Written Testimony of
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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.

[1] 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.