

Dana Mauriello, Co-Founder & President, ProFounder

Dana Mauriello is the Co-Founder and President of ProFounder, an online platform that gives entrepreneurs the tools to raise investment capital from their communities. ProFounder is the only online solution for entrepreneurs who desire to offer securities to unaccredited investors and, as such, is widely recognized as a leader in the crowdfunding space with deep legal expertise. Since opening its doors to entrepreneurs in September 2010, ProFounder has enabled 19 companies to complete 21 fundraising rounds for a total of over \$612K raised. These companies engaged a total of 356 investors in their fundraising.

Prior to founding ProFounder in 2009, Dana was a student at Stanford Graduate School of Business. Before attending Stanford, Dana conceptualized and brought new cosmetic products to market as part of the Corporate Product Innovations team at the Estee Lauder Companies. She was also involved in the formation and development of multiple small family businesses in areas ranging from exercise equipment to baked goods.

Dana is a frequent speaker at conferences on the topics of crowdfunding, non-traditional fundraising methods, and entrepreneurship.

ProFounder has been featured in publications include the Wall Street Journal, Forbes, MSNBC, Tech Crunch, Venture Beat, and the Dylan Ratigan Show.

Written Testimony of Dana Mauriello, Co-Founder and President of ProFounder, to the Committee on Oversight and Government Reform  
U.S. House of Representatives, Sub-Committee on TARP and Financial Services

“Crowdfunding: Connecting Investors And Job Creators”

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Good afternoon Chairman McHenry, Ranking Member Quigley and members of the committee. My name is Dana Mauriello. I am the Co-founder and President of ProFounder, which is an online platform for entrepreneurs to raise investment capital from their communities. In your invitation letter, you asked me to address how crowdfunding can become a viable means of capital formation. I am grateful for the opportunity to present my views on crowdfunding this morning.

First, I will provide an overview of the current crowdfunding landscape and provide my views on why crowdfunding is a critical tool for capital formation. Second, I will describe ProFounder, including its legal framework and features as well as the challenges that we faced in creating a crowdfunding product while remaining compliant with current regulation. Finally, I will suggest regulatory changes that should be made to facilitate crowdfunding while also maintaining a high level of investor protection.

My Background and the ProFounder History

I started ProFounder with Jessica Jackley in August 2009 out of a desire to give entrepreneurs access to the resources that they need to succeed. I was first exposed to entrepreneurship through my experience with my family’s businesses. My father taught me early on that there is no problem you can’t solve with ingenuity and hard work--a mantra that I consider to be at the very core of the American entrepreneurial spirit. In first grade, I found that when I tried to rip pages out of my workbooks they came out torn and messy, so I invented a “Page Helper” to solve this problem and my family helped me to produce them and create a business plan. That was my start and from there, I had the opportunity to be involved with the numerous business ventures that arose from dinnertime conversation and basement tinkering -- from exercise equipment to baked goods manufacturing. The first bit of

start-up capital always came from Uncles, Aunts, and friends who believed in us and what we were doing. Our story is one that I now know is repeated across dinner tables and basements the country over.

While attending the Stanford Graduate School of Business, I met my now-co-founder, Jessica Jackley, and we started a dialogue about how to bring entrepreneurial resources to small business entrepreneurs far from Silicon Valley. Jessica also founded KIVA, the first peer- to- peer microfinance site in 2005. KIVA is widely recognized as a pioneering financial technology organization and has facilitated over \$241 million in loans to entrepreneurs in 216 countries including the United States.

The idea for ProFounder came to us when we saw two classmates who were starting a business get investment interest from dozens of fellow classmates. When these entrepreneurs asked their lawyers to structure this investment deal, they were told that it is impossible for their classmates to invest even \$1K each because they are unaccredited investors. When pushed, the lawyers spent months and tens of thousands of dollars to structure a deal that would include only 35 of these classmates. We were struck by the incredible inefficiency of this arrangement; available capital existed in the community, but there were tremendous legal and administrative barriers to accessing it.

