



## Testimony on Crowdfunding and Capital Formation

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**Before the Subcommittee on TARP, Financial Services and Bailouts  
of Public and Private Programs of the U.S. House of  
Representatives, Committee on Oversight and Government Reform**

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Chairman McHenry, Ranking Member Quigley, and members of the Subcommittee:

My name is Meredith Cross, and I am the Director of the Division of Corporation Finance at the Securities and Exchange Commission. I am pleased to testify on behalf of the Commission on the topics of crowdfunding and capital formation.

The mission of the Securities and Exchange Commission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. As you know, Chairman Schapiro and I appeared before the Oversight and Government Reform Committee in May to testify on the topic of capital formation. In her testimony, Chairman Schapiro noted that a critical goal of the SEC is to facilitate companies' access to capital while at the same time protecting investors. Companies of all sizes need cost-effective access to capital to grow and develop, and the Commission recognizes that any unnecessary or superfluous regulations may impede their ability to do that. At the same time, the Commission must seek to ensure that investors have the information and protections necessary to give them the confidence they need to invest in our markets. Investor confidence in the fairness and honesty of our markets is critical to the formation of capital, and the protections provided by the securities laws are critical to large and small company investors alike.

Over the years the SEC has taken significant steps, consistent with its investor protection mandate, to facilitate capital-raising by companies of all sizes and to reduce burdens on companies making offerings, be it through introducing or increasing eligibility for shelf registration or implementing small business reforms. Going forward, the Commission will continue to consider and, if appropriate, implement changes to its existing rules to reduce regulatory burdens while maintaining important investor protections provided under the securities laws.

Indeed, a few months ago, Chairman Schapiro instructed staff to take a fresh look at some of our offering rules to develop ideas for the Commission to consider that may reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection. The staff's review is focusing on a number of areas, including:

- the number of shareholders and other triggers for public reporting;
- the restriction on general solicitation in private offerings; and
- restrictions on communications in public offerings.

An additional area the staff is reviewing concerns the regulatory questions posed by new capital raising strategies, including crowdfunding. My testimony today will focus on crowdfunding, as well as the broader capital formation regulatory review we are undertaking at Chairman Schapiro's request.

Chairman Schapiro previously stated that the staff would seek input in a number of these areas from the Commission's Advisory Committee on Small and Emerging Companies, which the Commission at the time was in the process of forming. I can report that the Commission recently announced the formation of this committee.<sup>1</sup> Its members represent a broad range of small and emerging companies, and investors in those types of companies, with real world experience under our rules. The advisory committee will provide a formal mechanism for the Commission to receive advice and recommendations about regulations that affect privately held and publicly traded small and emerging businesses. We look forward to working with the advisory committee and considering its views.

### **Crowdfunding – A New Capital Raising Strategy**

A new method of capital raising that is gaining increasing interest is crowdfunding. Generally, the term "crowdfunding" is used to describe a form of capital raising whereby groups of people pool money, typically comprised of very small individual contributions, to support an effort by others to accomplish a specific goal. This funding strategy was initially developed to fund such things as films, books, music recordings, and charitable endeavors. At that time, the individuals providing the funding were more akin to contributors than "investors" and were either simply donating funds or were offered a "perk," such as a copy of the related book. As these capital raising strategies did not provide an opportunity for profit participation, initial crowdfunding efforts did not raise issues under the federal securities laws.

Interest in crowdfunding as a capital raising strategy that could offer investors an ownership interest in a developing business is growing. Proponents of crowdfunding are advocating for exemptions from the Securities Act registration requirements for this type of capital raising activity in an effort to assist early stage companies and small businesses. For example, the Commission received a rulemaking petition requesting that the Commission create an exemption from the Securities Act registration requirements for offerings with a \$100,000 maximum offering amount that would permit individuals to invest up to a maximum of \$100.<sup>2</sup>

The staff has been discussing crowdfunding, among other capital raising strategies, with business owners, representatives of small business industry organizations, and state regulators. For example, crowdfunding was discussed at the Commission's November 2010 Forum on Small Business Capital Formation. In January, the staff met with a group from the Small Business & Entrepreneurship Council advocating an exemption from registration requirements for crowdfunding offerings meeting specific requirements. In addition, in March the staff discussed crowdfunding with

representatives from the North American Securities Administrators Association, the organization of state securities regulators.

Current technology allows small business owners to easily access a large number of possible investors across the country and throughout the world as a source of funding to help grow and develop their businesses or ideas. This source of capital and the ease with which an individual can communicate with and access investors electronically presents an opportunity for smaller companies in need of funds.

