“Crowdfund Investing – A Solution to the Capital Crisis Facing our Nation’s Entrepreneurs”

Testimony of

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United States House of Representatives

The Honorable Patrick McHenry, Chairman
The Honorable Mike Quigley, Ranking Member

INTRODUCTION

Chairman McHenry, Ranking Member Quigley, and members of the Subcommittee, thank you for holding this hearing today and allowing me to share with you a framework to allow a limited amount of critical seed capital to flow to entrepreneurs in a new form of investing called Crowdfund Investing. Over the next 5 years, this framework has the potential to create 500,000 companies and 1.5M net new jobs at zero cost to our government. My intention is to explain why 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 Crowdfund Investing, which includes prudent protections for investors, will spur innovation among your constituents, create jobs, increase consumer spending, and reinvigorate our economy. This framework enjoys bipartisan support with President Obama quoting from it in the 2011 American Jobs Act.

My Name is Sherwood Neiss and I am an Entrepreneur. This is my third time partaking in hearings before the U.S. Congress. I was most recently part of a hearing related to issues of capital formation in May 2011. Prior to that, I was here in 2006 testifying 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 Inc 500, 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' testimonies 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.

My co-founders at The Startup Exemption, Jason Best and Zachary Cassady-Dorion along with Karen Kerrigan of the Small Business & Entrepreneurship Council and I have been the main advocates behind the push for this Crowdfunding Exemption in Washington. We crafted the following Crowd Fund Investing framework and we are backed by thousands of entrepreneurs and Americans who have signed our Petition to make Crowdfund Investing legal.

THE REALITY OF HOW PEOPLE VIEW MONEY TODAY

First, I would like to point out the obvious: people don't easily part with their money. It isn't easy to come by and it isn't easy to let go. We have an attachment to money that is at times even more personal than our closest relationships. This is cited as one of the main reasons why so many marriages end in divorce. Granted the more money you have the more flexibility you have with it. So I think it is fair to say that people with a limited amount of money are more limited with what they can do with it and more cautious on how they spend it.

Now rather than hit you over the head with facts, let's just assume that everyone here is aware of the dire economic situation that surrounds us; the recession, high unemployment, low confidence and political stalemate. Because of this the stock markets are volatile and people are pulling their money out of them. On the flip side, according to an August 25th story in USA Today, Americans are saving more money than ever. So personal savings are going up as fear and skepticism increases. Not, what we would call, a healthy environment for liberal spending.

BUSINESS, THE JOBS ENGINE OF THE USA

Now let's jump to a couple other facts. Businesses create jobs. Jobs employ Americans. Americans spend their income on housing, food and travel in such a way that stimulates our economy. And both Americans and businesses provide tax revenue so our government can operate and pay its obligations.

And finally, businesses need capital to grow and hire. Prior to the 2008 financial meltdown, traditional capital for startups or small businesses either came from personal savings, credit cards, loans or, if you were in the lucky 2%, private money (venture capital, private equity or angels). Today, try going into a bank to get a loan or a line of credit. Try finding a credit card company that will give you a line of credit with what used to be considered a decent interest rate of 9%. And try peddling your idea to Venture, Private Equity or Angel people as they are all focused on the same deals. None of which are providing capital to those that collectively will create the vast number of net new jobs but those that have the greatest chance for a 10x return in the shortest period of time. So the point is, there's no capital out there for the majority of businesses that we need to hire Americans and get us out of this recession.

Hopefully we can all agree on those facts. Now I might be wrong with the following line of reasoning however I doubt it.

HOW MANY PEOPLE WOULD GIVE A PANHANDLER $100?

First, if I asked each of you to give me $100 for a business idea I have, having no relation to me or the idea, I'd bet 100% of you would tell me to take a hike.

Second, let's assume 10% of you in this room knew me. Even with that connection, I'm fairly certain that none of you would give me $100 without answering a few questions namely:

1) Why do you need the money?
2) What is the idea?
3) What problem does it solve?
4) Who is going to buy your product?
5) How does your business make money?
6) What will the money allow you to do?

