"Reversing the Decline in Capital Formation"

Testimony of

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May 10, 2011

Before the

Committee on Oversight and Government Reform
United States House of Representatives

The Honorable Darrell Issa, Chairman
The Honorable Elijah Cummings, Ranking Member

Introduction:

Chairman Issa, Ranking Member Cummings and members of the Committee, thank you for holding this hearing today and allowing me to share an entrepreneur's perspective on improving capital formation through regulatory modernization. My intention is to explain why outdated securities laws -- put in place before the Internet age -- need to be modernized and overhauled, and how these reforms can boost our struggling economy. By revamping the Security and Exchange Commission's (SEC's) position on solicitation and accreditation, we can open the doors to small business growth and prosperity. Allowing for an exemption for Crowd Fund Investing, which includes protections for investors, will spur innovation among your constituents, create jobs, increase consumer spending, and reinvigorate our economy.

My Name is Sherwood Neiss and I am an Entrepreneur. This is my second time testifying before the U.S. Congress. The last time I was here, in 2006, I testified on the unintended consequences of Sarbanes-Oxley on small businesses. I pointed out that the regulatory burdens under Section 404 were the reasons why the audit at our '3-time INC500, Entrepreneur of the Year award winning' company tripled in time and cost, ate up 14% of our net income and made us decide that we were better off selling the company than raising capital in the public markets to grow, hire and expand. I am delighted that my and others' testimony helped convince Congress to pass the small business exemption from 404(b) audit requirements, and I am hopeful that my testimony today will convince you to consider other adjustments to existing rules that hinder capital formation and access.

I am going explain to you what Crowd Fund Investing is and how it will help our nation's entrepreneurs, how the principals of crowd funding have been working for hundreds of years and over the past 5 years helped fund over $300M in ideas. Why based on our nation's current economic challenges we need to make it possible for the average American to crowd fund startups and small businesses. Why the burden of disclosure for registration of startups and small businesses unduly prohibits seed and early stage capital formation, and how we can address investor protection thru education.

I and my co-founders at startupexemption.com, Jason Best and Zachary Cassady-Dorion, have crafted the following Crowd Fund Investing proposal in collaboration with Karen Kerrigan of the Small Business & Entrepreneurship Council.

CROWD FUND INVESTING:

Crowd Fund Investing (CFI) is not permitted by securities laws today but it stands to be a powerful method of financing, where groups of people will come together to invest in startups and provide valuable knowledge and experience to help an entrepreneur succeed. It will provide a way for unaccredited investors to pool their individual small contributions (likely between \$50 – \$500 each), and invest in companies and entrepreneurs they believe in. The funding rounds will occur on Internet platforms, which provide an added level of transparency and communication between the investors and the entrepreneurs. And "Micro-Angel Investors" will support people and businesses they believe in and in turn, help to grow the economy.

In order to make this a reality, we support creating common sense modifications to existing regulations to enable small businesses to raise capital. These reforms are modest, follow the spirit of the Securities Act of 1933 and the Exchange Act of 1934 and include:

1. Strong anti-fraud provisions
2. Limited risk and exposure for unaccredited investors
3. Transparency
4. Standards-based reporting and a
5. Limit to the amount of seed capital a company can raise.

STARTUP EXEMPTION FRAMEWORK:

- We propose the creation of a "funding window of up to \$1M" for entrepreneurs and small businesses. ("Small Business" will be defined as one with average annual gross revenue of less than \$5M during the last three years or since incorporation if the business has existed for less than three years. This definition will be consistent with definitions utilized by the Small Business Administration).
- Where any individual (including unaccredited investors) can choose to invest; however investments from unaccredited investors would be limited to \$10,000. (The \$10,000 limit is in line with other established financial disclosure limits like those on banking transfer reporting requirements. That said, based on what is happening on Crowd Funding websites today (to be further explained below), we anticipate that the majority of individuals making Crowd Fund Investments will be below \$500 each).
- Investors will have to complete a questionnaire to determine their aptitude to participate in Crowd Fund Investing and answer a series of disclosures that demonstrate they have prior experience with making investments

and/or are familiar with the principles of investing and associated risks. (These safeguards provide investor protections so that Crowd Fund Investing is on par with the level of risk for other investments of this class (e.g. publically traded penny stocks)).

