April 14, 2017

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

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

Dear Chairman Crapo and Ranking Member Brown:

As a non-profit research and advocacy organization that supports high-growth, high-tech startups, we appreciate your interest in gathering legislative proposals to increase economic growth.

Startups are the backbone of the American economy, driving growth and innovation, creating jobs, and transforming communities. According to research by the Kauffman Foundation, small, young firms have created an average of 1.5 million jobs per year over the past three decades, accounting for nearly all net new job growth.[1] While startup growth slowed during the Great Recession, entrepreneurial dynamism has rebounded over the past couple of years, with a recent report from TechNet and the Progressive Policy Institute showing that the first three quarters of 2016 saw the fastest rate of growth in the number of private-sector establishments since 2008.[2]

While this upward trend is encouraging, there is still much that can be done to spur entrepreneurial growth. Through conversations with diverse startups across the country, we know that capital access remains a top challenge in getting a business off the ground, and more formal surveys support this assertion.[3] To address this, policymakers should prioritize efforts and pursue laws that help to create sustainable capital streams for entrepreneurs.

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[1] Ian Hathaway, Jordan Bell-Masterson, and Dane Stangler, *The Return of Business Creation*, Kauffman Foundation (June 2013), http://www.kauffman.org/what-we-do/research/firm-formation-and-growth-series/the-return-of-business-creation.
[2] Michael Mandel, *How the Startup Economy is Spreading Acorss the Country*, Progressive Policy Institute (March 2017), http://technet.org/blog/how-the-startup-economy-is-spreading-across-the-country.
[3] Silicon Valley Bank, *Innovation Economy Outlook 2016* (2016) https://www.svb.com/uploadedFiles/Content/Trends_and_Insights/Reports/Innovation_Economy/2016/US/svb_US-Startup-Outlook-2016.pdf.

As the Committee formulates its agenda for the 115th Congress, we encourage you to consider the following policy priorities, which we believe would encourage the formation of new businesses:

Clarify regulatory ambiguities around general solicitation for pitch events and demo days.

In recent years, federal policy regarding early stage capital formation has succeeded admirably in lowering regulatory barriers and opening up new avenues for startups to find investors. The *Jumpstart Our Business Startups (JOBS) Act* helped modernize the decades-old rules regarding general solicitation that made little sense in a digitally connected world. However, further modifications to general solicitation rules are needed to provide greater clarity to startups and facilitate angel investment.

Under current rules, startups presenting their business plans at "demo days" or pitch competitions—an exceedingly common occurrence within startup communities throughout the country—could unintentionally violate rules banning general solicitation to non-accredited investors if they do not adequately vet their audience to ensure that everyone in attendance is an accredited investor. Limiting pitch events in this way makes it much harder for cash-strapped startups to find the early stage funding they need, particularly if those startups do not already have strong pre-existing relationships with potential investors. For entrepreneurs working in communities without a robust venture capital or angel investor network, demo days represent one of the best ways to find seed capital, generate interest in their business, and even find new customers or clients. Requiring an extensive vetting process to ensure that such public pitches are limited to accredited investors establishes a burdensome regulatory barrier that will simply discourage angel investors and startups from participating.

To remedy this issue, Engine supports the *Helping Angels Lead Our Startups (HALOS) Act* (H.R.79), which would clarify regulatory ambiguity by excluding demo days from the general solicitation requirements, making it easier for startups to publicly showcase their ideas without accidentally running afoul of securities laws. The bill would allow startups to spend their limited resources on building their businesses, rather than navigating the regulatory requirements of a pitch event, an activity that's nearly become a rite of passage in the life cycle of today's startups. The *HALOS Act* passed the House in January of this year with broad, bipartisan support (344-73).[4] It has been introduced in the Senate as S.588 by Senators Christopher Murphy, Pat Toomey, Heidi Heitkamp, John Thune, Brian Schatz, and Thom Tillis. We urge the Committee to take up and approve this legislation.

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[4] Emma Peck, *Engine Welcomes House Passage of HALOS Act*, Engine (January 10, 2017) http://www.engine.is/news/category/engine-welcomes-house-passage-of-the-halos-act.

Improve the Title III equity crowdfunding landscape.

