PATRICK T. McHENRY
CHIEF DEPUTY WHIP
MEMBER OF CONGRESS
10TH DISTRICT, NORTH CAROLINA

2334 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
(202) 225-2576
FAX: (202) 225-0316
www.house.gov/mchenry

VICE CHAIRMAN,
COMMITTEE ON FINANCIAL SERVICES

# Congress of the United States
## House of Representatives
### Washington, DC 20515–3310

DISTRICT OFFICES:
87 FOURTH STREET, NW
SUITE A
P.O. BOX 1830
HICKORY, NC 28603
(828) 327-6100
FAX: (828) 327-8311

GASTONIA DISTRICT OFFICE:
128 WEST MAIN AVENUE, SUITE 115
GASTONIA, NC 28052
(704) 833-0096
FAX: (704) 833-0887

BUNCOMBE REGIONAL OFFICE:
BLACK MOUNTAIN TOWN HALL
160 MIDLAND AVENUE
BLACK MOUNTAIN, NC 28711
(828) 669-0600

TOLL FREE IN NC
(800) 477-2576

The Honorable Jay Clayton
Chairman
Securities and Exchange Commission
100 F St. NE
Washington, DC 20549

May 15, 2017

Dear Chair Clayton,

It is with great respect and enthusiasm that I congratulate you on your confirmation as Chair of the United States Securities and Exchange Commission (SEC). I believe that your extensive expertise and leadership in facilitating capital formation, and reducing unnecessary burdens for American small businesses, will help you in leading the SEC in ushering in a new era of capital formation and investment opportunities for all Americans.

This year marks the five-year anniversary of the JOBS Act. While that is cause for celebration, I remain concerned with Regulation Crowdfunding (Regulation CF), which was finalized prior to your arrival at the SEC.

Regulation CF has kept the JOBS Act from fully reaching its potential to encourage capital formation and foster economic growth. As the author of the House version of Title III of the JOBS Act, I believe that Regulation CF must be comprehensively reformed so that startups and small businesses can take full advantage of the opportunities that crowdfunding offers them to raise capital, create jobs, and develop innovative products and services.

For that reason, I respectfully submit the following regulatory reforms to improve investment crowdfunding and achieve the goals originally envisioned in the JOBS Act. These proposals do not require Congressional action, but instead can be implemented by the SEC in revising Regulation CF.

**"Testing the Waters"**

The biggest hurdle that entrepreneurs face is in determining whether they have created something that investors want to fund. "Testing the waters" is one of the most effective ways for companies to test market interest, and go back to the drawing board if necessary, before undertaking a formal offering. But "testing the waters," which was in the previous iteration of Regulation A and Regulation A+ under the JOBS Act, is not available under Regulation CF. Small businesses and startups should be permitted to test their ability to raise money on a crowdfunding portal just as they can for traditional private placements.

Changing Regulation CF to allow small businesses and startups to "test the waters" does not require the SEC to create new forms, or embark on a lengthy rule-writing process. Small businesses and startups can "test the waters" using the same forms and means of communication as they would for an actual offering under Regulation CF.

Specifically, small businesses and startups would not conduct an offering per se, but would instead follow the same requirements for "terms" and "non-terms" communications set forth in Regulation CF for an actual offering. No money would change hands. Potential investors would merely provide an indication of interest instead of actual capital, which in turn would give these companies a better understanding of the market's interest in a potential offering.

**Special Purpose Vehicles**

There is bipartisan, bicameral support in Congress for allowing startups and small companies to use special purpose vehicles (SPVs) under Regulation CF as another way to manage their crowdfunding efforts. The ability to provide investors with a secure, single entity to invest eases the burden on these small businesses and provides peace of mind to future investors. Given Congress's support for this practice, the SEC should permit issuers to use SPVs as another way for investors to participate in crowdfunding offerings.

Having hundreds or potentially thousands of investors in a small private company can be unwieldy and a potential impediment to future financing rounds. The use of the SPVs in crowdfunding would streamline investor participation, provide much-needed credibility to attract higher profile investors, and create administrative convenience to reduce the burden on the issuer. Moreover, SPVs attract future investment that is already being successfully used for other offering exemptions. In sum, SPVs are a logical next step for offerings conducted under Regulation CF.

**Section 12(g) Reporting Requirements**

In contrast to the SEC's initial Regulation CF proposal, the final SEC rule provides only a conditional exemption from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934. Under Regulation CF, an issuer with total assets exceeding $25 million and more than 500 non-accredited investors must register with the

SEC and is subject to reporting requirements similar to those that apply to publically traded companies.