- Eliminate the 500-investor limit and the broker/dealer licensing requirements for Crowd Fund Investing via this window.
- Exempt these offerings from state law registration requirements based on the limited size of the amount that can be raised, but leave intact applicable state law notice filing requirements, similar to the way SEC Rule 506 currently works.
- Allow for general solicitation on registered platforms where individuals, companies and investors can meet virtually, ideas can be vetted by the community as sort of peer review, informed decision can be made on whether or not to invest their money and crowd fund investing can take place. These platforms would provide standards-based reporting to the SEC on the entrepreneurs and small businesses utilizing the platform.
- Standardized and automated forms and procedures would be used for these financing offerings to reduce time and expense for all parties while maintaining transparency.

A similar framework is already in place in the U.K., Holland, India and China. Now is the time to make this happen in the U.S. so our economy is not left behind. We believe our framework is one that will allow for transparency, accountability, limited risk and exposure and the flow of capital.

CROWD FUNDING – A SIMILAR PRACTICE CURRENTLY AVAILABLE IN THE US:

A sort of Crowd Funding has been successfully taking place online for the past 5 years. The current model allows a group of people to pool their money to fund an idea. It has its roots in the foundation of our country and examples of it can be traced to the Statue of Liberty, as over half of the funds to erect the pedestal came from $1 and $5 donations by thousands of Americans. Most recently, crowd funding has become a source of capital for artists and musicians on websites like Kickstarter and Indiegogo where the average donation is $80. It has become a source of capital on Kiva, to the tune of $211M, for entrepreneurs in developing countries. People doing three-day walks or other activities for charitable causes raise contributions on websites set up specifically for them. Politicians, understanding the power of crowd funding, have raised millions of dollars in little donations for elections. And all this took place in the absence of clear securities laws governing Crowd Funding. Imagine the potential benefits if there *were* clear securities laws in place.

According to current law, crowd funding is perfectly legal if you are just giving $80 away without expecting anything in return. However, the minute you decide to invest the same $80 dollars in a startup, securities laws might be violated. These are the unintended consequences of our current securities laws and they are preventing startups and entrepreneurs from critical access to seed, early-stage and working capital.

Over the past 5 years, more than 500,000 people with ideas for films, albums and art projects, and entrepreneurs in developing countries, have used crowd funding sites to raise money. They make their pitch, say how much they need to get started, and ask for donations. The projects are vetted by the crowd and people in the crowd decide whether or not to fund these projects. A project is not funded until it meets its minimum target of funds sought. Only then is money withdrawn from donor accounts and projects start. If crowd funding of a project does not raise enough money to hit the minimum target, then no money is withdrawn. It is an all-or-nothing proposition.

Since then, backers have “donated” over $300M to crowd fund projects without expecting a penny in return.

CURRENT ENVIRONMENT:

If starting or growing a business weren’t hard enough before the 2008 financial crisis, try doing so today. Without bemoaning what we already know about the current situation, we think it is important to reiterate the facts so that we can connect the dots:

- According to the Small Business and Entrepreneurship Council, Small businesses represent over 99% of the employer firms in the U.S., and employ half of the private sector employees. Between 1993 and 2009, small businesses accounted for 65 percent of the 15 million net new jobs created. Bureau of Statistics data shows that since the 1970s small businesses hire two out of every three job seekers, and the Ewing Kauffman Foundation has noted that in the last 30 years, all net job creation in the U.S. took place in firms less than five years old.
- According to the Department of Labor, prior to the financial meltdown, 76% of small businesses received traditional funding (e.g.: bank loans, credit card advances, finance companies, etc). Any entrepreneur will tell you that cash is king. Without it you cannot grow or hire employees. Part of this comes from working capital (cash on hand) and the other part from financing (traditional funding just mentioned). With the financial meltdown, our economy stalled, over 8 millions jobs were lost and unemployment rose to its highest level in recent history.
- Economists and politicians are in agreement. Jobs create prosperity. With the launch of Startup America in February 2011, the White House stated that, “Startups bring a wealth of transformative innovations to market, and they

also play a critical role in job creation in the United States. Those entrepreneurs who are intent on growing their businesses create the lion's share of these new jobs." Jobs create taxable wages and spending which stimulate the economy and replenish the government coiffeurs.