Jessica and I started ProFounder to solve this market inefficiency and make it possible for entrepreneurs to unlock the capital in their communities. We called this method of financing “community funding,” and created a platform that allowed entrepreneurs to utilize their social networks for investment capital in a way that is be simple, inexpensive, efficient, and legally compliant for all involved.

We chose to focus our efforts on supporting small businesses in America because we feel that these businesses have the most limited resources, but limitless ideas and potential to create innovation and economic value.

To date we have enabled 19 companies to complete 21 fundraising rounds for a total of over \$612K raised from 356 investors. Our success cases include entrepreneurs like Bronson Chang who raised \$56K from 19 classmates, customers, family, and friends to expand his family’s candy shop in Hawaii and Raaja Nemani who raised \$60K from 37 classmates, friends, and family to start a now-thriving sneaker business.

The Crowdfunding Option

#### a) Definitions and Landscape

Crowdfunding refers to the process of many people contributing small dollar amounts which, in aggregate, meet the financial goal of a project. In this section, I will outline the services that the most influential technology companies in this industry provide, and the legal frameworks that they employ. Note that crowdfunding also happens infrequently offline through Reg D, Reg A, and co-op structures and I am not considering those offline pathways in this overview.

KIVA, founded in 2005 by my co-founder, Jessica Jackley, was the first peer-to-peer lending site. KIVA provides an online marketplace where microfinance institutions can list businesses from their portfolios seeking loans, and individuals can contribute to the loan in \$25 increments with the intention that they will be repaid their principal with no interest. Loans made on the site are not considered securities because there is no financial upside for the lender and KIVA is a non-profit that does not profit from the transactions. Prosper, also a peer-to-peer lending site, facilitates personal loans to individuals that are repaid at a fixed rate of interest. The loan products on Prosper (unlike on KIVA) are registered securities.

IndieGoGo ([www.indiegogo.com](http://www.indiegogo.com)), launched in 2008, provides a marketplace where donors offer capital and receive goods and services in return. An example of a typical project on IndieGoGo might be an author raising \$5K to self-publish his book, asking for individuals to contribute \$25 toward his goal to receive a signed copy of the book in return. Kickstarter ([www.kickstarter.com](http://www.kickstarter.com)) and almost 200 other sites have since launched to provide similar services. Kickstarter, IndieGoGo, and others do not facilitate investments; the capital contributed is not an investment, will not generate financial return, and will not generate a non-financial return that is dynamic depending on the success of the business. To avoid falling under the purview of state and federal securities regulators, these sites ensure that the reward for a financial contribution is limited to a good or service with a fixed value or to nothing at all.

Note that none of these crowdfunding sites allow for businesses to offer investments / transact securities. This biggest hurdle that prevents them from doing so is the prohibition of general solicitation. To a lesser degree, these sites are also thwarted by other regulatory hurdles such as: the restrictions on the involvement of unaccredited investors (Reg D 506), limits on the number of investors who can be involved in an offering (Reg D), extensive disclosure requirements (Reg A), state-by-state blue sky laws (Reg D 504), and requirements for broker dealer registration.

The last notable addition to the crowdfunding landscape is Angel List (<http://angel.co/>), launched in 2010 to connect accredited investors with start-ups looking for capital. They gained notoriety because of their careful curation of deals and the social validation tools that they employ to keep the network of investors and entrepreneurs very high caliber. I consider Angel List a crowdfunding innovation because it is an online platform that connects both sides of the financial marketplace. They have navigated legal barriers by only working with accredited investors, not advertising deal terms, and not charging any fees.

#### b) Why crowdfunding matters

It is important that crowdfunding exist because it democratizes access to start-up capital. Capital exists in people's communities and it just can't be accessed. Anyone who is bright, driven, and has a great idea can gather a supportive community around himself. Crowdfunding allows that entrepreneur to turn his community into a capital source.

Businesses that do not qualify for bank loans can get capital via crowdfunding because the crowd is using different decision making criteria than the bank. Whereas a bank looks at collateral and balance sheets, the community makes a decision based on personal knowledge of the entrepreneur's character and their affinity for her product. In addition to different decision making criteria, definitions of success are also very different for either party. Whereas banks evaluate the success of a loan solely on full, timely repayment at the market interest rate, the community may consider an investment successful if they recoup their principal, feel the pride of being a part of something, and get exclusive perks. For example, community members invest in local restaurants, not to get rich, but to be able to tell their friends that they are investors and ensure that their corner table is always waiting for them with their favorite drink on the house.

