Written Testimony of
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Chairman McHenry, Ranking Member Quigley, honorable Members of this Subcommittee, my name is Jeff Lynn, and I am the Chief Executive Officer and a co-founder of Seedrs, a forthcoming equity crowdfunding platform based in London. I want to thank the Subcommittee for inviting me to testify today on this very important and timely topic.

By way of background, I am a U.S. securities and corporate lawyer by training. I received my J.D. from the University of Virginia School of Law, I am a member of the New York Bar, and I practiced with the international law firm of Sullivan & Cromwell LLP from 2004 to 2008 in New York and London. During my time at Sullivan & Cromwell, I represented industrial, financial services and private equity firms on a range of securities, finance, corporate and governance matters. I also worked closely with the SEC and Britain's Financial Services Authority (FSA) on a range of matters, and I oversaw the periodic editing and updating process for *The Sarbanes-Oxley Deskbook* by Jack Bostelman.

I left the active practice of law in 2008 in order to pursue a career working with early-stage businesses, which I firmly believe will be the greatest source of wealth and job creation, as well as innovation, in the years to come. As part of my career transition, I enrolled in the MBA program at Saïd Business School at the University of Oxford, where I met my co-founder, Carlos Silva, and began working on what has become Seedrs.

Today I would like to tell you a bit about the Seedrs model, why we chose to start it in Britain rather than the U.S., and some of the lessons we have learned and thoughts we have developed around the regulatory framework for platforms like ours.

Seedrs is an equity crowdfunding platform that will allow entrepreneurs to raise up to £100,000 in equity capital from the "crowds". In short, the Seedrs process operates as follows:

- Entrepreneurs disclose information about their businesses, which we review and approve, as well as the amount of money the businesses are seeking to raise in exchange for how much equity, all via our website.

- Investors review businesses' information, decide which ones they want to invest in and how much, and purchase equity interests in the businesses they choose by transferring funds and signing electronic documentation, all via our website.

- We aggregate multiple small investments in each business into one large one, and once a business has received the full amount it is seeking, conduct legal due diligence and execute the share purchase through a special-purpose vehicle.

- Entrepreneurs access a powerful network of mentors and other support once they've been funded, all while limiting their administrative burdens by allowing them to interact with only one legal shareholder.

- Investors stay informed about and involved in the businesses as they develop following investment, and they receive payment of dividends and proceeds from sale.

In many ways the Seedrs user experience is similar to that of Kickstarter and other donation-based crowdfunding platforms, but with two crucial differences: first, people who use Seedrs will get genuine equity exposure—just as an angel or venture capitalist would—rather than non-monetary rewards; and second, in order to ensure that investors' interests are adequately protected, we provide significantly more intermediation—including disclosure review, legal due diligence and execution and post-completion management—than a donation-based platform would.

We have applied for authorisation by the FSA, which is a necessary precursor to launching the platform. We hope to be authorised within the next few months, and assuming that we are, we plan to launch Seedrs in the UK in early 2012, with the aim of rolling out through the rest of the European Union in 2013. We are backed by a group of angel investors from both Britain and the U.S.

When Mr. Silva and I first designed this model, we examined both the U.S. market and the British market as potential initial targets. Both had positives and negatives, but the overriding consideration was that current U.S. securities laws would present a major—and probably insurmountable—obstacle, whereas securities regulation in Britain (and the rest of the European Union, which has very similar rules) is significantly better-suited for this type of financial innovation. To briefly summarize the difference, and with the caveat that I am not a UK-qualified lawyer:

- The U.S. and British approaches to the regulation of public offers of securities are relatively similar. The Prospectus Directive—which is an EU-wide piece of legislation that has been implemented in each of the EU's 27 member states, including Britain—requires that any public offering that is not the subject of an exception must be made pursuant to a prospectus that has been approved by a relevant regulator, which is the FSA in the UK. This requirement is very similar to that contained in Section 5 of the Securities Act of 1933, and the effect of both is that raising money through a public offering requires a significant amount of administrative and legal work—more than any startup or other very small business could realistically be expected to perform.

- Recognizing that very small businesses often need to raise capital but cannot do so under the normal public offering rules, both the U.S. and Britain have adopted a series of exceptions for small offerings. In the U.S., these are contained primarily in Regulation D under the 1933 Act, while in Britain they form part of the Prospectus Directive and are also spread across several pieces of domestic legislation and regulation.