7) What's in it for me? and
8) Tell me why I should trust you with my $100 and why you are the right person to do this?

So those that know me and understand what I'm trying to do might just give me $100. It won't be everyone because everyone's financial circumstances are different. e.g., I just don't have $100 right now, I'm hesitant about investing in anything, I just don't think it is something I'd use and hence not sure it is the right investment for me, all my money is tied up, I'm saving for a vacation, etc.

Then again, some of you might be thinking this is a great way to take advantage of innocent people. While you might ask such questions because you are rational, there are plenty of irrational people out there that wouldn't. We see them on the news. Exuberant folks who hear a good idea and just jump in. For that, we need to understand what makes them irrational. There are 2 main drivers: trust and greed.

So how do we address this? Make them acknowledge that what they are doing means they can lose all their money. Using today's technology we can make people listen to the following disclosure thru their web browser and then require them to type it into a disclosure form.

> *"I understand that my investment in this idea may lead to no return. That any money I invest may disappear and I am making this decision of my own choice."*

That's a pretty long phrase and they'd have to listen to it a few times to make sure they enter it correctly or the system will not let them proceed.

Now if I made you repeat that sentence to me before I took your $100, I bet the majority of you that have no relation to me would say, "You want me to give you $100 for some idea you have, I have no clue who you are AND you have the audacity to ask me to type into a form a sentence that acknowledges I might never see this $100 again? Take a hike!"

A REAL LIFE EXAMPLE – TODAY'S UNFORTUNATE REALITY

Now let's put this into a real life example. Most people understand that if you are sick, medicine can help you get better. Adults take this logic for granted, however children don't quite understand it. Pharmaceutical companies have done a great job over the years developing pediatric forms of medicine so that it is easier to administer. However, if any of you have children you know that getting them to take nasty tasting medicines can be a 10-day battle. First, you can't reason with an infant that spits up a medicine because it is bitter. And second, you can't use logic on a sick, fussy toddler.

Let's say I'm a pharmacist and have worked with a flavoring company to come up with liquid flavors that can be added to liquid medicines without interfering with the basic properties of the medicine. I want to sell this flavoring system to pharmacies around the country and they will pay me a fee to use the system. The money I raise will be used to buy inventory, some office supplies, hire an assistant, and pay my rent. I envision I'll need $500,000 to really get things going but for this first stage (inventory & packaging) I need $50,000. That in exchange for the $50,000, I'm willing to give up 20% equity in my company.

Now how many of you would give me $100? Guess what? Probably not many of you for many of the same reasons I gave above. Welcome to the reality of raising capital. It isn't easy! It takes a lot of time, energy and connections to get the backing you need to launch a business. There's no guarantee that the people I speak with will be interested in my idea and hence there's no guarantee that I will raise the capital I need to grow my idea. However it can happen and it does.

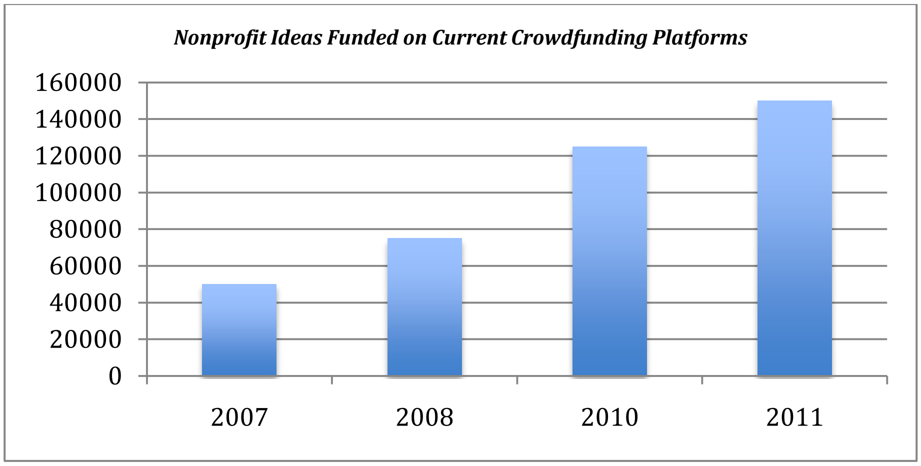
Now what if I told you that this company turned into a three-time, Inc. 500 company that had 50 employees, with paid healthcare and retirement benefits. That these employees had families, bought homes and used their hard-earned dollars to keep our economy chugging along. That other than payroll taxes we paid corporate taxes and bought countless products and services from a multitude of vendors that accounted for further economic spending. Well guess what, we did. That was, FLAVORx, the company that I cofounded.