At the same time, of course, an exemption from registration and the investor protections provided thereby also would present an enticing opportunity for the unscrupulous to engage in fraudulent activities that could undermine investor confidence.<sup>3</sup> As a result, in considering whether to provide an exemption from the Securities Act registration requirements for capital raising strategies like crowdfunding, the Commission needs to be mindful of its responsibilities both to facilitate capital formation and protect investors.

The Commission's rules previously included an exemption, Rule 504, which allowed a public offering to investors (including non-accredited investors) for securities offerings of up to \$1 million, with no prescribed disclosures and no limitations on resales of the securities sold.<sup>4</sup> These offerings were subject only to state blue sky regulation and the antifraud and other civil liability provisions of the federal securities laws. In 1999, that exemption was significantly revised due in part to investor protection concerns about fraud in the market in connection with offerings conducted pursuant to this exemption.<sup>5</sup> In assessing any possible exemption for crowdfunding, it would be important to consider this experience and build in investor protections to address the issues created under the prior exemption.

Some of the questions to consider with regard to crowdfunding include:

- what information — for example, about the business, the planned use of funds raised, and the principals, agents, and finders involved with the business — should be required to be available to investors;
- what restrictions should there be on participation by individuals or firms that have been convicted or sanctioned in connection with prior securities fraud;
- should a Commission filing or notice be required so that activities in these offerings could be observed;
- should securities purchased be freely tradable; and
- should websites that facilitate crowdfunding investing be subject to regulatory oversight?

Although the business venture may have a well formulated plan and a committed entrepreneur, potential investors may have little information about the plan, its execution, or the entrepreneur behind the business. Investments in small businesses can be open to opportunism created by this information asymmetry. Sophisticated investors generally negotiate protections for themselves and may provide their funding over time to protect their investment, but due to the nature of crowdfunding ventures, crowdfunding investors may have limited investment experience, limited

information upon which to make investment decisions, and almost no ability to negotiate for protections. While the small amount of any potential crowdfunding investment should generally limit the extent of any individual's losses, these issues are among those that would need to be considered as a part of the cost-benefit analysis that the Commission would consider in connection with any future proposal.

As mentioned, the staff is reviewing crowdfunding and other capital raising strategies at Chairman Schapiro's request. The Chairman also has stated that the Commission's recently formed Advisory Committee on Small and Emerging Companies will be asked to assess these issues. We fully expect that the input from the advisory committee, as well as the input we receive from the public, will be helpful to the Commission as it considers these matters.

### **Update on Review of Certain Offering Regulations**

Given the Subcommittee's interest in capital formation matters, I also would like to provide an update on the staff's review of our regulations relating to the triggers for public reporting, the restrictions on general solicitation, and communications in connection with public offerings.

#### **Triggers for Public Reporting**

Chairman Schapiro asked the staff to review the triggers for public reporting and the characteristics of companies that should be subject to public reporting obligations. Section 12(g) of the Exchange Act, which sets forth certain registration requirements for securities, was adopted in 1964 following a rigorous special study of the securities markets in the early 1960s, commissioned by Congress and conducted by the Commission.<sup>6</sup> The study included a survey of over 2,000 issuers that sought data from these issuers on, among other things, asset levels, their securities offerings, shares outstanding, stockholders of record, and the number of shares held by large shareholders. The data derived from the study was critical in developing the most appropriate metrics upon which to base the triggers for public reporting given the nature of the companies and the shareholders that would be impacted.

Section 12(g) requires a company to register its securities with the Commission, within 120 days after the last day of its fiscal year, if, at the end of the fiscal year, the securities are "held of record" by 500 or more persons and the company has "total assets" exceeding \$10 million.<sup>7</sup> Shortly after Congress adopted Section 12(g), the Commission adopted rules defining the terms "held of record" and "total assets."<sup>8</sup> The definition of "held of record" counts as holders of record only persons identified as owners on records of security holders maintained by the company, or on its behalf, in accordance with accepted practice. As such, this definition simplified the process of determining the applicability of Section 12(g).<sup>9</sup>