- Many of the small offering exceptions focus on what we call "accredited" investors in the U.S. and are referred to as "self-certified high-net-worth" investors and "self-certified sophisticated" investors in Britain. Rules 505 and 506 of Regulation D allow small offerings to be made relatively freely to accredited investors in the U.S., and there is a similar degree of latitude for high-net-worth and sophisticated investors in Britain. These exceptions, while important, are insufficient to allow for equity crowdfunding, because the power of crowdfunding is based on ordinary investors—and not just the super-rich—being able to participate.

- There are other small offering exceptions that are not just limited to accredited investors or their equivalent, and these are the exceptions that are relevant to equity crowdfunding. This is also where U.S. and British regulation diverge. In the U.S., Rule 504 of Regulation D allows small businesses to offer their securities to non-accredited investors so long as, among other things, they do not engage in general solicitation or general advertising. In Britain, by contrast, the business may reach out to potential investors much more widely, but an FSA-authorised firm must review and approve the offering materials that the business uses. The effect of this difference can be summarized as follows:

    - In the U.S., an entrepreneur can say essentially whatever it wants (subject to fraud and misrepresentation rules), but she can only say it to people with whom she has a pre-existing connection.

    - In Britain, an entrepreneur can only say things that a professional financial firm has signed off on, but he can say those things to pretty much anyone.

- The foregoing distinction is a slight over-simplification, but it gets to the heart of why crowdfunding can work in Britain (and, by extension, the rest of the European Union) but not in the U.S. today. As an FSA-authorised firm—which we are required to be anyway—Seedrs will be able to review and sign off on each startup's disclosures, thereby allowing them to be posted on the platform and communicated in a way that would constitute general solicitation and advertising in the U.S.

Given this key difference in rules, we decided to build Seedrs for the British and, ultimately, European market, and we are very excited about providing this innovative and potentially very effective method of finance to entrepreneurs and investors across Europe.

Nevertheless, it is highly encouraging to see that some members of Congress—and, as of last week, possibly the White House—want to consider rule changes that would allow equity crowdfunding platforms like Seedrs to operate in the U.S. I see this as a very positive development, as it will open up a very powerful tool to American entrepreneurs and investors alike and could prove to be a key factor in boosting the economy and creating jobs throughout the country.

At the same time, it is important that any rule changes be considered carefully, and in particular that a balance be struck between keeping administrative burdens low enough for these platforms to be viable, on the one hand, and maintaining adequate investor protection, on the other. The investor protection point is a particularly important one: not only is it essential from a policy perspective, but in the absence of adequate protections investors will shy away from using these platforms, and therefore their potential to get job-creating businesses off the ground will never be tapped.

I'd like to take this opportunity to share with the Committee our thoughts on how best to strike that balance. These thoughts come from over two years of work that we have done, including discussions and interviews with hundreds of potential users of the platform (both investors and entrepreneurs) as well as our own deep analysis of the level of protections that can be put in place while still allowing the platform to function economically:

1. *Equity crowdfunding platforms should be subject to some degree of regulation and supervision*.

    a. Equity crowdfunding platforms are fundamentally financial services businesses, and allowing them to operate in too much of a "Wild West" environment would be bad policy and bad for the market. It is bad policy because there is simply too much scope for a crowdfunding platform that lacks sufficient systems and controls to cause harm to investors through maladministration of their funds or, more importantly, failing to properly structure the investment or manage it following completion. And it is bad for the market because most investors simply will not use platforms that lack some sort of regulatory "seal of approval": we have been told repeatedly by potential Seedrs investors that the fact that we will launch only after becoming FSA authorised is absolutely crucial to their decision to use us.

   b. It is, of course, vital that the regulation not be so burdensome as to make it uneconomical to operate the platform. This is an especially serious concern in an area, like crowdfunding, where the individual transaction sizes are so small. Because most crowdfunding platforms, including Seedrs, make their money by charging a percentage of each transaction, the per-transaction revenues are relatively low and could easily be overwhelmed by per-transaction costs of compliance.

   c. We do not have a view on exactly what regulation structure would be most appropriate in the U.S., and we are conscious that the structure of the U.S. and British regulatory systems are sufficiently different that it would be difficult simply to "borrow" the British model. However, we think that a good starting point would be one of the types of regulation that is currently in existence and with which small businesses are able to comply. FINRA broker-dealer registration or SEC investment advisor registration both come to mind as examples of this, and while neither is precisely suitable for crowdfunding platforms, perhaps they could be adapted into—or serve as inspiration for—the appropriate form of regulation.

