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House Committee on Financial Services,

Subcommittee on Capital Markets and Government Sponsored Enterprises

"The JOBS Act at Four: Examining Its Impact and Proposals to Further Enhance Capital Formation."

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Introduction

Good Morning Chairman Garrett, Ranking Member Maloney, and members of the Subcommittee. My name is Bill Beatty. For the past 30 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 a member of the North American Securities Administrators Association, Inc. ("NASAA"),[1] having served as the association's President from 2014 to 2015, and before that, as Chair of its Corporation Finance Section Committee. Since October of 2015, I have served as the Chair of NASAA's 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 longer than any other securities regulator. Ten of my colleagues are appointed by Secretaries of State, and five are under the jurisdiction of state Attorneys General. Some, like me, are appointed by their Governors and Cabinet officials, and some of my colleagues work for independent commissions or boards. My colleagues and I are responsible for enforcing state securities laws including investigating complaints, examining broker-dealers and investment advisers, registering certain securities offerings, and providing investor education programs to many of your constituents.

States also are the undisputed leaders in criminal prosecutions of securities violators. In 2014 alone, state securities regulators conducted nearly 5,000 investigations, leading to more than 2,000 enforcement actions, including 271 criminal actions. Moreover, in 2014, among licensed financial professionals, NASAA members reported 230 enforcement actions involving broker-dealer agents, 190 actions involving investment adviser representatives, 156 involving broker-dealer firms, and 146 involving investment adviser firms.

States also continue to serve a vital gatekeeper function by screening bad actors before they have a chance to conduct business with unsuspecting investors. A total of 2,857 securities licenses were withdrawn in 2014 as a result of state action and an additional 728 licenses were either denied, revoked, suspended or conditioned. 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," state securities regulators serve as the primary regulators of many small and local securities offerings. As such, state securities regulators regularly work with and assist local businesses seeking investment capital. Moreover, state securities regulators, acting within NASAA, have a long history of working closely with the U.S.

[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.

Securities and Exchange Commission ("SEC" or "Commission") to effect greater uniformity in federal-state securities matters.

NASAA also plays an important role in coordinating state efforts to promote capital formation. In my capacity as Chair of the NASAA Committee on Capital Formation, one of my tasks this year will be to preside over NASAA's Capital Formation Roundtable – an annual meeting sponsored by NASAA sponsors and attended by dozens of innovators and corporation finance practitioners. The Roundtable provides attendees with the opportunity to speak directly with NASAA leaders about current state and provincial regulations, policies and actions that affect the ability of small businesses to raise capital.

Views on the Legislative Proposals Before the Subcommittee

The Subcommittee has requested that NASAA comment on four legislative proposals. H.R. 4852, the Private Placement Improvement Act, would alter the filing requirements under Regulation D and would foreclose certain actions that the SEC proposed in a 2013 release. H.R. 4850, the Micro Offering Safe Harbor Act, proposes three new exemptions from state and federal securities registration. A third proposal, H.R. 4854, the Supporting Americas Innovators Act, would amend the Investment Company Act to expand relief from investment company registration for venture capital or angel investment syndicates. Finally, a fourth bill, H.R. 4855, the Fix Crowdfunding Act, would amend Title III of the JOBS Act, which is the basis for the federal crowdfunding regime that will come into being when the SEC's Regulation CF takes effect in May, 2016.

I will address these proposals in the order listed above.

1. The Private Placement Improvement Act (H.R. 4852)

The Private Placement Improvement Act, H.R. 4852, directs the SEC to revise the filing requirements of Regulation D. The legislation would require an issuer that sells securities in reliance on Rule 506 to file with the SEC, no earlier than the date of first sale of such securities, a single notice of sales containing the information required by Form D for each new offering of securities. The bill prohibits the SEC from requiring the issuer to file any notice of sales containing the information required by Form D except for this single notice; from conditioning the availability of the Rule 506 exemption upon the filing of a Form D or similar report; and from requiring issuers to submit written general solicitation materials in connection with an offering subject to Rule 506, except when it requests such materials pursuant to specified authority. The bill further prohibits the SEC from extending restrictions on to private funds.

NASAA has serious concerns with H.R. 4852. We oppose any action by Congress to diminish the ability of the SEC to undertake prudent steps to limit the risks to investors resulting from the lifting of the ban on general solicitation. Further, it would be a mistake for Congress to weaken the few existing investor protections in Rule 506, as this bill would in important ways.[2]

[2] For example, H.R. 4852 would repeal the SEC's present authority to require the filing of amendments to Form D where there have been certain changes in the offering.