Similarly, business that can't access angel capital are often successful with the crowd. Angel investors are usually geographically focused (major metropolitan areas) and industry focused (technology). For the entrepreneur starting a vegan bakery outside of DeMoines, her options for angel capital are slim to none as neither the geography nor the industry is a typical fit. However, she is more likely to find success in raising capital from vegan neighbors in her DeMoines suburb who are eager to patronize her new establishment once it opens. This is a classic example of fan dynamics.

Crowdfunding is not a last resort, it is a strategic choice. For example, Marc raised \$50K for his motorcycle business from 16 investors in his community via ProFounder and by pursuing this funding path, Mark could include motorcycle enthusiasts among his investors. These investors could provide tremendous signaling value to future investors and customers and help with marketing by using his bikes at high profile events.

Crowdfunding programs that center around community investment also have strong, inherent investor protection. If an entrepreneur's community invests in her, the reputational consequences of her defrauding them are very strong. For example, Jared raised \$41K from 17 investors via ProFounder to open Fargo Brewing Company. If Jared ran with that money, many of his relationships would be ruined and his reputation would be so decimated that he'd never be able to show his face in Fargo again. On the other hand, if Jared was unscrupulous and he obtained funding from an anonymous institution across the country, he would have relatively weak incentives to repay and absolutely no incentive to exercise generosity above what is required of him.

Crowdfunding keeps money within communities, making the entire community richer and more economically stable. This applies to physical communities and ideological communities alike. For example, if I invest in my local deli, I am very likely to also contribute to increasing their revenue by eating there more often and telling my friends to eat there as well. When the deli does well, I can use my gains to then also invest in the local nail salon. The successful deli will also spend more money in the community, hiring new employees and contracting with the local printer. Another example: I invest in another woman owned business because I want to support women entrepreneurs. When the venture succeeds, I get a financial reward and my capital gains buoy the aggregate economic success of my community of women. The entrepreneur that I invested in now has money (and inspiration) to make an investment of her own in another women-led business and continue the cycle that I began.

## The ProFounder Solution

### a) Legal Structure

When Jessica and I created ProFounder, our aim was to create a solution for entrepreneurs to effectively and efficiently access capital from their communities. Our biggest hurdle was navigating a very complex legal environment and we spent a year working with numerous law firms, partners, and supporters to find an appropriate legal framework to meet our goals. The first conclusion that we reached was that it is important that entrepreneurs be able to offer their investors a

financial return. We felt that this was the fairest arrangement that honored the risk that investors would be taking on the venture. We also felt that a financial return was particularly important to offer given the significant individual investment amounts that we anticipated would be necessary to meet the high (\$50K+) investment goals on our platform. Offering a financial return makes the investment contract a security. Finally, we realized that entrepreneurs did not have the time or resources to register their securities offering, so finding an appropriate exemption from registration was necessary. We eliminated Regulation A because we felt that the disclosures and pre-filing were too onerous to be feasible for small businesses. We also got feedback from state regulatory bodies that Reg A offerings are so rare that the required pre-approval in each state is lengthy and onerous. We instead identified Regulation D, Rule 504 as an appropriate solution for our entrepreneurs because

- Most small businesses need less than \$1M in financing
- We wanted to be able to include any potential investor; including those who are unaccredited/ unsophisticated.
- The investors who are most likely to invest in a small business are those who know the entrepreneur; in other words those who share a “substantial, pre-existing relationship” with the entrepreneur
- Blue sky laws can be easily deciphered and automated with technology

We later choose to offer a Regulation D, Rule 506 compliance structure as well.

## b) Product Features

With this regulatory structure in mind, we created an online platform that had the following features for entrepreneurs:

### 1. Prepare for Investment

Plan investor outreach and see relevant compliance implications for your investor pool (unaccredited investors from all 50 states). Chose between basic (504) and enhanced (506) compliance engines. Our site takes into account dynamic state-by-state interactions caused by blue sky laws.