2. *There should be no across-the-board limits on how much can be invested through an equity crowdfunding platform, but there are other ways to ensure that investors understand the risks and do not invest more than they can afford to lose.*

   a. In order for equity crowdfunding platforms to function and actually see investments completed, it will be essential that some larger investors join alongside the small investors. While a £10 or $10 investment minimum is important for a number of reasons—including allowing investors to "test the waters" with a relatively small sum, ensuring that investors do not feel pressured to invest more than they can afford, and creating a viral marketing effect—very few $50,000 or $100,000 capital raises are likely to be completed solely on the back of $10 or even $100 investments. It is therefore crucial that platforms be open to larger investors who invest $500, $5,000 or even, potentially, $50,000 in a given business, and any across-the-board limit risks excluding these investors and undermining the efficacy and economics of the platform.

   b. We also think that across-the-board maximums are not particularly effective for investor protection purposes. Different amounts of money mean different things to different investors: even a $100 maximum would be more than many people can afford to invest in a high-risk asset, whereas a $10,000 maximum would unnecessarily restrict many larger investors.

   c. However, there is an argument that some type of limit may need to be in place in order to ensure that investors understand the risks and considerations of investing in startups, and to protect them from investing more than they can afford to lose. While we think that much of this can be addressed through clear, plain-English risk warnings that lay out the high-risk, illiquid nature of the asset class, Seedrs has also implemented two comprehensive screens on investors:

i. The first is a questionnaire that every investor must complete before investing: some questions ask about the potential investor's professional and educational background, while the others are multiple-choice questions about the risks and considerations of investing in startups. We then use an algorithm to score each questionnaire, and only those individuals whose score indicates that they have the experience, expertise and knowledge to understand the investment risks are allowed to invest. As a practical matter, we think this questionnaire will effectively screen out the more vulnerable individuals while allowing in the sort of ordinary investors who should be able to invest in startups.

ii. Second, once an investor has passed the questionnaire, she must declare her net worth to us within a range, and she is then limited to investing no more than 20% of the bottom end of that range through the platform in aggregate. She may then change the number later on as her circumstances change. This net worth restriction ensures that each investor is investing in this asset class no more that what is reasonable to her, while allowing her to choose how she wishes to spread it across the asset class.

d. There are no doubt a number of other viable approaches to the goal of ensuring that investors do not invest too much relative to their individual positions, and it would be well worth having an open discussion in the interest of adopting a consensus standard. We would be happy to explain our screening process in more detail at anytime, and we would also be grateful to hear others' thoughts on how we might be able to improve it.

3. *Equity crowdfunding platforms will be most effective where they are actively involved in executing the investment transaction and managing the investment after completion.*

a. The greatest risk to investors when investing in a startup comes not when the startup fails but rather when it succeeds. Startups are a very high-risk asset class, and any sensible investor knows and accepts that the odds are significant that he will never see his money again. However, if the startup succeeds, but due to a problem in the way the investment was structured or managed the investor does not get the benefit of that success, that is a much bigger problem. No investor will tolerate the prospect of having picked and allocated money to the "next Facebook" only to find that his investment was not what he thought it was, and that he is not entitled to the rewards he expected.

b. The scenario described above can occur for any of a number of reasons, but they fall into two basic categories:

i. *Problems with investment structure*. Investments in startups (and other private companies) are usually made pursuant to a subscription, or shareholders, agreement that is executed following a legal due diligence process. The legal due diligence process ensures that the company is what it says it is, and in particular that the company actually represents the underlying business, rather than key assets or operations of the business being held in a separate, undisclosed entity. Meanwhile, the terms of the subscription agreement have a substantial effect on the investor's rights: if the agreement fails to include appropriate provisions with respect to, for example, "tag-along" rights or anti-dilution measures, the investor may find that even though the company has succeeded, she is not able to realize value on her shares.

