Testimony

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Subcommittee on Capital Markets

Hearing on "Empowering Entrepreneurs: Removing Barriers to Capital Access for Small Businesses"

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Good morning, Chairman Wagner and members of the Capital Markets subcommittee. It is a pleasure to be a part of this important hearing "Empowering Entrepreneurs: Removing Barriers to Capital Access for Small Businesses. I was last before this subcommittee September 11, 2019 for the hearing: "Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment." There have been significant developments in the capital market since and we are now back to an environment where entrepreneurs need further assistance of Congress. I trust that you will seriously consider the Proposed Bills.

My name is Douglas Ellenoff. I am a partner at the New York based law firm of Ellenoff, Grossman & Schole. I am a corporate and securities lawyer and have been practicing for over 35 years. My law firm has been in business for more than 30 years and there are nearly 130 lawyers and we are regularly one of the top 10 IPO and finance law firms in the nation. We are market leaders in several alternative finance programs, including Crowdfunding, SPACs, PIPEs and Registered Directs.

I have spent nearly 10 years after the passage of the JOBS Act working with the leadership of the crowdfunding movement, traveling extensively domestically and abroad, including dozens of trips to DC, to provide our views on the proposed and final Regulation Crowdfunding and various JOBS Act rules and regulations.

I am counsel to the Association of Online Portals, the leading voice in DC for the industry and have had a prior association with the Crowdfunding Intermediary Regulatory Authority in a similar position.

I am a co-founder of LawCloud, and GUARDD, two legal technology companies catering to the broader crowdfunding industries.

My comments are those of my own and not my firm, nor my clients or the associations to which I am affiliated with.

Given today's volatile market conditions, where capital is scarce for entrepreneurs, not unlike the period right before an overwhelmingly bi-partisan Congressionally enacted JOBS Act, the timeliness of today's hearing is more important than it's been in the past decade.

According to the data published by Crowdfund Capital Advisors, from the period of inception of Regulation Crowdfunding to 2019 my last testimony here, there was $193.8mm raised in the aggregate. Since 2019, until today $1.4 billion has been raised. This 7x increase clearly demonstrates the commercial acceptance and viability of what Congress put in motion in 2012 with the JOBS Act. There have been over 4,300 funded transactions- 3,500 just since 2019. Importantly, the number of jobs created just from Crowdfunding and not the other provisions of the JOBS Act has been nearly 225,000. Although the studies are limited, the data indicates that of these funded transactions, 55% of them has at least one woman or minority founder, have an 81% success rate and represent nearly 47.8% of all capital raised. We can all be very pleased with the results of Crowdfunding, which would not have been implemented without the support of all constituents represented here. Regulators were decidedly uncomfortable with the idea of Crowdfunding and many of their stated concerns didn't materialize. Had we not proceeded and acted together, our economy wouldn't have benefited and, more importantly, those entrepreneurs wouldn't have been funded and been able to hire employees and execute their dreams and make them a reality. It's a wonderful example of Congress taking action that has very positive real-world impact.

On a personal note, since my last testimony, my fellow panelist Renee Jones left her professorship at Boston College Law School to be appointed Director of the Division of Corporation Finance of the Securities and Exchange Commission, and Mike Piecek finished his time as head of the Department of Financial Regulation of the State of Vermont to be elected as the State's Treasurer, so as you might suspect, I am a little disappointed that my status remains unchanged but I remain hopeful that my testimony here may have a similar impact on my professional resume as it has for my esteemed colleagues.

I look forward to sharing my views on many of the proposals that will be discussed at today's hearing and thank Chairman McHenry for hosting this important hearing today.