We were lucky because we were able to use all traditional means of financing available prior to the 2008 meltdown (credit cards, loans, lines of credit, and private money). Today, I'm confident in telling you based on my personal experience of trying to raise capital for two other startups of mine since we sold FLAVORx, that if we tried to start FLAVORx today, under the current environment, that we would have failed, no jobs would have been created, no products or supplies from third party vendors would have been purchased, no taxes would have been paid to our government and no investors would benefit from our eventual sale.

The fact of the matter is today, unlike 12 years ago when we were financing FLAVORx, there's a way for us to do this online where our friends, family and broader social network can vet us, our idea and our business model and decide if the 20% equity stake in the idea is worth their many $100 investments. It is called Crowdfund Investing and this is how it can work:

CROWFUNDING AND ITS HURDLE … THE SEC

If you go online today there are websites like Indiegogo, Kickstarter, and Kiva that allow a person with an idea (mainly art-related) or an entrepreneur in the developing world to seek funds from the crowd in order to make their idea a reality. These people pitch their ideas to their social network via these platforms. On the platform they talk about the idea, who they are, the need for the idea, and how much money they need to make it a reality. The crowd decides which projects they want to fund and with how much money they are going to **give**. The losing ideas don't get funded. All the money is just a donation and the only perks an investor gets ranges from a thank you card, to a mention, to a t-shirt or in some cases samples or thank you dinners. Over the past 5 years, on websites like the ones mentioned above over 500,000 ideas have been funded.



**Data related to this chart is an aggregate from the top 10 crowdfunding sites over the past 4 years.*

Pretty cool, right? People helping people. Sort of the American way. What if we wanted to tie a return to those same dollars? Well at that point you enter the domain of the SEC, and its rules that were initially crafted 80 years ago, which still dictate how we can fund companies using these antiquated rules.

Do you realize that as an American you are free to spend $100 however you see fit but if you wanted to take $100 and invest in my medicine flavoring business idea, I might end up in jail? The fact that we micromanage what Americans can do with a few dollars almost seems un-American and anti-business. Americans today are more sophisticated than they were 80 years ago.

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.

These thoughts are shared by experts as well. The following are some of the many academic reports written about the SEC rules and how they prohibit access to capital for small businesses and entrepreneurs:

Proceed at Your Peril: Crowdfunding and the Securities Act of 1933, Tennessee Law Review. Joan MacLeod Heminway & Shelden Ryan Hoffman, August, 2011

Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption, University of Pennsylvania Journal of Business Law. Nikki D. Pope, August, 2011

Petition for Rulemaking: Exempt Securities Offerings up to $100,000 with $100 Maximum per Investor from Registration. Sustainable Economies Law Center. Jenny Kassan, July, 2010

SEC Regulations Barricade The Crowdfunding Floodgates, The Crowdfunding Revolution. Kevin Lawton, November, 2010

Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns, New York University Journal of Law and Business. Stuart R. Cohn & Gregory C. Yadley – Fall, 2007

Security Regulations and Their Effects on Small Businesses, California Research Bureau. Rosa Maria Moller, Ph.D. - April, 2000

The general consensus of each of these articles is that except for those that can afford it, the rules as they are written are costly and burdensome, and stymie the flow of capital. For larger businesses looking to seek capital in excess of $5M, these rules and associated costs are indeed beneficial to the investor. However, for smaller businesses seeking less than $5M they are counterproductive. Most of these articles go on to say that while the cost of regulation might be offset by the benefit of disclosure that in small companies where transparency is just a fact of life, they are indeed a barrier to growth. Because of this people are deterred from raising capital and many would be successful ideas never go anywhere.