For the startup community, one of the most heralded provisions of the *JOBS Act* was Title III regulation crowdfunding. We continue to believe that investment crowdfunding has the potential to revolutionize startup financing and enable new groups of entrepreneurs to participate in the startup ecosystem. However, we support several basic adjustments to the regulation crowdfunding framework that could help create a more vibrant non-accredited investor crowdfunding market that maintains adequate protections for those investors.[5]

First, Engine encourages the committee to consider raising aggregate funding limits. Without any mature investment crowdfunding markets to draw from, Congress capped the crowdfunding exemption at $1 million per year in the *JOBS Act*. However, based on our analysis of both the Title II market in the U.S. and investment crowdfunding in the U.K., $1 million is an arbitrary limit that does not accurately reflect startups' actual capital needs and excludes a large swath of companies that would otherwise use Title III to raise funds.[6] Raising the funding cap to a reasonable amount of $5 million would help to ensure that Title III investment crowdfunding achieves its full potential as a vehicle for startup financing.

Second, we believe that special purpose vehicles (SPVs) should be permitted under regulation crowdfunding. Portfolio diversification is one of the core principles of sensible financial management, particularly when investing in a risky and high-variance asset class like startups. Yet, under the *JOBS Act*, SPVs are not eligible for the crowdfunding exemption. Essentially, this means that non-accredited investors are limited to investing directly in startups and cannot pool money into a venture fund or other such vehicle for portfolio diversification. Considering the *JOBS Act* caps participation by non-accredited investors to between $2,000 and $5,000, it is unlikely that such investors will be able to adequately diversify their investments without using SPVs. Allowing non-accredited investors to pool money into managed venture funds will help investors diversify their portfolios and also potentially limit investor risk by transferring the task of selecting profitable companies to fund managers who presumably have more experience than retail investors in valuing startups.

Third, while policymakers should emphasize investor safety in crowdfunding markets, particularly for the many non-accredited investors that participate in this investment class, we believe that the existing disclosure obligations in the *JOBS Act* and the corresponding SEC regulations may unduly restrict issuer participation with little to no corresponding investor

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[5] Engine Advocacy, *Financing the New Innovation Economy: Making Investment Crowdfunding Work Better for Startups and Investors* (October 2015) http://static1.squarespace.com/static/571681753c44d835a440c8b5/57323e0ad9fd5607a3d9f66b/57323e14d9fd5607a3d9fb53/1462910484566/Crowdfunding-White-Paper.pdf?format=original.

[6] Engine Advocacy, *supra* note 5.

protection benefit. Though financial statement disclosures prepared under GAAP standards make sense for more established companies with operating histories, financial statements for new companies seeking seed financing through crowdfunding portals are unlikely to have much informational value to prospective investors but are nevertheless burdensome for startups to produce. Portals have a strong incentive to ensure that investors have adequate, meaningful information on prospective issuers, so it is unlikely that giving more deference to portals to determine which upfront disclosures to require from issuers will harm investors. The U.K.'s successful crowdfunding regime features such a flexible disclosure regime, and the market has seen significant growth with minimal fraud.[7] We urge you to consider revisiting Title III's disclosure obligations to ensure that promising startups aren't priced out of the market by expensive but marginally useful disclosure obligations.

Finally, we are supportive of a so-called "testing the waters" policy that would allow startups to lawfully communicate with potential investors and gauge interest in their offerings before committing the time and incurring any of the burdensome filing and preparation costs required under current rules. Since around one third of rewards-based crowdfunding projects fail to meet their funding goals, allowing companies to evaluate whether they are likely to succeed or fail before spending valuable resources preparing a campaign is critical to making crowdfunding effective and efficient for startups.[8] Including a "testing the waters" provision in Title III would help improve overall campaign success rates by deterring issuers who recognize their businesses aren't investor-ready and, therefore, also keep would-be investors from committing equity to potentially failure-prone campaigns. Such a provision will ultimately make crowdfunding far more valuable to issuers while likely enhancing investor safety.

Each of these proposed modifications would make regulation crowdfunding more attractive to issuers. Appealing to more issuers, especially to quality companies, is essential to the overall health and stability of the crowdfunding market in the long term. If crowdfunding is simply too expensive and too onerous for issuers to bother, they're likely to rely on Regulation D instead—a far simpler capital-raising option that's limited to wealthy accredited investors. If the best companies find capital elsewhere, only startups without a shot at raising funds from more established investors will choose to crowdfund, establishing a risky foundation for a young market and for first-time investors.

In terms of specific legislation, Engine is supportive of the *Fix Crowdfunding Act* (H.R.4855 114th), which was introduced by Representative Patrick McHenry and passed in the House last year with broad, bipartisan support (394-4). The bill has not yet been re-introduced this

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[7] Engine Advocacy, *supra* note 5.
[8] Catherine Clifford, *Less Than a Third of Crowdfunding Campaigns Reach Their Goals*, Entrepreneur (January 18, 2016) https://www.entrepreneur.com/article/269663.

Congress, but we urge the Committee to explore similar policies as part of broader efforts to improve the capital access landscape for startups.