- Since the financial meltdown, traditional financing has virtually disappeared. Banks are holding on to their cash, credit card companies have upped interest rates and cut credit and according to the private financing group Angelsoft, only 2.3% of startups receive private financing, such as from venture capitalists or angel investors.
- Because money is very difficult to come by for the remaining 97.7% of startups today, they need to find other avenues to raise capital; namely their friends, family and community. However, if that startup offers any kind of financial return, it just might be breaking the law. That is unless they hire a lawyer and spend tens of thousands of dollars and countless hours completing forms.
- According to the Sustainable Economies Law Center, "the current registration requirements under Section 5 of the Securities Act of 1933, as well as existing exemptions from registration, impose considerable hurdles on small businesses." The securities laws were written to address the abuses of large corporations. However, today, these laws require a small start-up trying to raise $50,000 to jump through the same hoops as a large corporation seeking to raise millions of dollars.
- Even if a startup were to try to take advantage of regulations that permit companies to raise money without having to register with the SEC, the current regulations still include many restrictions that are unduly onerous for fledgling companies, including:
    1) Limits on startups in seeking capital outside of their immediate state;
    2) Requirements of additional costly and burdensome state filings;
    3) Restrictions on the amount of "unaccredited" investors to 35 individuals; and/or
    4) Requirements for complete audited financials and state filings.

In 1933 when the framework of our current securities laws was established, 4% of Americans invested in the markets. Today that number is over 50%, clearly showing that the majority of individuals understand the basics of investing.

Almost 80 years ago when the telephone was a luxury item, and television and the Internet didn't exist, we crafted rules to hold companies accountable and transparent. Today, we have 24-hour eyewitness news, the Internet and a wide array of social media where deceptive practices and false moves are documented and discussed by thousands on Facebook, Twitter, and other platforms.

So even though we live in an age where we encounter risk and manage it and we have tools at our fingertips to give us more information than ever before, we still act as if it were 1933.

WHY THE RULE CHANGE IS NECESSARY NOW, AND WHY IT WILL BE EFFECTIVE:

Why is that we allow anyone to invest their hard earned money in the regulated and "disclosed" markets where people have made and lost billions of dollars under the mindful watch of the SEC yet we can't let those same people invest modest amounts in local community startups and small businesses where they know the players with the same potential outcome? There are few rules in life about what you can spend your money on until it comes to investing.

Current securities laws presume that Americans are not responsible and are incapable of understanding that life is full of risk. And yet our everyday lives are full of examples. We don't expect a new restaurant to go through elaborate taste tests, even though people who spend $50 to $100 may wind up with a bad meal. Imagine if every seller on eBay had to be vetted with SEC rigor – commerce on the site would come crashing down. Or buy something on sale and then find out 2 weeks later, the same item is now 50% cheaper. People casually spend hundreds of dollars on iPads, tickets to concerts and sporting events, and even on products on the Internet from sellers that they might never have even heard of before. Why should we treat an investment of $100 as riskier than $100 of consumption? When it comes to securities laws there is a different standard. One in which we must protect the interests of the investors because they are not "wealthy," "smart" or "responsible" enough to make their own decisions.

The current rules make it seem that in order to take money from the general public we need to make investing in startups the most secure investment possible. It isn't, and it never will be. But people still *want* to invest in entrepreneurs because they believe in people with ideas. It is a shame that instead of encouraging this activity, we throw pessimism in the face of entrepreneurs. This is not American. This was not the intention of our forefathers and this is NOT the America of the future.