### 2. Create your Pitch

Simple, interview-style pitch creation process for a simple, clear, transparent end product that can be shared to ensure that investors are fully informed and knowledgeable about the offering.

### 3. Create your Offer Terms

Customize revenue- share or equity term sheet templates.

### 4. Publish your Fundraising Website

Pitch and term sheet are presented together in a private fundraising website created for your business

#### 5. Invite your Community to Invest

Send emails to your community through the ProFounder app inviting them to view your private fundraising website, keep a record of emails sent, and see analytics on their impact. All invitations sent contain a unique link created exclusively for the recipient of the email that can not be forwarded or shared. Compliance is further ensured by requiring that all issuers confirm that they have a substantial, pre-existing relationship with the issuer before being able to view the offering.

#### 6. Receive Pledges for Funding from Investors Directly on your Website

Investors can pledge an investment electronically on your fundraising website

#### 7. Manage the Collection of Funds

Disseminate information about how to send funds and track incoming cash

#### 8. Sign all Investment Documents Electronically

E-signatures of term sheets and related documents for you and your investors

#### 9. Receive Compliance Information

Get information on necessary filing documents and fees to be submitted after you receive your funds

#### 10. Manage Payments to Investors

Calculate payouts due to investors per your investment contract/ term sheet

We monetized our services by (1) charging entrepreneurs a flat fee of \$100 to publish their fundraising page and (2) charging entrepreneurs a flat fee of \$1000 to service their contracts. Servicing a contract involved generating an investment contract that was customized by each entrepreneur, facilitating e-signatures of the term sheets, and document storage among other basic administrative services. We made the choice not to charge commissions or otherwise involve ourselves directly in the transaction to steer clear of Broker Dealer registration and responsibilities.

We began serving entrepreneurs in September of 2010 with a small, private pilot and launch publicly in December 2010. Since that time we have enabled 19 companies to complete 21 fundraising rounds for a total of over \$612K raised. These companies engaged a total of 356 investors in their fundraising. The average raise size was \$29K, the average investment per investor was \$1,700 and the average number of investors per raise was 17.

At its peak in May 2011, our business employed 8 full time employees, 1 part time employee, and a variety of contractors.

#### c) Challenges Faced



- Broker Dealer Issues: We were approached by the California Department of Corporations in February 2011 to provide more information on the legal structure of our business. Conversations continued in a productive manner for a number of months, until June 2011 when the DOC determined that we needed to have a broker dealer license to continue to facilitate the transaction of securities online. This determination was based on the assertion that we were engaged in the negotiation of deals given that we provided templates for term sheets that entrepreneurs could customize and take advantage of, had at one time been involved in handling customer funds, and provided automated legal compliance support. We decided to enter into a consent agreement with the DOC, not pursue a Broker Dealer license, and remove the feature on our site that allowed for securities to be transacted (ie, publishing a private fundraising site, invite investors, and accepting pledges online). Our product still meets the same need of facilitating community-funding, the difference is that it is now a free DIY tool kit.
- Lack of Clear Definitions: Our compliance structured relied on restrictions around general solicitation, sophisticated investors, and investors with whom the entrepreneurs has a substantial pre-existing relationship. Unfortunately, none of these terms has a clear definition, so these concepts were challenging to implement in practice and we had to error on the side of excess caution in the face of ambiguity. Even at that, the entrepreneurs using our platform, and especially their lawyers, were hesitant about employing a structure that engaged these under-defined concepts and often felt more comfortable sticking to more traditional solutions (ie, accredited investors only).

### Suggested Regulatory Changes

I am very cognizant of the risks involved in opening the opportunity to invest in unregistered securities offered by private companies to the general public and I respect the caution that is being exercised around this issue. Below I outline the key features of a regulatory change that would enable entrepreneurs to raise investment capital from their communities while taking precautions to protect investors and prevent fraud.