Of course, securities markets have changed significantly since the enactment of Section 12(g) and the Commission's adoption of the definition of "held of record." Today, the vast majority of securities of publicly-traded companies are held in nominee or "street name" rather than directly by the owner. This means that the brokers that purchase securities on behalf of investors typically are listed as the holders of record. One broker may own a large position in a company on behalf of thousands of beneficial owners, but because the shares are all held in street name, those shares count as

being owned by one “holder of record.” This change in the way securities are held means that for most publicly-traded companies, much of their individual shareholder base is not counted under the current definition of “held of record.” Conversely, the shareholders of most private companies, who generally hold their shares directly, are counted as “holders of record” under the definition. This has required private companies that have more than \$10 million in total assets and that cross the 500 record holder threshold — where the number of record holders is actually representative of the number of shareholders — to register and commence reporting. At the same time, it has allowed a number of public companies, many of whom likely have substantially more than 500 shareholders, to stop reporting, or “go dark,” because there are fewer than 500 “holders of record” due to the fact that the public companies’ shares are held in street name. In light of these issues, some have called for changes to the definition and threshold adopted pursuant to Section 12(g).

The Commission has exercised its exemptive authority in the past to adjust the application of Section 12(g).<sup>10</sup> For example, in 2007, the Commission adopted Rule 12h-1(f) under the Exchange Act, which provides an exemption from the held of record threshold for compensatory stock options. This exemptive rule allows private companies to provide compensatory stock options to employees, officers, directors, consultants and advisors without triggering the need to register those options under the Exchange Act.<sup>11</sup>

A variety of proponents have advanced a wide range of proposals relating to possible amendments to Section 12(g) reporting standards. Some of these proposals seek to reduce the number of issuers required to report pursuant to the Exchange Act, for example, by raising the shareholder threshold,<sup>12</sup> by excluding employees, or by excluding accredited investors, qualified institutional buyers (“QIBs”) or other sophisticated investors from the calculation.<sup>13</sup> Bills have been proposed in the House and Senate that would seek to address many of these issues, including several seeking to increase the threshold with respect to community banks.<sup>14</sup> Conversely, the Commission has received a rulemaking petition requesting that the Commission revise the “held of record” definition to look through record holders to the underlying beneficial owners of securities that would prevent issuers from ceasing to report in certain circumstances.<sup>15</sup>

As stated, the securities markets have gone through profound changes since Congress added Section 12(g) to the Exchange Act. To facilitate the Commission’s review of the issues related to the thresholds for public reporting (and those for leaving the reporting system), the staff is undertaking a robust study like the one conducted when Section 12(g) was enacted. The study is seeking to determine whether the current thresholds and standards effectively implement the Exchange Act registration and reporting requirements and what it means to be a “public” company such that an issuer should be required to register its securities and file with the Commission. The staff has begun a detailed analysis of public company information — including numbers of record and beneficial owners, total assets, and public float — to assess the characteristics of public companies. The study also will seek to obtain and consider private company information to assess current reporting thresholds. To the extent that the staff develops recommendations or proposals regarding changes to the reporting thresholds for the Commission’s consideration, the consequences of any such proposed change will be subject to careful assessment as to the impact on investor protection and capital formation

and the other costs and benefits of any proposed change.

### **Restriction on General Solicitation**

Chairman Schapiro also asked staff to review the restrictions our rules impose on communications in private offerings, in particular the restrictions on general solicitation.

One of the most commonly-used exemptions from the registration requirements of the Securities Act is Section 4(2), which exempts transactions by an issuer "not involving any public offering." Currently, an issuer seeking to rely on Section 4(2) is generally subject to a restriction on the use of general solicitation or advertising to attract investors for its offering.<sup>16</sup> The restriction was designed to protect those who would benefit from the safeguards of registration from being solicited in connection with a private offering.

The Commission and staff have acted to facilitate capital raising in private offerings by adopting safe harbor rules, such as Rule 506, and providing guidance with respect to the scope of Section 4(2) and the restriction on general solicitation and advertising. Recognizing the increased use of the Internet and other modern communication technologies in private offerings, the staff has issued no-action letters providing issuers with flexibility to use modern communication technologies without the staff recommending enforcement action regarding the general solicitation restriction.<sup>17</sup>

Notwithstanding these efforts, the restriction on general solicitation is cited by some as a significant impediment to capital raising.<sup>18</sup> We understand that some believe that the restriction may be unnecessary because offerees who might be located through a general solicitation but who do not purchase the security, either because they do not qualify under the terms of the exemption or because they choose not to purchase, would not be harmed by the solicitation.<sup>19</sup> In addition, some have questioned the continued practical viability of the restriction in its current form given the presence of the Internet and widespread use of electronic communications. At the same time, others support the restriction on general solicitation on the grounds that it helps prevent securities fraud by, for example, making it more difficult for fraudsters to attract investors or unscrupulous issuers to condition the market.<sup>20</sup>

