SPEECH

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Harnessing the Internet to Promote Access to Capital for Small Businesses, While Protecting the Interests of Investors

Commissioner Luis A. Aguilar

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Today, the Commission is proposing new rules to implement Title III of the JOBS Act, which exempts qualifying crowdfunding transactions from the registration and prospectus delivery requirements of the Securities Act.[1] The new Regulation Crowdfunding is expected to be used primarily by small companies. As is well known, although personal savings is the largest source of capital for most start-ups, external financing is very important to many small and medium-sized businesses.[2] Unfortunately, as is also well known, many small businesses have difficulty finding external capital.[3] It is worth noting that the need for outside investment is even greater among minority entrepreneurs, who tend to have lower personal wealth than their non-minority counterparts.[4]

Supporters of crowdfunding believe that it may offer a potential solution to the small business funding problem.[5] Observers point to the success of existing crowdfunding services around the world, which raised almost $2.7 billion in 2012, an increase of more than 80% from the prior year.[6]

However, even the strongest supporters of crowdfunding acknowledge that it carries substantial risks.[7] Small business investing is inherently risky and, the fact is, the majority of new business establishments fail.[8] Research indicates that, in the U.S., about 70% of initial venture-capital investments lose money.[9] Moreover, small business investments tend to be highly illiquid, as most securities offerings may be too small for an active secondary trading market to develop.[10] As a result, crowdfunding investors must be prepared to hold and bear the risk of their investments indefinitely.

In addition to these risks, commenters, including state securities regulators, have noted that small business investments may pose relatively high risks of fraud, and may afford the potential for self-dealing or overreaching by controlling shareholders.[11]

As contemplated by the JOBS Act and our proposed rules, the hope is that such risks will be minimized by the disclosures that will be required under Regulation Crowdfunding, and by the individual and aggregate investment limits to be imposed in such offerings. It is also hoped that the risks will be further offset by the gatekeeping role of the crowdfunding intermediary—a registered broker-dealer or registered funding portal—which sits between the investor and the issuer. Under the proposed rules, the crowdfunding intermediary is required to keep an eye out for fraud and to have a reasonable basis for believing that the issuer has complied with the requirements of the exemption.[12] The crowdfunding intermediary will also provide a forum for information sharing, with communications by an issuer or paid promoter clearly identified as such. However, it is acknowledged that, while those and other proposed conditions may possibly reduce harm, they can never eliminate the risks.[13]

Many believe that, if structured appropriately, crowdfunding can bring great benefits to our economy. However, for crowdfunding to have a positive impact on the small business funding problem, it must work for both issuers and investors. In particular, it is vitally important that investors have confidence in the crowdfunding process—or they will stay away. The need for both investor protection and investor confidence is why Section 302(c) of the JOBS Act specifically directs the Commission to issue such rules "as the Commission determines may be necessary or appropriate for the protection of investors" to carry out the statutory exemption.[14] As we enter the public comment process for this rulemaking, it will be important to hear from investor advocates if the proposed rules have enough safeguards built-in to protect investors

from fraud and self-dealing and to provide them with confidence that they are being dealt with fairly and honestly.

The use of crowdfunding to reach potentially vulnerable segments of society is a particular concern. Many of the SEC's enforcement cases arise from "affinity frauds" that exploit the trust and friendship that often exists among members of any ethnic, religious, or other community.[15] Given the possibility that crowdfunding may facilitate affinity fraud by making it easier to identify and target vulnerable groups, I would urge the Commission's enforcement staff and state securities regulators to take a proactive approach to monitor the crowdfunding space for potential problems. In that regard, I am pleased to note that the North American Securities Administrators Association announced the formation of a task force on Internet fraud investigations shortly after the enactment of the JOBS Act.[16]

Clearly, all investments bear some degree of risk. However, to the extent that crowdfunding increases the risks of fraud, illiquidity, and self-dealing to relatively unsophisticated investors, it will be incumbent upon the Commission and state securities regulators to take appropriate measures. Problems that arise from the actions of crowdfunding issuers or portals could generally affect investor confidence in the capital markets and have an adverse effect on capital formation.

It is therefore essential that the Commission work to establish this new financing technique in a responsible manner. Because of the importance of small business funding, I support the issuance of this proposal. However, I recognize that crowdfunding may entail substantial risks. I look forward to public comments, particularly from investors and investor advocates, as to how the rules can be improved. I also note that Title III of the JOBS Act expressly requires that, in carrying out the rulemaking required to implement the crowdfunding exemption, the Commission shall consult with the state securities commissions.[17] To that end, I look forward to hearing from state regulators.

I thank the staff for their hard work on this proposal.

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[1] Crowdfunding can be defined as using the Internet to raise small investments from a large number of investors. *See,* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 Colum. Bus. L. Rev. 1, 10. Title III of the JOBS Act amended the Securities Act of 1933 (the "Securities Act") to add Section 4(a)(6) and Section 4A to the Securities Act. Together, these new sections establish the foundation for a regulatory structure for the offering and sale of securities through crowdfunding. *See*, Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (the "JOBS Act"). The rules proposed today would both govern the offer and sale of securities in transactions that qualify for the crowdfunding exemption and create a framework for the regulation of crowdfunding platforms.