Note: While I have not yet seen the crowdfunding bill proposed by Chairman McHenry at the time of writing this testimony, I have been informed of the major provisions that he intends to include and I have structured my thoughts based on these provisions.

### Points 1-2: Necessary pre-conditions for new businesses to be started that will facilitate these crowdfunding transactions

#### 1. National Pre-Emption

Federal law should trump state law in this new regulatory area, for simplicity of compliance and so that solution can be standardized. Only once the process is standardizable, can online platforms be created to facilitate this process in a scalable way. And only once this process is scalable can these business facilitate a high volume of small deals for the mass small business market.

## 2. No Broker-Dealer Requirements

Currently, any platform that facilitates the transaction of securities is required to obtain a Broker Dealer license. This is overly restrictive for start-ups wanting to facilitate crowdfunding. The rule change should include a clause stating that if the facilitating entity does not have a salesman stake in deals (ie, no commissions, no selective marketing of investment opportunities or endorsements), it is considered a hands-off marketplace and does not require licensing. This is a critical component of any new legislation because the broker dealer requirement creates a massive barrier to entry for new businesses looking to innovate in this industry. Furthermore, broker dealers are required to conduct extensive due diligence on issuers and purchasers and, due to this expense, it is cost prohibitive for them to facilitate the offerings of small businesses looking for minimal dollar amounts. While a \$100K deal might be meaningless to a typical broker dealer, that is the size of the deals that have the ability to really jump start new business creation and growth. Lastly, if there is any general solicitation allowed in this proposed rule change, there is no longer a role for the broker dealer to play in the vetting of opportunities.

## Points 2-3: Critical characteristics for the bill to be usable in practice for entrepreneurs

### 3. 500 shareholder limit

I propose allowing an unlimited number of investors into crowdfunding deals, as long as the company does not exceed the 500 shareholder limit. I understand that bills are pending to increase this shareholder limit, as primarily motivated by ensuring that employee stock issues and secondary trades are not limited, and I am fully in favor of that change, however I don't feel that it is necessary to implement that increase solely for crowdfunding to be successful. In fact, we have found that there is a natural limit to the number of investors that an entrepreneur can include based on the sheer human effort required to make the sales (effort which we have found that technology cannot eliminate). This natural limit also arises because many entrepreneurs are cognizant about not including so many shareholders that future investors are turned off from participating. Since, as we learned, people want to invest personally meaningful amounts (\$1700 on average per investor via ProFounder), thousands of investors are not necessary to achieve financial goals.

#### 4. “General solicitation”

General solicitation is currently defined as seeking interest from the general public for an offering through mass communication and this is prohibited for all unregistered securities offerings. The spirit of this law is to ensure that false claims about an offering can not be spread to unknowing potential investors. However, given its current definition, general solicitation serves to create unreasonable barriers for businesses to share information about an offering with even a close community of potential purchasers. A more balanced definition of general solicitation would state that issuers can publicly advertise offerings with appropriate disclosures, given that the opportunity to purchase the securities is only open to qualified purchasers (described below).

#### Points 5-9: Investor protection clauses.

##### 5. Qualified Purchasers

While I am proposing that issuers be able to general solicit by sharing offering information, I would like to balance that with investors protection pertaining to who is qualified to purchase said securities. Specifically, I can identify three groups of individuals who should be able to purchase because they will be most well informed and able to make an educated decision about the opportunity: those who are sophisticated, those who know the entrepreneur, and those who are local to the (bricks and mortar) business.

a) “Sophistication” - Sophisticated investors are defined as those individuals who are sufficiently knowledgeable with respect to financial matters such that they can fend for themselves in the purchase of securities and do not require the full protection of securities law (<http://www.sec.gov/info/smallbus/qasbsec.htm>). This definition currently comes into play in Regulation D, Rule 506, which states that up to 35 “sophisticated” investors can participate in a fundraising event. The spirit of this law is to acknowledge that some investors are educated/ experienced enough to make their own investment decision regardless of their personal wealth level. Unfortunately, the definition is very vague and difficult to use in practice. As a result, lawyers frequently choose to ignore the sophisticated investor exemption of Regulation D, Rule 506 and insist that their clients only include accredited investors when fundraising. A more effective alternative would be a standard questionnaire to determine that someone is a sophisticated investor. Once defined more clearly, any sophisticated investor should be able to participate in an offering through this proposed crowdfunding exemption. One potential use case for this provision is young alumni who are educated, but not yet wealthy, investing in student businesses from their alma mater.