We believe it is important to consider both of these views about the need for the restriction on general solicitation in private offerings when considering possible revisions to our rules. In analyzing whether to recommend changes to the restriction, the staff is considering next steps, including a possible concept release for the Commission to seek the public's input on the advisability and the costs and benefits of retaining or relaxing the restrictions on general solicitation. The Commission could seek views from all interested parties on a number of issues related to the restriction on general solicitation, including specific protections that could be considered if the restriction is relaxed and the types of investors who would be most vulnerable if it is relaxed. The staff also will seek input from the Advisory Committee on Small and Emerging Companies. Of course, in considering whether to recommend that the Commission make changes to the rules restricting general solicitation, we will remain cognizant of our investor protection mandate.

### **Communications in Public Offerings**

We also are assessing our rules, and the regulatory burdens they impose, with respect to communication in public offerings. Over the years, the Commission has taken steps to facilitate continued communications around public offerings. For example, as early as 1970, the Commission adopted safe-harbor exemptions to make it clear that continued analyst research coverage does not constitute an unlawful offer.<sup>21</sup> In 2005, the Commission significantly reformed the registration and offering process by adopting a comprehensive set of rules and amendments to facilitate capital raising and relax restrictions on communications by issuers during the registered offering process.<sup>22</sup> These changes significantly liberalized the rules governing communications by the largest issuers during public offerings, thereby allowing more information to reach investors. The staff is reviewing the rules relating to communications in public offerings to consider whether any of the liberalizations adopted in 2005 should be adapted for smaller public companies, including whether more companies should be able to use free writing prospectuses before a substantially complete prospectus is filed. As a result of this review, the staff may recommend proposed changes to the offering rules, or recommend that the Commission seek additional input through the issuance of a concept release.

## Conclusion

In considering possible revisions to the Commission's rules, it is critically important that the staff gather data and seek input from a wide variety of sources, including small businesses, investor groups, and other members of the public. The data and input the staff receives should aid in the development of thoughtful recommendations for the Commission consistent with the goals of facilitating capital formation and protecting investors.

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.

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<sup>1</sup> See *SEC Announces Formation of Advisory Committee on Small and Emerging Companies* (Sept. 13, 2011), <http://www.sec.gov/news/press/2011/2011-182.htm>.

<sup>2</sup> Petition from Sustainable Economies Law Center to SEC (July 1, 2010), <http://www.sec.gov/rules/petitions/2010/petn4-605.pdf>. To date, the petition has received almost 150 comment letters, all in favor of the creation of such an exemption, with some offering different thresholds for offering size and/or individual investment limits. The comment letters are available at <http://www.sec.gov/comments/4-605/4-605.shtml>.

<sup>3</sup> Note that the antifraud provisions of the federal securities laws continue to apply to any offering or sale of securities, even if an exemption from registration applies. In Fiscal Year 2010, offering frauds — cases where promoters, issuers or others defraud investors in the offer of securities — comprised 22 percent of the Commission's cases.

<sup>4</sup> See Release No. 33-6949, *Small Business Initiatives* (July 30, 1992), <http://www.sec.gov/rules/final/6949.txt>.

<sup>5</sup> See Release No. 33-7644, *Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption* (February 25, 1999),

<http://www.sec.gov/rules/final/33-7644.txt> (referencing "disturbing developments" in, among other things, initial Rule 504 issuances).

<sup>6</sup> *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 88-95, pt. 3 (1963). According to the Committee Report summarizing the results of the study:

There is no convincing reason why the comprehensive scheme of disclosure that affords effective protection to investors in the exchange markets should not also apply in the over-the-counter market. . . . [B]ecause the over-the-counter market includes not only securities of widely known and seasoned companies but also those of relatively unknown and insubstantial ones, the need of investors for accurate information is at least as great, if not greater than in the exchange markets.

S. Rep. No. 88-379, at 9 (1963).

<sup>7</sup> See Exchange Act § 12(g)(1); Exchange Act Rule 12g-1. When Section 12(g) was enacted, the asset threshold was set at \$1 million. The asset threshold was most recently increased to \$10 million in 1996. Release No. 34-37157, *Relief from Reporting by Small Issuers* (May 1, 1996), <http://www.sec.gov/rules/final/34-37157.txt>.

<sup>8</sup> See Release No. 34-7492, *Adoption of Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934* (January 5, 1965).