INTRODUCTION

Similar to most industrialized nations, the presumption contained in our securities laws is the requirement that any offer and sale of securities must be registered with the Securities and Exchange Commission (SEC). The underlying notion is that the public at large generally needs some protection from bad actors and that full and fair disclosure (i.e., a true and accurate description of the business, its management, the capital structure, financial status of the operations and the associated risks) will be provided to them prior to an investment in order to enable all investors to make an informed investment decision. Our federal securities laws, as opposed to certain of our states, premise our statutes on the thoroughness of the disclosure of

each issuer and not the merits of the investment. Since the enactment of the Securities Act of 1933 and its related provisions in the Securities Exchange Act of 1934, which requires ongoing and updated disclosure by registrants to facilitate secondary trading, it is fair to say that this regime has been the foundation for the most active liquid securities market in the world. Our securities laws are the basis for many other jurisdictions and are regularly monitored by other governments and regulators to assist in informing their own continuing positions with respect to new innovations and reforms. We too should be mindful of what these other jurisdictions are seeking to accomplish, since they are competing with us to attract companies to raise capital more efficiently and retain these companies for secondary trading. This is why it continues to be important to analyze what is working with our capital markets and what isn't or is achievable in new methods with the introduction of new technologies. While I am not an expert in the securities laws of many of the other competitive jurisdictions, it seems unquestionable to me that based upon many experiences we have had with cross-border transactions and alternative finance programs, that our business enterprises are required to operate in the most complex series of intertwining rules and regulations.

The positive result generally is that our markets are trusted and attract capital from around the world. There are negatives though that should not be lost or ignored simply because our overall formula for market structure and governance has been unarguably successful.
Is the cost of being public too burdensome? Yes. Compliance costs are resulting in companies remaining private substantially longer than previously. Although off topic from today's proposals, how is it ok that before SEC proxies by a company in a public merger, the plaintiff's bar is already lining up to claim that there have been deficiencies in the process? It is simply unseemly. It makes sense episodically to analyze where we are in the regulatory cycle and ask whether we are being too lenient or too restrictive. Like many complex issues, there is no easy answer and it may depend upon where you are looking—in the public markets or the private. Unquestionably, the current regulatory environment is unkind to being either a public company or a private company. There is a culture of regulation by enforcement, as well as, the convenient re-interpretation of rules and regulations that have been on the books for years and years.

Compliance is unquestionably complex and, in many cases, unclear. While regulators generally are available to provide guidance on how to proceed in a manner that they are comfortable with, there is inconsistency at times, even subjectivity to prohibit activity that it would appear they are uncomfortable with. Much of it is just human nature but does create tension in the system and give pause to businesses that are considering being public in the U.S., or remaining public. At this time, I would however note that in our experience, much of the confusion seems by institutional intention and not by individual choice. In a global market, we need to recognize that our securities laws and how they are interpreted are being assessed around the world to determine if we are a hospitable and beneficial place to entrust their capital formation and trading.

We are here today to consider proposals for improving our capital markets. I will argue that some enhance our standing in a meaningful manner and others are merely incrementally

attractive. Please consider that as a securities practitioner who respects the efforts of all securities regulators and their daily tasks of protecting investors from the opportunism of bad actors, who are either expedient in their approaches without regards to the effects on others or outright wrongdoers, I am very sensitive to the SEC's charter of continually seeking the proper balance between capital formation in both the private and public markets, even though I would observe that the current zeitgeist believes that it is decidedly more investor protective and more antagonistic to investing and capital formation.

EXEMPTIONS

It has always been acknowledged by Congress and the SEC since the beginning of our Federal securities laws that not all securities offerings must be, or even should be, registered and reviewed by the SEC.
The statutory inclusion of exemptions from registration with the SEC, is an acknowledgment by both Congress and the SEC that there are certain investors that don't need the protections that other less sophisticated and more vulnerable investors may require.

Presumed in these exemptions is the notion that those investors have the ability to make their own informed decisions, perform due diligence, value the companies being considered and structure the financings as appropriate. The benefit of being in this category of investors, albeit whether one is an individual accredited investor or an institutional investor that meets one of the exempted investor category status, is that the private enterprise seeking the necessary funding will not have to subject themselves to the financial, regulatory and administrative burdens of having to register with the SEC.

Being an investment opportunity that can access the private markets is of significant advantage because it saves the time, resources and expense of having to register and comply with the very complex securities disclosure laws and PCAOB financial statement requirements, among other regulatory costs.

Mind you, neither registering nor being exempt changes the risk profile or investment character of the investment. I would like to emphasize that just because an enterprise is prepared to register their securities and comply with the SEC registration process doesn't makes them a better investment or less risky. The point of registration in my judgment is that we collectively have decided that full and fair disclosure is necessary and important to protect unaccredited retail investors from making an uninformed investment decision.