The reporting requirements of 12(g) are poorly suited to crowdfunding's goals of assisting small businesses and democratizing investment opportunities for everyday Americans. The reality is that 500 non-accredited investors is a particularly low ceiling considering that the very nature of crowdfunding is to raise capital by leveraging networks of millions of potential, low-dollar investors. And the prospect of a company showing assets—not even net assets—of $25 million will dissuade many small businesses from considering crowdfunding as a way of raising capital.

Because these companies are too small to bear the burden of complying with Section 12(g)'s onerous reporting requirements, I urge the SEC to return to the exemption in the form set out in the Proposing Release, consistent with Congress's intent in enacting the JOBS Act.

**Offering Limit**

Raising the offering limit above $1,070,000 would not only assist companies raising money, but also protect investors.

Under the current offering limit, many businesses cannot justify the time and cost of a Regulation CF offering for the relatively small amount of capital that can be raised. Mandated third-party costs alone—such as compensation paid to the funding portal, escrow agent and transfer agent—consume a significant portion of the proceeds raised in the offering, and other fees similarly come at no small cost.

Increasing the amount that small companies can raise would attract more mature and thus less risky businesses that still need significant capital. In addition, a higher offering limit might sway a company from engaging in a traditional private placement to conducting an offering with its followers and customer base in a more public "light of day" Regulation CF offering. For these kinds of companies, the regulatory burden would be mitigated by greater potential capital and visibility.

Because the SEC has the discretion to review the offering limit and adjust it to reflect changes in the consumer price index, the issue is ripe for the SEC to consider reform.

**Accredited Investors Limit**

Accredited investors should be allowed to invest as much as they want in a Regulation CF offering, just as they can in Regulation A+ offerings.

Sophisticated, experienced investors cannot provide significant funding to entrepreneurs on crowdfunding portals, which diminishes a way for small businesses to access capital. Additionally, removing accredited investor limits will help protect less experienced non-accredited investors because less experienced investors benefit from the expertise that

"sophisticated" or professional investors bring to bear in choosing which startups are worthy of investment. Thus, their willingness to commit substantial amounts of their own funds serves as a signal to less experienced investors.

The SEC has the power to grant exemptions from the Securities Act of 1933 if doing so is in the public interest and in furtherance of the protection of investors. Exempting accredited investors from the investment caps for offerings under Regulation CF will provide a layer of oversight and expertise into this new area of capital formation, and open up a meaningful amount of capital for small businesses and entrepreneurs.

**Accounting Disclosure Requirements**

Regulation CF requires accounting disclosure requirements that are unduly burdensome to startups and new small businesses. Particularly for startups that have no revenue, the requirements of financial statements using the Generally Accepted Accounting Principles (GAAP) is ill-suited for providing the accounting information that potential investors need for making their decisions on crowdfunding portals.

The SEC should replace GAAP requirements under Regulation CF with a simple disclosure of cash on hand, and incurred liability and prior cash investment the company has received—all certified by the company's CEO or founder. This approach would provide investors with the relevant information they need to assess a company at most early stages, while significantly reducing the cost and time that it takes for new startups to pursue a crowdfunding campaign using Regulation CF.

**Advertising Guidelines**

The advertising rules in Regulation CF are needlessly complex and restrictive.

Under the SEC's adopting release and subsequent SEC interpretations, issuers can advertise in two ways: (1) with a tombstone ad that lists only certain deal terms, including the amount being raised, type of security, price of security and offering deadline, but does not give any in-depth information about the company; and (2) with an ad that generally states that the company is raising money, but does not list the enumerated deal terms. The statute also directs issuers to "not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker." Thus, to reach potential investors, companies must prepare two types of ads and distribute them through different channels, often at different times.

Regulation CF's advertising guidelines ought to be expanded. Companies should be allowed to communicate information sufficient to engage a potential investor's attention. For example, small businesses and startups should be permitted to produce digital ads that direct potential investors to the company's campaign pages on the funding portal sites.

In addition, Regulation CF should incorporate flexibility for small businesses and startups to interact with third-party media. As the regulations stand, issuers are unable to respond to media requests for information related to news articles and stories for fear of violating the advertising guidelines. The press provides an important window into the companies and crowdfunding portals. As long as the content is produced by an independent news source without compensation from the issuer, interviews and the provision of other information should be permitted under Regulation CF.

**Multiple Postings (Fee Splitting) for Funding Portals**

Regulation CF requires that issuers can only use one registered funding portal, albeit with the ability to use additional broker dealers.

The problem is that funding portals would like to work together to promote a deal and to share the related fees amongst themselves. This allows funding portals to cooperate to promote and monitor an offering. And it protects investors by ensuring more eyes are reviewing the offerings pre- and post-launch, which assists the issuers by exposing deals to multiple networks.