WHY THE RULE CHANGE IS NECESSARY, 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 security 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 two 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 security 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 who will be competitive in the future.

Crowdfunding 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 than 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 Crowdfund Investing requires that "the investor" sit down, look at a deal, and analyze rather than trust the judgment of an advisor who makes their commission 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.

Crowdfunding 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 crowdfunding 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, crowdfunded 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. 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 Crowdfund Investing (CFI) 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."

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 crowdfunding bring down the entire economy? To them we say, recall what happened in the Ireland Banking crisis of the late 1970'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.

Naysayers act as if crowdfund 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 Crowdfund Investing as lower risk than any other choice they make in their daily lives when in fact we all know this isn't true.

Crowdfund Investing is more than just money – it is facilitation, diligence, team building, and valuation. Most importantly, it is the engine that will create much needed 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 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 crowdfund 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 public 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.

The solution is simple. It doesn't require deregulation but reregulation -- a new regulatory framework. It doesn't require new thinking but rethinking the current rules to account for transparency and accountability.

CROWFUND INVESTING … THE FRAMEWORK

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 and $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
5. Limit to the amount of seed capital a company can raise

This Framework is a proposal to the SEC for creating an exemption to enable entrepreneurs and small businesses to utilize their personal networks to raise small amounts of capital to start or grow their businesses. It would provide a framework for how much capital they can raise and restrict who can participate. This model was vetted by the

Small Business & Entrepreneurship Council (SBE Council) and again at a Crowdfunding Thought-Leaders Symposium held in San Francisco on August 1, 2011.

The goal of calling the industry participants together was to gain buy-in for the rules under which equity-based crowdfunding should be allowed. In addition, they believe having the group draft the rules better serves the foundational principles of limiting investor risk, optimizing fraud protection, enhancing informational transparency, and standardizing disclosure and enforcement.

This framework is meant to be a guide for any and all crowdfunding platforms on the Internet. Any entrepreneur/business that does not meet the criteria outlined below or "graduates" from the framework would have to comply with existing SEC rules. As with all security-related instruments U.S. anti-fraud provisions prevail.

1. **Amount and Class of Shares**: We propose the creation of a "funding window of up to $1M" for entrepreneurs and small businesses. "Small Business" is defined as one with average annual gross revenue of less than $5M during each of the last three years or since incorporation if the business has existed for less than three years. This definition is consistent with definitions utilized by the Small Business Administration. Straight common shares along with their standard rights could only be used. This is on par with similarly used shares in early stage rounds of family and friends financing.
2. **Limit**: We believe that investments from unaccredited investors should be capped at $10,000. The $10,000 limit is in line with other established financial disclosure limits like those on banking transfer reporting requirements. Accredited investors will not be subject to any limits. *Note*: The vast majority of individuals who choose to make Crowdfund Investments will most likely invest below $500. The current average is approximately $80 on existing crowd funding platforms.
3. **Risk Disclosure**: Given that 60% of Americans now own stocks or mutual funds, there is a certain level of investor sophistication that is greater today than ever before. (In the 1930s, only 5% of the population invested their money). In addition, unlike investing in the public markets where individuals rely upon the experience/advice of advisors, people choosing to invest via crowd funding will often be investing in their social networks with people they know and trust. Hence, accreditation should be attached to investors understanding of the risks inherent in this type of investment. Prior to using these platforms, investors will have to agree using current standard verification technology that they understand there is no guarantee of return, that they could lose their entire investment and that their liquidity/return is limited to any dividends, sale, public offering or a merger of the company.
4. **500-Investor Rule**: Eliminate the 500-investor limit for Crowdfund Investing via this window.
5. **State Law**: 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.