Title II of the JOBS Act repealed a long-standing prohibition on general solicitation and advertising of securities under Rule 506. State securities regulators remain deeply concerned about the negative impact these changes will have on investors in our states. In 2014, the most recent year for which data is available, Regulation D Rule 506 offerings were the second most frequently reported fraudulent product or scheme involved in enforcement actions by state securities regulators.[3]

As the SEC recently noted, the exemptions in Regulation D are the most widely used transactional exemptions for securities offerings by issuers. Issuers using these exemptions raised over $1.3 trillion in 2014 alone, an amount comparable to that raised in registered offerings.[4]

Under Section 18 of the Securities Act of 1933, states are preempted from requiring registration of securities that are sold in compliance with Rule 506 of Regulation D. However, states are not prohibited from investigating and bringing enforcement actions related to fraud and deceit. In reality, states have proven to be the primary regulators of offerings conducted under Rule 506 because we have demonstrated a willingness to exercise this antifraud authority, and to expend resources monitoring this market by reviewing Form D notice filings to detect fraud.

When the SEC adopted rules to implement Title II on July 10, 2013, it also voted to propose rules that could mitigate the risk to ordinary investors from 506 offerings, including by requiring a pre-filing of Form D when issuers intend to advertise Rule 506 securities to the general public, and by imposing meaningful penalties on issuers who fail to file a Form D. NASAA strongly supports these proposed rules. We called upon the SEC to propose them, and we believe that if adopted, they stand to confer substantial benefits to investors at minimal costs to issuers. By prohibiting the SEC from adopting these common-sense investor reforms, H.R. 4852 threatens to eliminate the few investor protection components the SEC has either adopted or proposed adopting in connection with Rule 506. It also threatens to undercut the SEC's most promising effort to gather additional, essential information about the Rule 506 marketplace.[5]

The importance of requiring the filing of Form D prior to sales or general solicitation:

NASAA has consistently advocated that the SEC require the filing of Form D prior to the sale of securities in reliance on Rule 506 – especially prior to the use of any type of general solicitation. The information contained in a Form D is crucial to state securities regulators who

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[3] NASAA Enforcement Section. (2015, September). *NASAA Enforcement Report* (p.7). Retrieved from nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/08/2015-Enforcement-Report-on-2014-Data_FINAL.pdf

[4] Bauguess, S., Gullapalli, R., & Ivanov, V. (2015, October). *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014*. Retrieved from sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf. Underlying data in the Unregistered Offerings White Paper obtained from Form D filings. While Rule 503 of Regulation D (17 CFR 230.503) requires the filing of a notice on Form D no later than 15 days after the first sale of securities, the filing of a Form D is not a condition to a Regulation D safe harbor or exemption. Consequently, it is possible that some issuers do not make Form D filings for offerings relying on Regulation D and the available data on Regulation D offerings could underestimate the actual amount of capital raised through those offerings.

[5] 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. *Amendments to Regulation D, Form D and Rule 156, SEC Release Nos. 33-9416, 34-69960, IC-30595. 78 Fed. Reg. 44806.* (2013, July 24). Retrieved from gpo.gov/fdsys/pkg/FR-2013-07-24/html/2013-16884.htm

regularly encourage investors to "investigate before you invest." When investors contact their state regulators with questions about an offering they may have learned about through an advertisement or solicitation, a Form D filing is often the only information the state can use to determine if an issuer is conducting the offering in compliance with a lawful exemption. Without the information contained in a Form D, state securities regulators are blind to these offerings. This is why we welcomed the SEC's proposal to institute such a pre-filing requirement.