b) Personal Relationship - Anyone who has a personal relationship with the business owner should be allowed to invest in the offering. Under Regulation D,

Rule 504, business owners can engage unaccredited/ unsophisticated investors to invest so long as they share a “substantial, pre-existing relationship.” The spirit of this law is that people who have an intimate, personal knowledge of your finances, and you of theirs, should be able to invest based on this knowledge regardless of their wealth or financial expertise. An updated version of this “personal relationship” provision would state that anyone who can certify that they have a personal relationship with the entrepreneur and can confidently speak to his or her character and business acumen can invest and the “pre-existing” portion of the definition would be eliminated. This is adequately broad such to allow entrepreneurs to tap into their online social networks and request introductions to friends-of-friends.

c) Local Investors - Anyone who lives within 100 miles of the business (bricks and mortar location) should also be able to invest based on the premise that they can do appropriate due diligence by visiting the business, verifying that it exists, testing its product, and seeing its traffic. This provision is inspired by Rule 147, an intra-state offering exemption available to local businesses that do nearly all of their trade within the state and are looking to include only investors within the state.

#### 6. Limit Investment Amounts

The amount that any individual investors can invest in securities organized through this exemption annually should be limited to 5% or less of his or her liquid investable assets. I understand that the proposed legislation contemplates setting this limit as the lesser of 10% of net income or \$10K. While this would be sufficient for the majority of cases, I see no reason to limit the specific dollar amount as it is meaningless if not stated in relative terms to an individual’s net worth.

#### 7. Limit Total Raise Amounts

The dollar amount that an entrepreneur can raise annually using this exemption should be limited to \$1M and it should be permissible to combine this exemption simultaneously with any combination of others (for example, with Reg D, Rule 506 which is most commonly used in angel investing) for an unlimited aggregate dollar amount. I understand that Chairman McHenry’s bill proposes a \$5M limit and while I certainly would not be opposed to this higher ceiling, I also don’t see a pressing need for it. As a point of reference, the average dollar amount that a business wants to raise on ProFounder is \$30K. SBA- backed small business micro-loans center around \$75K and the average start-up capital invested in Inc 500 companies is around \$75K as well. The crowdfunding exemption is most useful in providing the first capital in the door for a business and I believe that it will serve as a gateway for businesses to raise larger rounds of growth capital from traditional sources down the road.

## 8. Disclosures

It is appropriate and necessary to require a limited, concise set of disclosures to be shared with potential purchasers. Specially, I see a place for an abridged balance sheet of historical and forward looking financials, risk factors, and an explanation of forecasts. Striking a balance is imperative here; if disclosures are too extensive, time consuming, or confusing to new businesses, then this exemption will never be utilized.

## 9. Notice Filings

I feel that it is appropriate for the issuer to submit a notice filing (in the fashion of Form D for all Reg D offerings) to so that all securities are properly documented and accounted for in case of fraud. If nominal fees are necessary to support governmental administrative costs, this would be a minimal hurdle and is not something that I would object to.

## Conclusion

I want to thank Chairman McHenry, Ranking Member Quigley and members of the committee for the opportunity to participate in this Hearing. I applaud the Committee for turning its attention to crowdfunding and working so quickly to draft a bill that addresses the key issues. My experience starting and running ProFounder has left me with a deep respect for the small business entrepreneur and her potential to create real economic change for herself and others. Without capital from their communities, Bronson would not have been able to open his second candy shop, Raaja would never have started his sneaker company, and Marc would not be producing high performance electric motorcycles. Each of these businesses engaged in community-fund via ProFounder and went on to create jobs and infuse more capital into their local economies. I look forward to a time soon when these success stories can be replicated more widely; a time when entrepreneurs can seek investments from their community at-large in a way that is simple and efficient.

Thank you.