6. **General Solicitation**: Allow for general solicitation on registered platforms where individuals, companies and investors can meet virtually, ideas can be vetted by the community as a sort of peer review and individuals can make informed decisions regarding whether or not to invest their money.
7. **Filing and Reporting**: Standardized forms (generic term sheets & subscription agreements) based on industry best practices will be used to maintain transparency and reduce time and expense for all parties. They will be electronically maintained using standardized procedures. Post funding standardized and automated reporting for use of proceeds will be required on a quarterly basis by entrepreneurs. Platforms will provide the SEC monthly offering reports that include information on: deals funded, entrepreneurs' names, social security numbers, addresses, date of births, amount of capital raised, list of investors and individual dollar amount contributed.
8. **Platform broker/dealer exemption**: Due the small nature of the dollar amount, and the high volume of automated activity, allow facilitation of funding for securities without need for a (FINRA) broker/dealer license by the facilitator, where deals facilitated fall within the constraints of this framework.
9. **Availability:** This exemption shall not be available to foreign issuers, investment companies, and public companies.

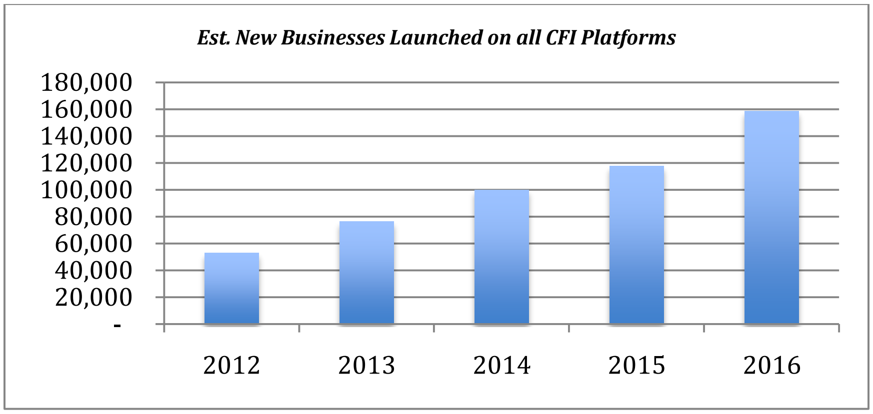
A similar framework is already in place in the U.K., France, Holland, India and China. Now is the time to make this happen in the U.S. so our economy is not left behind. We believe our framework is one that will allow for transparency, accountability, limited risk and exposure and the flow of capital.

WHAT CROWFUND INVESTING CAN ACCOMPLISH

Crowdfunding 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."

In my May 2011 testimony I write, "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 crowdfunding sites to raise money." Since then numerous crowdfunding sites have not only launched here in the USA but around the world as well, and the amount of ideas funded has far exceeded 500,000.

According to the SBA about 500,000 companies incorporate each year. While our belief that is that Crowdfund Investing will help stimulate ideas and businesses we do not believe that we can create 500,000 companies overnight. However we do believe that following typical crowdfunding trends, we can create 500,000 companies over the next 5 years.



Based on SBA statistics on normal business attrition[1] (closure, merger, sale) times a trending growth curve by the US Census Bureau Statistics[2] about Business Size we estimate that the 500,000 companies created on CFI platforms over the next 5 years have the ability to create the 1.5M net new jobs.

