A Message from Secretaries of State on Crowdfunding Regulation

November 30, 2011

The Honorable Tim Johnson, Chairman
U.S. Senate Committee on Banking,
Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Richard C. Shelby, Ranking Member
U.S. Senate Committee on Banking,
Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

RE: Crowdfunding and S. 1791

Dear Chairman Johnson, Ranking Member Shelby and members of the Committee:

As Secretaries of State with primary securities regulatory jurisdiction, we welcome this opportunity to discuss the developments in "crowdfunding" as a useful tool in small business capital formation, and the work of the U.S. Senate to ensure that such a mechanism remains viable for small businesses and safe for investors.

Crowdfunding is an online, typically grass-roots, money-raising strategy that allows the public to use websites to contribute small amounts of money to help artists, musicians, filmmakers and other creative people finance their projects. Recently, crowdfunding financing has been applied to small businesses and start-ups, facilitating their attempts to get their ventures off the ground.

We applaud the work of Congress, via H.R. 2930 and S. 1791, aimed at allowing small businesses greater access to crowdfunding financing through the Internet. We are keenly aware of how critical small businesses are to job growth and to improving the economy.

However, Congress' attempt to enact laws meant to reinvigorate the economy could, in fact, have a detrimental effect. If passed as currently drafted, these bills would prohibit the States from working proactively to enforce laws designed to protect investors.

State securities regulators are proud of their 100-year history of effectively regulating smaller businesses seeking to raise capital. States securities laws protect investors by requiring registration of securities offerings and preventing the exploitation of investors through unjust or incomplete offerings. State securities regulators are uniquely able to protect investors in that they are not only present in the state, but they are also attuned to the particular state's economic conditions. It would therefore be impractical and a disservice to investors to remove state regulators entirely from this important role. To that end, we recommend the following adjustments to current legislation concerning crowdfunding.

Currently-proposed Federal legislation would limit state authority to protect their investing citizenry. H.R. 2390 leaves enormous gaps in investor protection. S.1791 is a more reasonable piece of legislation, but still requires changes, in at least three areas, to protect the public and maintain a functional regulatory structure.

Though it does preempt the traditional state registration requirement, S.1791 does not entirely eliminate the concept of a state filing by a crowdfunding issuer. The contemplated "notice filing" would provide nowhere near the information provided in a traditional registration, but would preserve the States' ability to proactively secure information about issuers and make certain that key disclosures are provided to investors. If S. 1791 is modified to allow a state with a practical and reasonable connection to an issuer to serve as a key contact and to coordinate the States' effort to collect a single filing, the States will maintain a workable mechanism for protecting the public. S. 1791 should be amended to allow the States, through a single jurisdiction such as the state of an issuer's principal place of business, to require a single filing that includes reasonable and full issuer disclosures on use of proceeds, issuer and promoter history, and risk factors.

S. 1791 also improves upon H.R. 2930 by establishing more reasonable limits on investment amounts. S.1791's $1,000-investment limitation for individuals is a more reasonable cap than that found in H.R. 2390. But S.1791 would also allow crowdfunded businesses to raise $1 million in total. Such a high cap on aggregate investment makes the bill inconsistent with the expressed rationale for the crowdfunding exception to help small scale projects and entrepreneurs. A company that is sufficiently large to warrant the raising of $1 million in investment capital can afford to comply with registration and filing requirements.

Finally, S. 1791 also appears to exempt crowdfunding "intermediaries" from the oversight traditionally applied to brokers who match buyers with sellers for compensation. This wholesale exemption disadvantages licensed brokers and existing small business financial advisors, and eliminates the important protections of a licensing structure. Small businesses and investors alike have suffered from the fraudulent activities of unregistered brokers and unqualified business advisers who, escaping regulatory oversight, seek only to profit by exploiting the legitimate capital formation community and ultimately harm its investors through unchecked and improper practices. Website operators functioning as intermediaries, among others, should complete at least minimal filings with regulators and demonstrate minimum competencies. Congress should preserve the States' ability to address this issue.

We commend Congress's efforts to be responsive to small business owners' capital formation needs. Similarly, the States are currently developing a framework for encouraging and facilitating the formation of small business capital. Last month, NASAA voted to establish a special committee to propose steps that state securities regulators can take collectively to facilitate small business capital formation. This special committee is actively pursuing its first order of business, the immediate creation of a model rule which state securities regulators may adopt to responsibly encourage small business capital formation through a crowdfunding exemption. S. 1791 should ultimately complement these efforts, and can best do so by ensuring that the role of state regulators in this area is addressed in broad parameters.

State securities regulators understand that technology has vastly improved the methods by which entrepreneurs can communicate with potential investors. We also understand, however, that securities offerings made through the Internet—which H.R. 2930 and S.1791 are based on—are fraught with risk. In such cases, the need for the state securities laws becomes even more urgent for the protection of investors and legitimate, worthwhile small business offerings. We urge Congress to resist preemption and preserve state securities regulators' authority to protect their investors.

Sincerely,

Robin Carnahan

Missouri Secretary of State

William F. Galvin

Massachusetts Secretary of the Commonwealth

William Gardner

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