Opponents of pre-filing requirements have expressed opposition to the SEC's proposal to require the filing of Form D prior to conducting a Rule 506 offering, and again upon the completion of the offering, on the grounds that "multiple" filings impose an onerous compliance burden. The facts simply do not support such claims. Form D is a short, 11-page form that contains instructions and captures only eight pages of information, including basic information about the issuer (e.g., business address, officers, directors, business type, etc.). The amount of information required on this form relative to the information contained in an issuer's private placement memorandum or offering document is minimal. These additional modest filing requirements designed to provide limited but important information to regulators are particularly important in light of the fact that more than $1 trillion in unregistered Regulation D, Rule 506 securities are sold to the investing public.[6]

The importance of providing penalties for issuers who fail to file Form D:

The Private Placement Improvement Act also would prohibit the SEC from adopting proposed rules intended to establish consequences for issuers who fail to file a Form D when conducting a Regulation D, Rule 506 offering. Much like the pre-filing requirement, the imposition of a penalty for failure to file is a common-sense remedy that is long overdue. Absent such a penalty, there is no sufficient incentive for issuers to file Form D. NASAA is not alone in this view. The SEC's Inspector General, in 2009, noted, "There are simply no tangible consequences when a company fails to file a Form D." This current, "voluntary" nature of Form D has significant negative repercussions for state regulators.[7] In addition, the data gathered by the Form D provides essential insight into the opaque Rule 506 market, which rivals the public market in size, and about which very little is known.[8]

Comments on other elements of H.R. 4852:

[6] Securities & Exchange Commission. (2015, December 15). *Report on the Review of the Definition of "Accredited Investor" (p.1). Retrieved from* sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf

[7] As the SEC's Investor Advisory Committee noted in a 2013 report, "One reason for the dearth of information is that the Commission relies on Form D filings for data, and an unknown but apparently significant percentage of issuers do not file Form D." Securities and Exchange Commission. *Recommendation of the Investor as Purchaser Subcommittee and the Investor Education Subcommittee: Accredited Investor Definition*. (p.5). Retrieved from sec.gov/spotlight/investor-advisory-committee-2012/accredited-investor-definition-recommendation.pdf

[8] As the Commission noted in the release for the final rule lifting the ban on general solicitation in Rule 506 offerings, it has "relatively little information on the types and number of investors in Rule 506 offerings." *Amendments to Regulation D, Form D and Rule 156, SEC Release Nos. 33-9416, 34-69960, IC-30595. 78 Fed. Reg. 44806.* (2013, July 24). Retrieved from gpo.gov/fdsys/pkg/FR-2013-07-24/html/2013-16884.htm

Finally, NASAA questions the basis for Section 5 of H.R. 4852, which would also block the SEC's effort to extend the antifraud guidelines of Rule 156 to sales literature of private funds, whether or not used in a Rule 506(c) general solicitation.[9] It is important to note that Rule 156 merely provides guidance on when sales literature may be materially misleading. As noted in the rule "whether or not a particular description, representation, illustration, or other statement involving a material fact is or might be misleading depends on evaluation of the context in which it is made." The rule goes on to state that all pertinent factors should be considered and provides examples of situations that may be pertinent. NASAA believes that this information could be useful to private fund issuers.

H.R. 4852 further prohibits the Commission from requiring "an issuer to file any notice of sales containing the information required by Form D except for the single notice [to be filed no earlier than the date of first sale of securities in the offering]." The apparent intent of this language is to eliminate any further filing requirements under Regulation D. This ostensibly would prohibit the Commission from requiring termination filings as proposed in 2013, as well as eliminate existing amendment filing requirements that have been in place since at least 2007. Amendment filings are currently required, for example, where an issuer appoints additional officers and directors. Regulatory notice is appropriate in such an event to ensure bad actors are not participating in offerings that do not benefit from the disinfecting effect of registration. Amendment filings also are required when the issuer has raised the offering amount or the amount of sales commissions by more than ten percent. This information aids regulatory oversight and helps to detect fraud. While the SEC mandates this information, it is used by state regulators to detect fraud in their own jurisdictions. The mere fact that amendments are required serves a prophylactic effect that protects investors.

2. The Micro-Offering Safe Harbor Act (H.R. 4850)

The Micro-Offering Safe Harbor Act would amend Section 4 of the Securities Act to create three new exemptions from registration. Contrary to the bill's title, these exemptions are not limited to "micro offerings." The bill would exempt offerings that meet any of the following three criteria: (1) each purchaser has a substantive pre-existing relationship with either an officer or director of the issuer, or with a shareholder holding 10 percent or more of the issuer's shares; (2) there were no more than, or the issuer "reasonably believes" that there were no more than, 35 purchasers of securities from the issuer during the preceding 12 months; or (3) the aggregate amount of all securities sold by the issuer during the 12-month period preceding the transaction does not exceed $500,000. The bill also preempts state regulation of these securities offerings. The bill would not prohibit general solicitation, disqualify "bad-actors," limit offering amounts, or even permit notice filings to state and federal regulators.