<sup>9</sup> See *id.*

<sup>10</sup> Exchange Act Section 12(h) provides the Commission broad authority to exempt issuers from the registration requirements of Section 12(g) so long as the Commission finds that the action is not inconsistent with the public interest or protection of investors. The Commission has previously relied on Section 12(h) to raise the total assets threshold. Additionally, Congress has provided the Commission broad exemptive authority in Section 36 of the Exchange Act. The Commission has previously established exemptions from the Section 12(g) requirement and Section 12(g) provides the Commission with authority to define the terms "held of record" and "total assets." See Exchange Act Rule 12g3-2 and Exchange Act § 12(g)(5).

<sup>11</sup> Release No. 34-56887, *Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934* (December 3, 2007), <http://www.sec.gov/rules/final/2007/34-56887.pdf>. The staff of the Division of Corporation Finance also issued a no-action letter saying that it would not recommend an enforcement action to a company that issued restricted stock units due to the similarities between them and stock options. See *Facebook, Inc.* (October 14, 2008).

<sup>12</sup> In a November 12, 2008 letter, the American Bankers Association made the argument that the 500-shareholder threshold should be increased to reduce the regulatory hardship suffered by small community banks. See Comment Letter from American Bankers Association to SEC (November 12, 2008), <http://www.sec.gov/rules/petitions/4-483/4483-21.pdf>.

<sup>13</sup> See *2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report* (May 2010),

<http://www.sec.gov/info/smallbus/gbfor28.pdf>.

<sup>14</sup> See H.R. 2167, 112<sup>th</sup> Cong. (2011); S. 556, 112<sup>th</sup> Cong. (2011); H.R. 1965, 112<sup>th</sup> Cong. (2011); and H.R. 1697, 112<sup>th</sup> Cong. (2011).

<sup>15</sup> On February 24, 2009, the Commission received a rulemaking petition urging the Commission to count beneficial owners instead of record holders to prevent companies with large numbers of holders from exiting the reporting system. See Petition from Lawrence Goldstein to SEC (February 24, 2009), <http://www.sec.gov/rules/petitions/2009/petn4-483-add.pdf>. This followed an earlier, similar petition. See Petition for Commission Action to Require Exchange Act Registration of Over-the-Counter Equity Securities (July 3, 2003), <http://www.sec.gov/rules/petitions/petn4-483.htm>.

<sup>16</sup> See Rule 502(c) of Regulation D and Release No. 4552, *Non-Public Offering Exemption*, (November 6, 1962).

<sup>17</sup> See, e.g., IPONET (July 26, 1996) (general solicitation is not present when previously unknown investors are invited to complete a web-based generic questionnaire and are provided access to private offerings via a password-protected website only if a broker-dealer makes a determination that the investor is accredited under Regulation D); Lamp Technologies, Inc. (May 29, 1998) (posting of information on a password-protected website about offerings by private investment pools, when access to the website is restricted to accredited investors, would not involve general solicitation or general advertising under Regulation D).

<sup>18</sup> See, e.g., *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission* (April 23, 2006), <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>; Joseph McLaughlin, *How the SEC Stifles Investment — and Speech*, *The Wall Street Journal* (February 3, 2011). Concerns about the scope of the Commission's rules on general solicitation and advertising have been raised by the participants in the annual SEC Government-Business Forum on Small Business Capital Formation. See *2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report* (May 2010), <http://www.sec.gov/info/smallbus/gbfor28.pdf>.

<sup>19</sup> See *Pinter v. Dahl*, 486 U.S. 622, 644 (1988) (“The purchase requirement clearly confines §12 liability to those situations in which a sale has taken place. Thus, a prospective buyer has no recourse against a person who touts unregistered securities to him if he does not purchase the securities.”).

<sup>20</sup> See, e.g., J. William Hicks, *Exempted Transactions Under the Securities Act of 1933* § 7:160 (2d ed. 2002); Comment Letter from Investment Companies Institute to SEC (October 9, 2007), <http://www.sec.gov/comments/s7-18-07/s71807-37.pdf> (warning that unlimited general solicitation would “make it difficult for investors to distinguish between advertisements for legitimate offerings and advertisements for fraudulent schemes”).

<sup>21</sup> See Release No. 33-5101, *Adoption of Rules Relating to Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Filing of a Registration Statement Under the Securities Act of 1933* (November 19, 1970).

<sup>22</sup> See Release No. 33-8591, *Securities Offering Reform* (July 19, 2005), <http://www.sec.gov/rules/final/33-8591.pdf>.

<http://www.sec.gov/news/testimony/2009/ts091511mbc.htm>

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