ii. *Failure to take necessary shareholder action*. After an investment has been completed, there are often actions that need to be taken by investors. Many of these, such as casting procedural votes at shareholder meetings, are unlikely to be of consequence to the investor's ultimate realization of value, but in some cases the failure to take an action can cause a significant problem. This is particularly true in the case of executing documents when a subsequent financing or sale of the business occurs: if investors do not sign the papers they need to sign, the transaction may fall through, potentially causing great detriment to the business. There may also be times when the collective action of shareholders is needed to enforce minority shareholder rights and protections.

c. Given these types of risk, and the difficulties involved in a large number of small individual investors avoiding them on their own, we think crowdfunding platforms have an important intermediary role to play. At Seedrs, we will conduct legal due diligence on, and enter into a subscription agreement based on our standard form with, every company before an investment is completed. Then, following completion, we will act on behalf of all investors as the manager, using our discretion to take shareholder actions and make decisions (other than voluntary sale decisions). We believe that this approach ensures that when an investment is successful, there is as little risk as possible that investors fail to derive the value they expect from it.

d. While we believe the type of intermediation Seedrs plans to provide is tremendously important, we do not think that it necessarily needs to be required by law or regulation. This would seem to be a matter on which people can vote with their feet: those who want the crowdfunding platform they use to provide this intermediation will use one that does, and those that are happy going it alone will use a platform with less intermediation. It is nevertheless important that whatever set of regulations is adopted for crowdfunding, they be drafted so as to allow for a meaningful level of intermediation. Equity crowdfunding platforms must be permitted—and perhaps even receive explicit authorisation—to act in more than a pure execution-only capacity and thereby have the opportunity to provide the protections that come from legal due diligence, a well-drafted subscription agreement and post-completion management.

e. Closely related to permitting crowdfunding platforms to provide this intermediation is the issue of protecting them from vexatious litigation in doing so. By virtue of the volume of businesses with which crowdfunding platforms are likely to be involved, along with the inevitably high failure rate of many of those businesses, there is a meaningful risk that plaintiffs' lawyers and even competitors who want to clear out the market will launch baseless strike suits. This is less of a risk in Britain, where the loser-pays court system means that a culture of spurious litigation has not yet developed. But given the long history of these types of lawsuit in the U.S., combined with the particular vulnerability of crowdfunding platforms, it will be important that they be protected to the extent possible. To be clear, I would not advocate protecting platforms against any form of legitimate litigation, and in particular I think that if a platform holds itself out as providing certain protections to investors, as Seedrs will, it is reasonable that the courts be available to enforce that commitment where necessary. That is very different, though, from the strike suits that many businesses have been subject to through the years, and it is this latter type of litigation that needs to be addressed as part of opening the doors to equity crowdfunding.

Finally, as a broader thought, I hope that consideration will be given to allowing cross-border crowdfunding, so that foreign investors can invest in U.S. startups (to the extent that foreign laws allow), and American investors can invest in foreign startups. I would expect the former of these to be non-controversial, but I appreciate that facilitating investment abroad may not seem, at first glance, to be helpful in the creation of American jobs. I disagree with this view, and I firmly believe that if American investors can invest in foreign startups, that will make it substantially more likely that those startups set up operations in the U.S., both because they now have the money to do so, and because they have the connections and support of an American investor base. Those operations will, in turn, be just as valuable creators of jobs for Americans as are the startups that began here. I have full confidence in the ability of American entrepreneurial talent to continue to build some of the most innovative and successful new businesses, but my years living in London have shown me than Brits, Europeans and others around the world also have the ability and desire to build great companies. Rather than wall off the U.S. market to these companies, the best thing the U.S. can do is give them a reason to bring their success here, and having a base of investors located here is just such a reason.

To conclude, I am both encouraged and excited by the prospect of equity crowdfunding becoming a reality in the U.S. Seedrs has worked very hard to build a model that works in Britain and Europe, and we have no doubt that, once legal, a number of very strong models will develop here as well. I hope the thoughts and insights I have provided from our experience are helpful as consideration of rule changes moves forward, and I would be happy to amplify or clarify these statements, or to provide additional detail about the Seedrs approach and our views on crowdfunding, both now and at anytime in the future.

Mr. Chairman and members of the Subcommittee, thank you for the opportunity to appear before you today.