[9] Rule 156 is an elaboration on the general antifraud rules under the Securities Act and Exchange Act, including Rule 10b-5, that applies to sales literature of investment companies and contains various examples of statements and representations in such sales literature that could be deemed misleading, such as unqualified representations regarding past or future performance, as well as portrayals of past results that may expressly or impliedly convey misleading inferences about past or future results.

The legislation stands to expose investors, including retail investors, to literally unlimited investment risk.[10] We have learned that efforts to spur successful capital formation must reflect a balanced regulatory approach that minimizes unnecessary costs and burdens on small businesses while protecting investors from fraud and abuse.[11] Without adequate investor protections to safeguard the integrity of the private placement marketplace, investors should and will flee from the market, leaving small businesses without an important source of capital.

The legislation also would undoubtedly serve to make the task of policing the Rule 506 marketplace much more difficult for state securities regulators. In fact, the bill likely would supplant Rule 506 given the similarities in the types of offerings but without the basic information provided in Form D. Given the lack of regulatory oversight, it is not hard to imagine that fraudsters would use these provisions to raise money from unsuspecting investors, ultimately eroding investor confidence and harming legitimate small businesses. Further, because the bill would not impose a holding-period or other restriction on the resale of securities purchased under the new exemptions, these offerings could be highly susceptible to price manipulations and "pump-and-dump" schemes.

Beyond the specific shortcomings of the safe-harbors established by H.R. 4850, which I will briefly discuss below, the goals of the legislation are unclear. The bill's title suggests its goal is to facilitate small-sized or "micro" offerings, but the bill would in fact permit the raising of unlimited amounts of money. Each of the new "safe harbors" that would be established by H.R. 4850 presents its own challenges for Congress.

Safe-harbor contingent upon substantive preexisting relationship:

Section 2(e)(1) of the bill would create a safe-harbor for transactions where "each purchaser has a substantive, preexisting relationship with an officer of the issuer, a director of the issuer, or a shareholder holding 10 percent or more of the shares of the issuer." It should also be noted that H.R. 4850 would impose a requirement of a substantive pre-existing relationship prior to the *sale* of securities, as opposed to prior to the *offering* of securities.

The availability of this type of exemption would very likely all but eliminate the need for Rule 506 of Regulation D. According to the SEC, a vast majority of Regulation D offerings are made to investors that have preexisting relationships with the issuer or its management.[12] Establishing a substantive preexisting relationship is not overly onerous. In SEC no-action letters

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[10] In contrast to other exemptions focused on small-sized offerings, such as Title III (crowdfunding) and Title IV (Regulation A+) of the JOBS Act, the exemptions established by H.R. 4850 would not impose any limitation on investor losses. Further, in contrast to the exemption under Rule 506, while H.R. 4850 would allow unrestricted general solicitation, it would not require issuers to even take "reasonable steps" to verify the accredited status of prospective purchasers.

[11] In 1992, the SEC amended Rule 504 to allow general solicitation, but reversed course when investors were inundated with fraudulent offerings. Securities & Exchange Commission. *SEC Release No. 33-7644*. Retrieved from sec.gov/rules/final/33-7644.txt

[12] *Securities Act Release No. 9416* (2013, July 10). ("The vast majority of Regulation D offerings are conducted without the use of an intermediary, suggesting that many of the investors in Regulation D offerings likely have a pre-existing relationship with the issuer or its management because these offerings would not have been conducted using general solicitation.").

dating back to the 1980s, the staff of the SEC have provided relief to issuers wishing to offer and sell securities in so-called private offerings. The SEC staff first dealt with issues involving intermediaries, allowing issuers to take advantage of non-public offering exemptions in selling to investors with which they have no connection if an intermediary had a relationship with the investors.[13] Most recently, the SEC staff have issued guidance that has been interpreted as permitting issuers themselves to establish pre-existing, substantive relationships with investors through the internet.[14] Given the relative ease with which broker-dealers and even issuers may establish "substantive pre-existing relationships" with prospective investors, the proposed exemption in Section 2(e)(1) of the bill would allow far more than "micro offerings."