Registration doesn't ensure a successful investment, just relevant information. Since investors in exempt offerings are presumed to be able to protect themselves and not require those protections, a private market has always been in active existence and is substantially larger than our public markets. This is a good thing and the venture markets and real estate markets are but a couple of examples of how private entrepreneurship has flourished free from the burdens of registration with a statistically tolerable amount of fraud and litigation profile. To be clear, however, no amount of fraud is acceptable, and we should and have laws in place to

penalize those that act outside of the bounds. Unfortunately, just because there is the reality of fraud shouldn't deter capital formation and capital markets advances. Crowdfunding is another wonderful example of a private market exemption balancing proper disclosure and investor protection in a new manner that was previously not permissible.

Are there failures as well as successes? Absolutely. However, we as a collective society are supportive of that subset of the private markets because it doesn't harm individuals that aren't arguably able to bear the risk of those losses. From a practical matter at this point, it would seem unrealistic to me that the existing SEC would even be equipped, much less want, to assume the burden of the tens of thousands of private enterprises that avail themselves of the exempt markets and have raised investor funds.

EXPANDING THE PRIVATE MARKET IN A CONTROLLED AND RESPONSIBLE MANNER

The various JOBS Act provisions that Congress enacted (to its credit) back in 2012 have been beneficial for retail investors while maintaining the appropriate balance between capital formation and investor protection. Notwithstanding a remarkable amount of outspoken investor protection advocacy to the build-up of the passage of the JOBS Act, Title III Regulation Crowdfunding in particular, it is now commonly acknowledged by regulators that none of the doom and gloom prognostications of fraud or litigation has presented itself. It is unlikely that fraud won't occur in the Regulation Crowdfunding space, but many of the stated reasons for frustrating this quite novel exemption haven't presented themselves yet.

There is no doubt there have been investor losses (as well as profits), but yet no meaningful investor upset spilling into the complaint lines of the SEC, FINRA or the state regulators. I believe the reason is that so far retail investor through advanced technology solutions has ensured that they be educated about the risks of Crowdfunding generally, as well as being provided all the necessary business and financial disclosure, as well as, advising them of the associated risks. The digital footprint for recording the full transparency of the process also keeps both sides compliant.

The funding platforms and issuers have properly educated their investors and provided them with limited scaled down legal and financial disclosure in a readable and digestible manner. I am often asked why Regulation CF has only funded a little less than a thousand companies and raised less than a few hundred million dollars. My response has been both that all new programs take a considerable amount of time in my experience to develop if you want them to grow organically and responsibly. And secondly, and more importantly, if the size of the market is the primary issue of concern now and not that the experience of this exemption hasn't actually caused severe regulatory backlash, then we should all sigh a big relief that we have bench tested the program and it is working successfully. Potential for fraud was one of the primary reasons that Congress reduced the maximum amount that companies could raise and in this light it should be reconsidered. Now that such fear hasn't been substantiated, we should take this opportunity to explore making some improvements, and taking off or relaxing some of

the guardrails of regulation. My observation would be to take a victory lap on this bipartisan initiative, and reflect on what changes are necessary for greater impact. The few thousand entrepreneurs have been funded, several hundred thousand jobs is a good start!

More businesses and jobs would be created, more geographically diverse enterprises would be funded, and more entrepreneurial opportunities started by more minorities and women would access capital. We thought this ultimately would be the outcome of Regulation CF – and this was a key rationale in advocating for it. Now that these positive outcomes have come to pass, key additional reforms would fully leverage these early successes.

This is also true of Title II General Solicitation and Regulation A+. I think General Solicitation speaks for its success. Regulation A+ on the other hand needs to still find its footing.

My sincerest emphasis and admonition though for you today, as you consider additional changes and additions to the JOBS Act provisions and other private market proposals, is to remember that Congress took bold bipartisan action in 2012 against much antagonism from regulatory adversaries of the legislation. Many of those concerns as stated at that time have not materialized. We have enough information to know that much more good can come by enhancing the sound bipartisan legislation that passed in 2012.