Remedy the "99 Investor Problem."

As you know, in 2013, the Securities and Exchange Commission (SEC) lifted the ban on general solicitation, pursuant to Title II of the *JOBS Act*, allowing companies to publicly solicit funds from accredited investors under Rule 506(c) of Regulation D. This change has enabled the emergence of numerous crowdfunding portals where accredited investors can browse through and connect with hundreds of startups and entrepreneurs seeking funding. These crowdfunding portals have helped bring new investors into the market by allowing them to pool funds into a larger LLC, often led by a more experienced investor—a structure commonly known as syndicate funding. This approach also simplifies the transaction for a startup, which ends up with only one investor on its cap sheet—the syndicate LLC—instead of numerous individual investors.

However, under the securities law, if a syndicate LLC exceeds 99 investors, an SEC registration requirement is triggered. As a result, most syndicates are currently capped at 99 investors. This issue, commonly referred to as the "99 Investor Problem," is troublesome for two reasons: first, it limits investor participation, and second, it limits the amount of capital that startups receive from a syndicate, since there may be investors who would like to contribute additional funds but are excluded from the syndicate.

To remedy this issue, Engine supports Senator Heidi Heitkamp's *Supporting America's Innovators Act* (S.444), which passed the Committee in March. The bill's companion in the House, H.R.1219, passed the full chamber with bipartisan support (417-3) earlier this month. The legislation would raise the cap to 250 investors for qualifying venture capital funds that purchase no more than $10 million in securities per round. This narrow fix would address the above issues and enhance Regulation D for both investors and issuers, and we are hopeful that the full Senate will take up the bill as expeditiously as possible.

Retain the current accredited investor financial threshold and add qualitative measures for investor sophistication.

Last year, the SEC indicated that it was considering updating its accredited investor definition for the first time since 1983. This definition is extremely important for the startup ecosystem, because the most common legal arrangement that startups use to raise funds, Regulation D, limits participation almost exclusively to accredited investors.

While it's perfectly understandable to revisit the definition to make sure it's still accomplishing its original goals of protecting individuals without sufficient financial foundations to take on the economic risks of private investments, we believe that the current financial thresholds ($200,000 income for an individual/$300,000 for a couple or $1,000,000 in net worth) are sufficient for protecting investors. There is no evidence that the present definition has harmed individuals who would be excluded under an inflation-adjusted threshold. Further, as we elaborated on more fully in our 2016 comments to the agency,[9] we are concerned that adjusting the existing threshold to inflation would substantially diminish the already limited pool of people eligible to fund startups, in turn damaging the ability of entrepreneurs to raise capital.

Instead, the Committee should explore policies that would maintain or expand the number of eligible investors. Specifically, Engine supports preserving the current accredited investor financial threshold as it is. Additionally, we urge the Committee to consider additional qualitative measures for investor sophistication that could be used to establish accredited status. We encourage the Committee to look to the U.K.'s approach to regulating retail investor activity in the investment crowdfunding market for guidance, which we outline in detail in our 2016 comments.[10]

Should the Committee choose to adjust the threshold to inflation, we would urge you to allow investors who currently qualify as accredited investors but fall short of the proposed inflation-adjusted thresholds to maintain their accredited investor status through a "grandfathering" provision.

Conclusion

We believe that the policies outlined above represent commonsense, meaningful reforms that will improve the current capital access landscape for innovators across the U.S. Building a sustainable, thriving startup ecosystem is key to long-term economic success, and policies that encourage the creation of new businesses and the growth of local entrepreneurial economies will reap massive returns in the long run. As the Committee formulates its agenda for the 115th Congress, it is our hope that you will take the concerns of the startup community into account. Engine and the startups with whom we work look forward to continued engagement with you

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[9] Evan Engstrom and Anna Duning, *Comments of Engine Advocacy on Report on the Review of the Definition of "Accredited Investor,"* Securities and Exchange Commission (March 14, 2016) https://www.sec.gov/comments/4-692/4692-17.pdf.

[10] Evan Engstrom, *Statement for the Record*, U.S. House of Representatives Committee on Financial Services Hearing "The JOBS Act at Four: Examining Its Impact and Proposals to Further Enhance Capital Formation" (April 13, 2016) http://static1.squarespace.com/static/571681753c44d835a440c8b5/57323e0ad9fd5607a3d9f66b/57323e15d9fd5607a3d9fbc9/1462910485356/StatementfortheRecord41416HouseHearing-1.pdf?format=original

and all of the members of the Senate Banking Committee over the coming months and appreciate your consideration.

Sincerely,

Evan Engstrom
Executive Director