Safe-harbor contingent upon 35 or fewer purchasers:

Section 2(e)(2) of the bill would create a safe-harbor for offerings when an issuer reasonably believes there are no more than 35 purchasers of the securities during the 12-month period preceding the sale. The significance of limiting the offering to 35 purchasers is of dubious significance. A recent SEC Staff Study noted that the average number of purchasers in Rule 506(c) offerings from September 2013-December 2014 was 10, and average of 14 purchasers in Rule 506(b) offerings during the same period.[15] The exemption undoubtedly would be attractive to bad actors, however, who would not be disqualified from relying on the exemption. Indeed, under the bill, fraudsters would be free to raise an unlimited amount of money from up to 35 investors every 12-month period. Federal and state regulators would have no ability to respond to inquiries from potential investors concerning the legitimacy of the offering in the absence of any regulatory notices or oversight.

Safe-harbor for offerings of below $500,000 in a 12-month period:

Section 2(e)(3) of the bill would create a safe-harbor for offerings where the aggregate amount of securities sold by the issuer in the 12-month period preceding the sale does not exceed $500,000.[16] Most state securities acts have small offering exemptions designed specifically for these kinds of small, local offerings. Again, this is an opportunity for fraudsters to sell to investors without any regulatory oversight, as this provision would not appear to permit any federal or state notice filings. Further, this provision is unnecessary in light of the federal crowdfunding rules and state intrastate offering exemptions that are already implemented to facilitate micro-offerings in a way that is consistent with investor protection. Rather than trying to create an unprecedented and dangerous new exemption, we urge Congress to allow the SEC to focus on implementing the proposed changes to the intrastate offering exemption under Rule 147 and the small offering

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[13] For example, the Staff have indicated that a company can sell securities to investors through a broker-dealer that has formed a relationship with the investors through the use of a questionnaire. E.F. Hutton & Co. *SEC No-Action Letter*, *1985 WL 55680*. (1985, November 3).

[14] Citizen VC, Inc. (2015, August 3).

[15] Bauguess, S., Gullapalli, R., & Ivanov, V. (2015, October). *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014* (p.36). Retrieved from sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf

[16] Further, this provision contains no integration clause. Effectively, the $500,000 cap is illusory with no integration clause.

exemption under Rule 504 that would provide relief to issuers that want to pursue offerings under state law.

In summary, the policies embodied in H.R. 4850 are unnecessary, confusing, contradictory and dangerous. NASAA strongly urges Congress to reject this deeply flawed and incoherent piece of legislation.

3. The Supporting America's Innovators Act (H.R. 4854)

Section 3(a)(1) of the Investment Company Act defines an "investment company" as an issuer which is "engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in 'securities," or "proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire 'investment securities' having a value exceeding 40 percent of the value of its total assets."[17] If an investment company is organized or otherwise created under the laws of the United States or of a state, meets the definition of an investment company, and cannot rely on an exception or an exemption from registration, generally it must register with the Commission and must register its public offerings under the Securities Act.

The Investment Company Act also specifically excludes certain investment pools from the definition of "investment company," and exempts from regulation a number of investment pools and entities. If an issuer falls within one of these exclusions or exemptions, it may not register as an investment company with the Commission. Many companies rely on one of the exceptions from the definition of investment company set forth in Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act - hedge funds and private equity funds, for example.[18]

Section 3(c)(1) excepts from the definition of investment company any issuer whose outstanding securities are beneficially owned by not more than one hundred persons, and that is not making and does not at that time propose to make a public offering of such securities. H.R. 4854 proposes to expand the limitation on beneficial owners established in Section 3(c)(1) from 100 to 500 investors for any "qualifying venture capital fund," which the bill defines pursuant to SEC Rule 203(I)-1.[19]

Expanding 3(c)(1) in the manner proposed by H.R. 4854 would expand not only the current exemption allowing yet another investment vehicle to operate without regulatory oversight, but also allow an investment adviser that is not licensed or examined to manage funds raised from a pool of investors that would be five times the size of that currently permitted (100 to 500). The Dodd-Frank Act took steps to bring more regulatory oversight of these important market

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[17] (1940). *Investment Company Act of 1940* (Section 3(a)(1)).

[18] These companies are commonly known as "private investment companies."

[19] Rule 203(1) defines a venture capital fund as a private fund that: (i) holds no more than 20 percent of the fund's capital commitments in non-qualifying investments (other than short-term holdings); (ii) does not borrow or otherwise incur leverage, other than limited short-term borrowing, excluding certain guarantees of qualifying portfolio company obligations by the fund); (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to its investors and prospective investors; and (v) is not registered under the Investment Company Act of 1940, as amended (the "Investment Company Act") and has not elected to be treated as a business development company ("BDC").

participants. Expanding the exemptions as contemplated by this bill would undermine important investor protections by allowing more firms to avoid regulatory scrutiny.