Crowd funding offers something unique with its strong elements of social networking. Opening the funding process to the general public adds transparency and trust signaling. It's much harder for fraud to occur when the whole world is watching on an open and transparent platform, especially with credibility and performance ratings that are visible to the community. Raising money nearly always requires using a first-level network as a trust signal to drive the network effect. No trust circle equals no funding.

In addition there is a disparity that exists in between the funding world and gender. Women run only 8% of companies that receive money from venture capitalists. Compare this to the 41% of small businesses that are run by women. If getting capital to women under the old methods was challenging, ask them today. As you well know, women make great entrepreneurs and investors, and they continue to start businesses at a greater rate then men. Opening up other avenues for capital will help women-owned enterprises grow more rapidly -- a distinct challenge for women entrepreneurs as they continue to lag behind men in business growth.

It is ironic that thousands of people were able to invest money into scams like that perpetrated by Bernie Madoff (predominately through experienced and licensed financial advisors) yet they are prevented from making their own decisions about putting a fraction of that same money to use in a community startup. Never mind that Crowd Fund Investing requires that "the investor" sit down, look at a deal, and analyze rather than trust the judgment of an advisor who makes their money the instant the investment is made.

Our nation's small businesses have suffered disproportionately during the downturn and continue to struggle more than their larger counterparts.
Many existing businesses, with their credit lines tapped out and their revenues battered, have struggled to remain afloat, much less expand. Businesses wanting to grow have often found themselves stymied by the reluctance of banks to lend again after the crisis. New start-ups, which have fueled job creation after previous recessions, have not taken root at the same pace as in the past.

Crowd funding is like being part of a college team. You are only as strong as your weakest link. You aren't in the majors, and it takes both a good team and a great fan base to propel you to the championship. In crowd funding the fans are the investors that more likely than not will know the players and rally around them, providing strategy, experience and money, not so they can pay their way to the BIG game but so they can launch a company that will benefit the entire community.

Believe it or not, crowd funded companies will be the vetting ground for both public and private financing of winning companies. The ones the crowd gets behind and helps succeed will be the ones the VC's will line up to help grow. And you know what? In the end, everyone will benefit – the entrepreneur, the crowd that supported them and the VC that took them to the next level.

INVESTOR PROTECTION:

When discussing the current crowd funding taking place, the question is raised: "why are people doing this?" If only 43% of projects on Kickstarter succeed, why aren't people crying foul but instead pledging more than ever before? ($7M in March on Kickstarter compared to $4m in January). The answer is simple. They want to help someone they know. They want to support an idea. They want to be part of a community and they want some recognition for it. People are drawn to crowd funding because they are capitalists. They admire entrepreneurs, and they know that sooner or later they may be entrepreneurs as well.

What are they basing it on? It comes down to trust and transparency. AirBnB is one of the nation's fastest growing crowd sourcing startups focuses on renting other people's floors, rooms, homes, yachts – even igloos. It is growing at a staggering 45% per year because people trust the system, vet the offerings and rate them as well. On the Internet, when your "wares are out there," it is on the line for everyone to see. By being transparent, you build trust. Users check out the reviews, read what other people are writing and make careful and informed decisions. All of this is recorded and becomes part of a larger "self-policing community" of profiles for both parties and a greater community rating system. These reputations today are carrying across the web from eBay to Tripadvisor to Rate-a-VC.

Other companies like TrustCloud aim to become a portable reputation system where their algorithm collects your online "data exhaust" – the trail you leave as you engage with others on Facebook, LinkedIn, Twitter, commentary-filled sites like TripAdvisor and beyond – and calculate your reliability, consistency and responsiveness. The result is a contextual badge you carry to any website, a trust rating similar to the credit rating you have in the offline world. These are tools that can and will be incorporated into any online crowd funding platform to help foster transparency and accountability.

I think any of you would find it hard to disagree with this statement, "the internet today has made the world a more transparent place. Your actions are followed and the opinions flow freely."

According to the Sustainable Economies Law Center, "The success of crowd funding sites demonstrates the desire of the public to support projects that they believe in. Enabling the additional motivation of possible financial return would only reinforce this economically healthy impulse."