BIPARTISAN SUPPORT FOR CROWDFUND INVESTING

Perhaps it is for this reason that President Obama during his September 9, 2011 speech to a joint session of Congress said, "Everyone here knows that small businesses are where most new jobs begin. And while corporate profits have come roaring back smaller companies haven't." "Ultimately our recovery will be driven not by Washington but our businesses and our workers. We can help." "I agree there are some rules and regulations that do put an unnecessary burden on businesses at a time when they can least afford it." So "we are … planning to cut away the red tape that prevents too many rapidly growing startup companies from raising capital and going public." "We should have no more regulation than the health, safety and security of the American people required. And every rule should meet that commonsense test." "We should be in a race to the top and I believe we can win that race." "And it has been the drive and initiative of our workers and entrepreneurs that has made this economy the engine and envy of the world." "Members of congress it is time for us to meet our responsibilities."

Pursuant to his speech the American Jobs Act was released with the following paragraph:

Reducing Regulatory Burdens on Small Business Capital Formation: As part of the President's Startup America initiative, the Administration will pursue efforts to reduce the regulatory burdens on small business capital formation in ways that are consistent with investor protection. This includes working with the SEC to explore ways to address the

[1] http://web.sba.gov/faqs/faqindex.cfm?areaID=24
[2] http://www.census.gov/econ/smallbus.html

costs that small and new firms face in complying with Sarbanes-Oxley disclosure and auditing requirements. **The administration also supports establishing a "crowdfunding" exemption from SEC registration requirements for firms raising less than $1 million (with individual investments limited to $10,000 or 10% of investors' annual income**) …. This will make it easier for entrepreneurs to raise capital and create jobs.

CONCLUSION:

Crowdfund Investing has bipartisan support. 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 crowdfund 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, both the President and Republican members of Congress agree that it isn't in the government's interest to regulate investments in startups when the exposure to risk is limited to modest amounts. Hence we need to advance the framework presented here so that the government's interest in ensuring the success of our nation's entrepreneurs is also met. The scope of current securities laws is too broad, so broad that such laws stifle new forms of capital formation where 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.

Sherwood Neiss

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Chances are this entrepreneur has already helped you, your child, someone very close or even your pet. As a 3-time INC500 winner and an Entrepreneur of the Year recipient, Woodie understands the keys to entrepreneurial success from concept to company to sale.

Sherwood Neiss started his post-MBA career on Wall Street and moved to Silicon Valley where by his 29th birthday reached the personal and financial goals he set for his 30th year. Wondering what to do next and also left struggling with a debilitating family dilemma, he used his entrepreneurial drive to help turn his family adversity into a multi-million dollar company that today is helping millions of sick children, animals and adults get better by being more compliant with their medicines.

Sherwood Neiss co-founded FLAVORx (www.flavorx.com) the company makes 42 yummy flavors that take the yuck out of medicine. His structured approach helped not only build a business model that threw off millions of dollars in cash but also helped grow the business from one pharmacy to over 80% of the pharmacies in the United States. He raised millions of dollars in capital and saw the culmination of his endeavors with the sale of the company in 2007.

Sherwood is an avid public speaker. He speaks at universities and seminars around the country about what it takes to be an entrepreneur, how to fund your idea, and building a winning company. Woodie also testified at a Congressional hearing on the impediments to capital formation under Sarbanes-Oxley. His testimony was one of the reasons the Small Business Exemption to section 404(b) audit requirements was passed in July 2010.

Most recently Sherwood won both November, 2010 and May 2011 Startup Weekend Challenges in Miami for 2 startup ideas that have the potential to create many jobs – unfortunately neither of which qualify for traditional funds. Currently he advocating for the SEC to update the securities laws to make it legal for groups of people to pool small dollar amounts of money together to invest in startups aka "Crowd Fund Investing."

When not working, Sherwood is an avid traveler. He lived in Japan for a year and post-sale of FLAVORx took his second backpacking trip around the world. In addition to speaking at universities and businesses around the country he invests in real estate in the U.S. and Brazil, is part of a Private Equity group in Los Angeles, is working on a clean tech project in Puerto Rico and is involved with several other start-up ventures.