4. The Fix Crowdfunding Act (H.R. 4855)

State securities regulators appreciate Congress's continued interest in federal crowdfunding and frustration that federal crowdfunding has yet to take effect. Implementing Title III of the JOBS Act undoubtedly required the SEC to weigh novel questions and complex issues. However, it has been more than four years since the passage of the JOBS Act. During that time, dozens of states have adopted and implemented intrastate crowdfunding exemptions.[20] The United States is on the verge of entering a new era in crowdfunding with the SEC's Regulation CF due to take effect on May 16, 2016. In light of the soon to be effective federal rules, the developing nature of state laws, and the recent proposal of the SEC to revise Rules 147 and 504, Congress would be prudent to wait until the regimes have matured and there is a sufficient regulatory record in place before making changes to the crowdfunding laws.

The Fix Crowdfunding Act proposes a variety of revisions to Title III of the JOBS Act. It would amend Title III of the JOBS Act to increase the offering cap from its current $1 million to $5 million. The bill provides a grace period of 5 years to comply with the requirements of notice and confirmations, registration, written policies, and record keeping. The bill requires a "good faith" standard for those five years. The bill would also re-define "reasonability" for purposes of background checks and risk for fraud, and allow testing the waters. H.R. 4885 also provides relief from liability for funding portals, which would not be considered issuers under section 4A(c) of the Securities Act unless they knowingly make untrue statements or omissions, and grants a wholesale exemption from Section 12(g) of the Exchange Act. H.R. 4885 further provides that special purpose vehicles ("SPVs")[21] may invest in these offerings, and would allow public reporting companies and investment companies to conduct crowdfunding campaigns.

State securities regulators understand the theoretical basis for several of the proposed adjustments embodied in H.R. 4855, and do not necessarily oppose them. However, the critical point for Congress is that there is not now any way to provide a thoughtful answer to the question of what steps will or will not improve or "fix" federal crowdfunding, because we do not yet know what will work, what will not, or even what the new marketplace will look like, under existing law. There is no data whatsoever about what is or is not working with regard to federal crowdfunding, and only limited data about what is working at the state level. By contrast, several years from now, there will be a wealth of data, both from the state and federal crowdfunding regimes.

[20] Thirty states and the District of Columbia now have provisions on their books aimed at facilitating capital formation through crowdfunding. With the exception of the states of Maine and Mississippi, state crowdfunding provisions are premised upon the offering being conducted in compliance with the exemption from registration under Section 3(a)(11) of the Securities Act of 1933 and Rule 147 adopted thereunder.

[21] An SPV is a legal entity created to serve one function, such as facilitating a financial arrangement or creating a financial instrument. An SPV allows the ownership of a single asset, often by multiple parties, and allows for ease of transfer between parties.

Nevertheless, I am pleased to offer some observations on H.R. 4855, based on both my own analysis of the bill and the state experience with intrastate crowdfunding to date.

Pooled investments and equity crowdfunding:

One of the more interesting features of H.R. 4855 is Section 3(b) of the bill, which seeks to encourage investors to purchase crowdfunded securities through special purpose vehicles or "SPVs." Section 3(b) seeks to remedy a legitimate challenge for issuers that rely on crowdfunding. One of the defining features of equity crowdfunding is that it enables businesses to access equity capital from many investors at the earliest stages of their business growth cycle, sometimes known at the "seed stage." However, the flip-side to this feature is that businesses that choose to avail themselves of crowdfunding during the "seed stage" may complicate their ability to raise additional investment capital at a later date from other types of investors, such as from venture and private equity. This is because having numerous small-dollar shareholders may prevent the company from presenting a clean "capitalization table" to such prospective later-stage investors.

The basic concepts embodied in Section 3(b) – the pooling of many individual investments into a single entity, with one point of contact, the SPV organizer, who represents all of the SPV's investors – are familiar ones. SPVs have been used for many years in private equity to purchase equity in private and fast-growing companies. The utilization of SPVs in this context has the potential to offer benefits to both investors and issuers, but is not without significant concern. In case of investors, SPVs serve as a way for high net-worth individuals, families or other investors without specialized knowledge of or access to fast-growing companies to make investments alongside professional investors, who presumably possess detailed knowledge regarding such investments. The question for Congress is whether or not the pooled-investor structure makes sense in the context of small-dollar equity crowdfunding, as provided for under Title III of the JOBS Act.