But crowd funding goes beyond money, experience or trust. Michael Shuman, author of *The Small Mart Revolution: How Local Businesses Are Beating the Global Competition*, states "Crowdfunding has the potential to deliver the jobs Americans have been longing for. We know that small businesses, especially locally owned ones, are key for expanding the nation's employment, and these businesses comprise (by output and jobs) more than half the private economy. And yet almost none of the $30 trillion we have in our long-term investments (stocks, bonds, pension funds, mutual funds, insurance funds) touches these businesses. This is a colossal market failure, driven by obsolete securities laws. Moving even a few percentage points of our capital into local, small business could effect a stimulus home run."

So let's address all the naysayers. What if we carve out an exemption and it all comes tumbling down? What if we open the doors to defrauding thousands of people out of $80? Are these protectionists right? Will crowd funding bring down the entire economy? To them we say, recall what happened in the Ireland Banking crisis of the late 70's when the bankers went on strike and warned the public that the economy would collapse without a banking system. What happened instead was a peer-to-peer banking system where the local pubs became de facto banks, lending money to their customers. It worked so well that some people even joked that there is no better judge of character than a bartender.

Opening the doors to a limited exemption will not cause the fraud that Worldcom and Enron did to their employees and investors, or that Wall Street and Bernie Madoff perpetrated on the American people. It will create a peer-to-peer system where communities become the de facto seed and early-stage funders to entrepreneurs. And if you think about it, there is no better judge of character in the United States than your neighbor, friends, and family.

But there are more reasons to trust the crowd. First, they are massively diverse. Fundamentally the collective IQ of the crowd works like this. Every time a new member joins who has one or more superior facets of IQ, the collective IQ is raised by those unique facets. Second, the values that VC's claim to provide will be disrupted by the crowd. A VC's Rolodex is easily replaced by social networks (i.e.: LinkedIn). And the Rolodex of a few thousand crowd investors is much stronger than that of a few VCs. Third, expertise – it is disputable that the people who manage money bring more operational experience to the table than an interconnected crowd of people, many of whom are investing in you because they understand your business. And finally, valuation sophistication – the crowd has been putting their value on things since the beginning of time. Price anything too high and no one will buy it.

These naysayers act as if crowd fund investing were made legal, then every American will dump their savings into this. So either that makes us think they REALLY think we have the solution to kick starting our economy and are afraid of money not being invested traditionally OR they think that everyone for some reason will see Crowd Fund Investing as lower risk than any other choice they make in their daily lives when in fact we all know this isn't true.

Crowd Fund Investing is more than just money – it is facilitation, diligence, team building, and valuation. Most importantly, it is jobs.

That being said, we shouldn't assume that "everyone" will bring expertise. Some will be a marketing engine for the entrepreneur and others will just bring a few dollars. Collectively, they will gather behind entrepreneurs they believe in, they will fund only those they are willing to risk their investment in and they will invest only if they think what they are being offered is fair. Trying to circumvent the crowd to bilk them out of a lot of little dollars isn't going to be worth the time or energy of a shyster.

There seems to be a general understanding here in Washington that government spending stimulates the economy, but that when it comes to letting the average

American decide how he or she wants to spend and/or invest his or her own money, then we need government oversight.

We stand at a moment in time when we can use crowd fund investing to start an education process. Where the average American who wants to be part of the process (mind you there's no forcing here) can be taught to think like an investor and ask questions of entrepreneurs like, "How does your idea generate cash? Do you offer a product or service I would buy? What skills/experience do you have to be accountable with my money and why should I trust you?"

In doing so, Entrepreneurs will learn how to communicate, be accountable and transparent, and investors will provide critical seed and early stage capital. Jobs will be created, innovation will be spurred and our economy will continue to grow.

We do not believe it is the role of government to limit how we can spend our money. Nonetheless, we appreciate your desire to protect our savings and so I want to have the discussion, "if you believe that $10,000 is too much for an American to risk, what is the smallest amount you believe I should be able to invest in my entrepreneurial friend without SEC scrutiny? If you are fine with $1, at what point are you uncomfortable?" That is the point whereby we should set the limit. I wouldn't be surprised though, if we put it to a vote, the crowd would tell you "I'm an adult, I can make my own financial decisions."