With respect to the 4 proposals to be considered at today's hearings, please find my views and thoughts below:

1. H.R. ___- "To amend the Securities Act of 1933 to preempt state securities law requiring registration for secondary transactions."

Otherwise referred to as "Improving the Crowdfunding Opportunities Act", this proposal seeks to further enhance the secondary trading of the securities purchased by investors. This proposal is similar to the treatment that publicly-traded securities receive pursuant to the National Securities Markets Improvement Act of 1996, whereby Congress facilitated the pre-emption of state securities regulation for those securities publicly-listed and traded on either NYSE/AMEX or NASDAQ. Practically, this would enable investors to obtain greater liquidity for their already-held positions and improve the attractiveness of crowdfunding and other private market exemptions. To the extent that tokens are encouraged to be treated as securities offerings by regulators, this improvement would be one less reason for those issuers to remain non-compliant.

For the stated reasons, and others, I would encourage the approval of this proposal.

2 H.R. ___- "To amend the Securities Act of 1933 to provide small issuers with a micro-offering exemption free of mandated disclosures or offering filings."

Otherwise referred to as the "SEED Act of 2021", this proposal seeks to further enhance private exemptions and make it substantially easier for start-ups and small business to raise capital.

The proposal would relieve issuers from the substantial disclosure and filing burdens imposed by other offering exemptions, but, remain subject to the anti-fraud and "bad boy" disqualifications. As we all observed during the Covid lock-downs, small businesses and restaurants suffered immeasurably. Had this exemption been in place, those entrepreneurs may have had an easier time raising capital from their customers and avoided liquidation or going out of business. Raising capital in the amount of $250,000 or less is not currently cost effective given the compliance issues. H.R. 5458 seeks to redress this marketplace friction.

For the stated reasons, and others, I would encourage the approval of this proposal.

3. **H.R. ___- "To amend the Securities Exchange Act of 1934 to create a safe harbor for finders and private placement brokers."**

Otherwise referred to as the "Unlocking Capital for Small Businesses Act of 2022", this proposal seeks to finally codify one of the longest lasting proposals floating in the securities industry that would enhance private market activity and make it easier for start-ups and small business to work with member accepted finders to facilitate and assist in the capital raising process. As SEC Commissioner Roisman wrote in his October 2020 remarks on this proposal, "for almost fifty years, finders have approached the staff regarding whether a particular activity or business model would require broker registration." He also highlighted that "in 2005, the ABA Task Force on Private Placement Broker-Dealers recommended that the SEC work with FINRA and state regulators to establish a simplified system that would allow persons to solicit investors for small issuers, subject to a reduced but appropriate , level of regulations." As he then points out "The lack of clarity regarding the status of finders has had detrimental effects for issuers and investors." Commission Roisman is joined by many other securities law professionals that believe it is high time to finally address this lingering issue and benefit our small business community.

For the stated reasons, and others, I would encourage the approval of this proposal.

4. **H.R. ___- "To require the Securities and Exchange Commission to revise rules relating to general solicitation or general advertising to allow for presentations or other communication made by or on behalf of an issuer at certain events."**

Otherwise referred to as the "Helping Angels Lead Out Startups Act of 2022" or the "HALOS Act of 2022", this proposal seeks to finally codify another ongoing debate about how to comply with certain of the private offering exemptions and be able to disseminate presentations and other communications at certain events, particularly Angel Investor Groups, a defined term, which may only be comprised of Accredited Investors, who meet regularly, without running

afoul of the general solicitation or general advertising rules. This proposal is seeking to clarify that certain routine activity used by an issuer in its fund raising process, to a defined audience, will not cause such issuer to have to comply with the more onerous provisions of 506c and have to verify the accreditation of all the participating investors. H.R. 9451 recognizes that Angel Investor Groups by their very nature are sophisticated investors with net worths that don't require regulatory protections in this manner and without this proposal the securities law are unnecessarily preventing the issuer from using the Angel Investor Group forum efficiently and providing them with more detailed information and presentation. This frustrates the capital formation process.

For the stated reasons, and others, I would encourage the approval of this proposal.