Regulation CF should be amended to allow issuers to use one or more registered funding portals where the technology permits investors on any portal to see all crowd comments made on all portals. The fees would be split only among the regulated funding portal entities or registered broker dealers, so that there is still both FINRA and SEC oversight over the process.

**Multiple Closings**

Although the SEC staff has stated that multiple closings for crowdfunding offerings are permitted under Regulation CF, the requirements for doing so make it nearly impossible for crowdfunding portals to take advantage of this opportunity.

Under the current process, issuers who hit their target offering amount must either (1) wait until the final offering deadline to close the offering, or (2) accelerate the close of the offering, possibly leaving funds on the table. In practice, however, issuers who hit their target offering amounts before the offering deadline often seek to employ the capital immediately to create jobs, invest in equipment, and grow the business.

Multiple closings allow founders and small business owners the flexibility they need to grow the business. And multiple closings could be conducted in accordance with Regulation CF as described in the early closing scenario provided by the SEC. Thus, the SEC needs to reform the position that it has taken regarding multiple closings and the mechanics provided in the rules to provide guidance as to how multiple closings affect other provisions of Regulation CF, including how a company should deal with material changes occurring after a closing has been held.

**Reconfirmation Time for Material Changes**

At present, Regulation CF requires that an issuer receive reconfirmation within five days of a material change made to the offering. As a result, issuers are losing investment dollars when seeking reconfirmations simply because investors are missing the five-day deadline. While there should continue to be affirmative notification requirements for material changes, five days is not a reasonable timeframe for most everyday investors. For that reason, I suggest that the period for an investor to affirmatively reconfirm its investment be extended until 48 hours prior to the close of the offering. That provides investors more flexibility for responding to the requests, and it gives small businesses and startups more time to secure the capital they need.

**Credit Card Payments**

While it is clear under Regulation CF that payment for securities on a crowdfunding portal may be made using a debit card, it is not clear that a credit card may be used to make such payment. The confusion arises from the SEC's prohibition of payments for securities on "margin." All stakeholders in Regulation CF—issuers, investors, and funding portals—strive to make the investment process as user-friendly as possible. I do not believe that the intent of such margin rules was to prevent these types of transactions. If policy decisions about margin and credit card payments are within the purview of the Federal Reserve Board, I urge the SEC to work with the Fed to ensure that credit cards are permitted.

**Warrants as Compensation**

Regulation CF sets forth rules governing the creation and operation of funding portals as the intermediaries between the issuers and the investors. The regulations give funding portals the right to receive the same type of securities received by investors as compensation for facilitating the offering. This is essential; often the only compensation that cash-strapped start-ups can offer in exchange for labor and other services is their equity or other similar interests.

However, receiving actual equity in the issuer as compensation poses practical problems for the funding portal. After all, funding portals are startups as well, and the consequences of such non-cash items creating a cash tax bill are problematic.

The simple fix is to adopt the structure that investment banks have long implemented that allows payment to be made in warrants for the underlying securities that the crowdfunding investors receive. This allows the funding portal to defer the tax bill, but still requires it to receive the underlying securities with all the same terms as the investors that use their platform.

The language of Regulation CF arguably allows for intermediaries to receive warrants, as there is a distinction between "financial interest" and "securities." The rules currently allow for funding portals to receive a financial interest that "consists" of securities with

the same terms, conditions and rights as those received by the crowdfunding investors. In this case, the financial interest—the warrants—would consist of and have the same underlying terms as the securities provided to investors.

While the language is arguably in the rules already, an express provision—or interpretation—would remove the guesswork and potential for a different interpretation.

**Secondary Market**

Regulation CF should be updated to encourage the development of a robust secondary market for securities issued under Regulation CF. Currently, the transfer limitation period for such securities expires after one year and much uncertainly resides around how to properly effectuate a transfer.

Regulated trading sites are a logical answer. These sites could be operated by the funding portals or their affiliates, and leverage the annual reports required to be filed with the SEC to ensure potential secondary market investors receive adequate information about these potential investments. Additionally, state securities registration requirements need to be preempted with respect to such transfers, just like the initial offering, while maintaining state anti-fraud and enforcement authority to ensure that states can adequately protect their citizens. The liquidity provided by a secondary market is an investor protection in and of itself, because it would allow individuals whose financial situation has changed to exit these investments in times of need.

While this area was not addressed by the JOBS Act or Regulation CF, it is well within the SEC's jurisdiction. More importantly, it is vital for small businesses and startups interested in accessing capital via crowdfunding.

***

In sum, Regulation CF is in desperate need of regulatory reform. I look forward to working with you to advance crowdfunding and achieve the core mission of the Securities and Exchange Commission in protecting investors and facilitating capital formation, particularly for America's entrepreneur, small businesses, and startups.

Sincerely,

Patrick McHenry (NC-10)
Vice Chairman
House Committee on Financial Services