If the dollar amount isn't what concerns you but the potential for fraud, even at $1, then we need to have a frank discussion about that.

As Kevin Lawton, author of *The Crowdfunding Revolution* says, "Fraud isn't really the issue, 'Failure' occurs much more frequently in startups." According to a Kauffman Foundation survey, approximately half the time you will lose all or some of your investment. Just as you diversify in the publics markets to reduce exposure, having a portfolio of varied investments solves failure in the crowd funding space. As we have seen from over $300 million donated to projects and ideas through crowd funding already, while people are concerned about losing their money, they are more interested in helping someone bridge the gap, bring an idea to fruition, succeed, and in the end being able to tell their friends and family they had a part in the creative and entrepreneurial essence of what it is to be American. It's like paying for a brick in a new park or baseball stadium to be engraved with your name.

As Kevin Lawton said, "Fraud is just some noisy component of failure, and at that, it's going to be pretty hard to get away with much of it when there are millions of eyeballs worth of visibility and mechanisms which social networking enables to further vet entrepreneurs."

And thus, the biggest problem we need to solve is education. Running a portfolio and understanding the risk-vs.-reward dynamics of investing in early phase companies is essentially an education problem. One way to solve the problem of unaccredited investors making investments, if you think of it as a “problem,” could be to make people 'educationally accredited'. This can be done with a simple document, which explains the basics of the risk-vs.-reward curve of risk startups and the basic principles of a portfolio. It can be done in a few pages and can be sent out in paper form, transmitted via email as a pdf, or done online in a more scalable way via a platform. Before being allowed to invest, people would have to answer a series of questions that test their comprehension of the document.

Instead of pushing people down with a relentless assault on their intelligence, perhaps we should contemplate that people are adults and will make their own decisions. Our job should be to educate: education helps to create prosperity.

Education will teach the participants about analyzing and understanding risk. Nearly every company has a level of opacity. Even a brick-and-mortar restaurant business probably doesn't give you their recipes. Tech startups don't give you their 'IP', often not even to VCs. That's how it is. Lack of complete transparency creates a level of risk, which is why we have varied portfolios. And within an open market, if an investor has access to two similar deals, one of which is more transparent, which do you think he'll invest in? Concerns should be focused on the basics of investing, such as disclosures of the principal people in the company, details of the business model, use of funds and the securities offered.

Conclusion:

Hopefully by now we have explained to you how Crowd Fund Investing really isn’t something new. That with the proper framework and education we can allow the average American to take a few low risk dollars and use them in a powerful way to crowd fund entrepreneurs. That in doing so not only will we be solving the capital formation problem but we will be creating thousands of companies and employing thousands of Americans.

The good news is, the SEC has the authority to make these changes. According to Section 3(b) of the Securities Act, the SEC grants the commission the power to:

> “Add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering …”

At the end of the day, we need to have an open dialog about whether it is in the government’s interest to regulate investments in startups when the exposure to risk is limited to modest amounts. This begs the following questions: Do the current regulations advance the government’s interest in ensuring the success of our nation's entrepreneurs or do they cause entrepreneurs more harm where there is nowhere for them to turn? Is the scope of current securities laws too broad, so broad that such laws stifle new forms of capital formation when the interests of entrepreneurs are already underserved?

We are in favor of a balanced approach. One that does not require excessive government oversight but allows Americans to invest in startups and small businesses in a limited way. When it comes to the economy, it is important to remember that be it government, investment or entrepreneur, we are all on the same team.

Thank you and I look forward to your questions.

Committee on Oversight and Government Reform
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)(5)

Name:

1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2008. Include the source and amount of each grant or contract.

none

2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

none

3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2008, by the entity(ies) you listed above. Include the source and amount of each grant or contract.

none

I certify that the above information is true and correct.
Signature: Elwood [illegible]

Date: 5/5/11