, but, instead, uses an investor deck as a tool to explain the company to potential investors. SecondMarket works with many of these early and mid-stage startups, providing transaction management services such as potential investor onboarding, accreditation verification, data room entry, electronic document execution and fund transfer. As a general rule, these transactions do not follow the traditional "investment bank supported" capital raising model more suited to the proposed amendments.

With respect to the specific provisions of the draft legislation that I view as necessary to preserve a functional capital raising environment for startup businesses, I have the following comments.

Section 1(1) - Advance Filing of Form D

The SEC's proposed rules would require that an "Advance Form D" be filed by the issuer with the SEC no later than 15 days before the commencement of general solicitation. Under current rules, issuers must file a Form D within 15 days following the commencement of an offering. Requiring a filing in advance of an offering will effectively impose a 15-day cooling off period for offerings by startups seeking capital on a continuous basis and is quite simply inconsistent with the intent of the original JOBS Act.

Many startups will be unaware of the legal technicalities and may unintentionally run afoul of the proposed rules. The continuous offerings of startup businesses often lack a clear "commencement date" that can be relied upon to mark the start of the proposed 15-day filing period. This creates confusion for issuers trying to determine when the Advance Form D filing requirement would be triggered.

In the release outlining the proposed rules, the SEC specifically notes that it "does not anticipate that the staff will review each Advance Form D as it is being made." [10] An advanced filing will unduly burden issuers and provide limited additive benefit to the SEC on top of the benefit already gained from Form Ds timely filed under the current regime. There is significant potential negative impact that a perceived "failed offering" could have on a startup's ability to raise capital in the future. Requiring an issuer who abandons an offering and does not actually raise capital under Rule 506(c) to file a form is overly burdensome when weighed against the potential negative implications for the issuer, and there is no true public policy served by requiring it to provide advance notice to the market that it is seeking to do so.

The Advance Form D filing requirement also has significant implications for state law compliance. While the SEC's rules require that current Form D be filed with the SEC, state laws also require that the Form D be filed in every state where securities have been sold. Satisfying

[10] SEC Release No. 33-9416; 34-69960; IC-30595; File No. S7-06-13.

the current state notice filing requirement already exposes issuers and broker-dealers to a myriad of differing filing requirements and varied state filing fees due to the current lack of uniformity in the Form D filing process across the states. Adoption of the Advance Form D requirements could trigger states to amend their rules to also require issuers to file the Advance Form D in every state where an issuer might sell securities. This would make compliance with the proposed amendment even more unworkable, costly and burdensome for issuers.

I strongly believe that the imposition of the requirement to file an Advance Form D will deter a wide range of private issuers from relying on Rule 506(c), and significantly diminish a central focus of the JOBS Act. Therefore, I support Section 1(1) of the proposed legislation.

Section 1(2) – Failure to file Form D

The proposed amendment to Rule 507 to disqualify an issuer who failed to comply with the Form D filing requirements within the past five years from relying on Rule 506 for any new offering for a one year period is clearly contrary to the intent of the JOBS Act and punitively disproportionate to the impact that such failure would have on investors and the market. There is absolutely no basis for an amendment that would penalize an issuer for the failure to properly file the Form D by imposing a one-year ban from reliance on the exemption for future offerings.

Such a ban would serve as a death knell for many startups and other issuers that inadvertently fail to comply with highly technical legal filing requirements due to a lack of sophistication or lack of access to legal counsel. Investors participating in a Rule 506 offering will be accredited investors and will have access to all of the information that they consider necessary to make an investment decision. Investors will surely suffer no harm if the issuer fails to properly file a Form D (or possibly multiple variations of Form D). The SEC rightly noted in its proposing release that not every issuer chooses to file a Form D under the current rules, a fact that does not reflect a pattern of problematic practices around Rule 506 offerings under the current rules.

Section 1(2) of the proposed legislation will eliminate this overly burdensome penalty.

Section 1(6) – Submission of Written General Solicitation Materials

Rule 510T of Regulation D would require that an issuer conducting a 506(c) offering submit to the SEC general solicitation materials prepared and used in connection with the offering in advance of the use of such materials. This would impose a significant expense and burden on issuers. As I mentioned previously, many issuers that will utilize Rule 506(c) are startups in need of constant capital infusions. The lack of a clear commencement date for the offering will cause confusion for compliance with this proposed rule. Many private companies raising capital are run by individuals who have no knowledge of the securities laws and lack the resources to retain capable external counsel on an ongoing basis. Thus, these companies will try to navigate complicated obligations on their own.

The absence of a definition of "written general solicitation materials" will cause widespread confusion and noncompliance. Startups seeking capital will likely utilize social media as a means to solicit investor interest, a communication format that does not allow for long and complicated legal legends. Notwithstanding that it is difficult to know which communications would be subject to the disclosure requirement, many private issuers will be intimidated by an obligation to provide every written communication used in investor communications in the context of a Rule 506(c) offering to the SEC. As a matter of clarification, in no case should these materials be made available to the public via the SEC submission process should the proposed rule be adopted. There is no conceivable public interest that would be served by such disclosure and it would significantly deter reliance on Rule 506(c).

As a result, of all of the Commission's proposed changes to Regulation D, proposed Rule 510T would likely prove the greatest deterrent to an issuer considering whether to raise capital under Rule 506(c). Accordingly, I support Section (6) to require the submission of materials in a single filing after the closing of an offering but would also request that the SEC be directed to provide workable, rational guidance on what types of materials would be considered "general solicitation materials."

Conclusion

In summary, I want to thank Chairman Garrett, Ranking Member Maloney, and the members of the Committee for the opportunity to participate in this important Hearing.

Thank you.