[2] Ewing Marion Kauffman Foundation, *2013 State of Entrepreneurship Address* (February 5, 2013), p.2, http://www.kauffman.org/uploadedFiles/DownLoadableResources/SOE Report_2013pdf.pdf . Many entrepreneurs max out their credit cards, or take loans or investments from friends and family; others rely on trade credit and other forms of vendor financing, or seek commercial bank loans and lines of credit. *See,* Alicia M. Robb and David Robinson, *The Capital Structure Decisions of New Firms*, Ewing Marion Kauffman Foundation (November 2008), http://www.kauffman.org/uploadedfiles/Capital_Structure_Decisions_New_Firms.pdf .

[3] A 2012 study by the National Small Business Association found that 43% of small business owners surveyed could not get the financing they needed. National Small Business Association, *Small Business Access to Capital Survey* (July 11, 2012), p. 4, http://www.nsba.biz/wp-content/uploads/2012/07/Access-to-Capital-Survey.pdf .

[4] U.S. Department of Commerce, Minority Business Development Agency, *Disparities in Capital Access between Minority and Non-Minority-Owned Businesses: The Troubling Reality of Capital Limitations Faced by MBEs* (January 2010), pp. 6-8, *et seq.*, http://www.mbda.gov/sites/default/files/DisparitiesinCapitalAccessReport.pdf. Women and persons of color also face additional obstacles raising outside capital for their small businesses. *See,* Board of Governors of the Federal Reserve System, *Report to the Congress on the Availability of Credit to Small Businesses* (September 2012), pp. 42-45, http://www.federalreserve.gov/publications/other-reports/files/sbfreport2012.pdf; *supra* note 23, pp. 19-22.

[5] *See, e.g. Bradford*, p. 5.

[6] Today, crowdfunding platforms in the U.S. generally operate on a "pre-sale" or "donation-and-reward" model, in which participants contribute to a project they wish to support in exchange for a copy of the finished work or some other token of thanks. *See,* Kent Bernhard Jr., *Crowdfunding's tally: $2.6 B in 2012 and growing,* Upstart Business Journal (April 8, 2013), http://upstart.bizjournals.com/money/loot/2013/04/08/crowdfundings-tally-26-b-in-2012.html .

[7] *See, e.g. Bradford*, pp. 9, 99.

[8] *See,* Bureau of Labor Statistics, Business Employment Dynamics, *Entrepreneurship and the U.S. Economy*, http://www.bls.gov/bdm/entrepreneurship/entrepreneurship.htm.

[9] Telephone Interview by Marc Leaf, Counsel to Commissioner Luis A. Aguilar, with Shikhar Ghosh, Senior Lecturer, Mel Tukman Faculty Fellow, Harvard Business School (October 22, 2013). *See,* Deborah Gage, *The Venture Capital Secret: 3 Out of 4 Start-Ups Fail,* The Wall Street Journal (September 20, 2012), http://online.wsj.com/news/articles/SB10000872396390443720204578004980476429190 (citing research by Shikhar Ghosh).

[10] *See, e.g. Bradford*, pp. 9, 99*; see, also,* Dina ElBoghdady, "'Crowdfunding' trend poised to make mark on U.S. investing landscape," The Washington Post (April 29, 2013), *available at* http://articles.washingtonpost.com/2013-04-29/business/38902177_1_crowdfunding-small-businesses-investors (citing NASAA president Heath Abshure).

[11] *See, e.g. Bradford*, pp. 9, 99. *See, also,* letter from Andrea L. Seidt, Commissioner, Ohio Division of Securities (January 9, 2013), *available at* http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-199.pdf (crowdfunding provides investors with "almost no bargaining power and little information").

[12] *See, Crowdfunding,* Release No. 33-XXXX (October 23, 2013) (the "Proposing Release"). The crowdfunding intermediary is required, at a minimum, to conduct a background and securities enforcement regulatory history check on each issuer and its officers, directors and 20% beneficial owners, and must deny access to its platform if (i) the intermediary believes that the issuer or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection, or (ii) the intermediary believes that it is unable to effectively assess the risk of such fraud. If, after it has granted access to an issuer, an intermediary becomes aware of information that causes it to believe that the issuer or offering presents the potential for fraud, or otherwise raises concerns regarding investor protection, the intermediary must promptly remove the offering from its platform, cancel the offering, and return (or direct the return of) any funds that have been committed by investors in the offering.

[13] *Bradford*, pp. 9, 99.

[14] JOBS Act § 302(c).

[15] *See, e.g.,* "Investor Bulletin: Affinity Fraud," SEC Office of Investor Education and Advocacy (September 2012), www.sec.gov/investor/alerts/affinityfraud.pdf.

[16] Press release, "NASAA Sees Sharp Spike in Crowdfunding Presence on the Internet" (December 5, 2012), http://www.nasaa.org/18951/nasaa-sees-sharp-spike-in-crowdfunding-presence-on-the-internet/

[17] JOBS Act § 302(c).

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