At the most basic level, shifting the center of gravity away from individual investors, and toward SPVs managed by a single organizer, seems to invert the basic premise underlying crowdfunding: the wisdom of the crowd. Should Congress determine to introduce SPVs to crowdfunding, there are additional questions Congress should consider, including what fees could be associated with SPVs that invest in crowdfunding, and whether such fees have the potential to misalign the incentives for SPV organizers from those of investors.[22] Congress should also carefully consider what rights shareholders will be ceding by investing in crowdfunded offerings through an SPV, as opposed to purchasing shares directly.

Increasing the Offering Cap from $1 million to $5 million:

As already noted, NASAA strongly believes that the best way to evaluate the impact of many, if not all, of these changes to is monitor the actual experience of the crowdfunding marketplace once Regulation CF goes into effect next month. This is particularly true concerning the appropriate offering cap. At the present, we see little, if any, evidence to suggest that

[22] Depending on how the vehicle is structured, investments in crowdfunded offerings placed through SPVs could be subject both to management fee and carried interest fees, on a per SPV basis, making crowdsourced investments through an SPV rather than directly could be a more costly proposition for investors.

crowdfunding as envisioned by the JOBS Act would be more successful with an offering cap of $5 million. The limited information that is available from state crowdfunding experience suggests it likely would not. On the other hand, we cannot rule out the possibility that increasing the investment cap could be beneficial under some circumstances. We also note that the SEC has proposed amendments to Rule 504 that would increase the offering cap to $5 million for the expressed purpose of encouraging intrastate crowdfunding.[23]

Immunity for funding portals:

Section 3(e) provides that "no enforcement action" may be brought against a funding portal before May 16, 2021. The bill does require funding portals to make a good faith effort to comply with applicable rules. However, the requirement appears to be independent of the prohibition on SEC enforcement action. In other words, the legislation does not appear to require a demonstration of a good faith effort to comply in order to prevent a potential enforcement action. If that is the intent of the legislation then funding portals would be free to disregard all such rules. Further, there is no need for an exception for a "good faith effort" in the first place as the SEC has enforcement discretion and its limited resources necessarily cause regulatory reaction to violations to be appropriately scaled. This provision would frustrate the ability of the SEC to bring enforcement action where it deems such action is appropriate and in the public interest. We can see no legitimate basis for such a provision.

Testing the waters:

Section 3(d) of bill provides that testing the waters in Title III offerings would "not be considered an offer or sale of securities under this Act or the Securities Exchange Act of 1934." These provisions would effectively allow fraudulent offers in testing the waters campaigns without liability. The anti-fraud protections under the Securities Act (Sec. 12) are triggered by offers and sales of securities. Where there is no "offer" or "sale," there can be no violation.

Recommendations for Congress:

With the finalization of federal crowdfunding rules and intrastate crowdfunding available in more than half of the states, we shall now find out whether these new capital-raising tools will be frequently used, and whether state or federal rules prove more useful. As we learn what works and what does not from the viewpoint of entrepreneurs and small business owners, states and the SEC may make further adjustments to their crowdfunding rules. Any further adjustments should give due consideration, however, to investor protection.

State securities regulators urge Congress to refrain from amending Title III of the JOBS Act at this time. To enact legislation at this point would be counterproductive and premature. Until Congress has a body of data that can yield answers to questions about the efficacy of Title

[23] State crowdfunding provisions generally limit the offering amount that may be raised in a crowdfunding offering to $1 million in a twelve-month period with the opportunity to raise up to $2 million if audited financial statements are provided to prospective investors and filed with the state. Some states allow even greater amounts, with Illinois coming out on top with a maximum offering amount of $4 million in a twelve-month period. Other states specify lower amounts. Oregon, for example, limits the offering amount to $250,000, while Maryland has the lowest offering amount cap at $100,000.

III, it has little basis upon which to legislate coherently save for informed speculation, and the value of such speculative analysis cannot begin to compare to the value of real information that Congress will have at its disposal soon. Instead, Congress would be well served to closely monitor the implementation of Regulation CF, to conduct oversight, and to gather information about this new marketplace. Once real information begins to emerge about federal crowdfunding, Congress can seriously begin to explore how it can be improved.

Conclusion

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.