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Testimony of

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Before The
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT

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538 Dirksen Senate Office Building

EXAMINING INVESTOR RISKS IN CAPITAL RAISING

Chairman Reed, Ranking Member Crapo, distinguished members of the Committee, thank you for the opportunity to appear here today to discuss investor risks in capital raising.

My name is Mark Toshiro Hiraide. I am a partner in the law firm of Petillon Hiraide & Loomis LLP, in Los Angeles, California. I have been in private practice since forming the firm with my partners in 1994, after serving eight years as an attorney for the Securities and Exchange Commission.[1] Since leaving the Commission over 17 years ago, I have spent my career as legal counsel to entrepreneurs and small and mid-sized public companies, assisting them in private and public securities offerings. My practice includes defending officers and directors in civil litigation arising out of securities offerings and merger and acquisition transactions and prosecuting civil claims on behalf of aggrieved investors. I also practice before the SEC and FINRA in regulatory defense matters. Relevant publications include the legal treatise, "Representing Start-Up Companies," published by Thomson Reuters, of which I am a co-author, and the Guide to California Securities Practice published by the Corporations Committee

[1] I joined the Commission's Division of Enforcement, as an attorney and later Branch Chief, in the Los Angeles Regional Office from 1986 to 1989. From 1990 to 1994, I served as an Attorney-Advisor in the Commission's Division of Corporation Finance in Washington, D.C. While at the Commission, I was appointed by the United States Attorney's Office to serve as a Special Assistant United States Attorney to prosecute a major criminal securities fraud case that I had litigated for the Commission.

of the Business Law Section of The State Bar of California for which I served on the Editorial Committee.

The Funding Gap

The importance of early-stage capital to our economy, and the challenges to entrepreneurs in accessing it, even prior to the recent economic downturn, has been well documented.[2] Recent events have made it even more difficult for new companies requiring seed capital to attract it. Home equity, traditionally a source of capital for seed stage investors, has diminished with the deep decline in real estate prices. Moreover, continuing economic uncertainty has caused many early stage investors to be risk averse.

In my experience, a start-up's first seed capital investment of $250 - $500,000 is critical to the development a health equity market "food chain." This initial funding level allows technologies and concepts to be validated. Without such validation, it is often difficult for our client entrepreneurs even to be considered by professional venture capital and Angel investors.

According to a recent survey, 76% of 253 investment bankers surveyed said that the number of companies with $1 million EBITDA (a company's earnings before the deduction of interest, tax and amortization expenses) who are worthy of

[2] *See, e.g.*, recently released *Fall 2011 State of Small Business Report*, John Paglia, lead researcher of the Pepperdine Private Capital Markets Project and associate professor of finance at Pepperdine University's Graziadio School of Business and Management.

investment exceeds the amount of capital available (whereas, only 58% of the investment banked respondents said the capital available exceeds the number of companies with $100 million EBITDA that meet investment criteria).[3]

Can the internet and modern communication technologies help close the funding gap? If the current statutory limitations on conducting private offerings are eliminated, what are the risks to investors? I look forward to answering any questions you may have regarding each of the bills being considered by the Committee. However, I will limit my remarks to two experiences that may prove instructive in considering crowdfunding legislation, as this legislation has the greatest potential for abuse.

Lessons Learned From Ace-Net – The Critical Role of Securities Intermediaries

Attempts at utilizing technology to make processes more efficient, in this case the market for seed and early stage capital, are not new. In the early 1990s, as the world was for the first time coming online, "disintermediation" was the mantra…technology would cut out the middle-man. In the case of the market for early-stage capital, however, it did not.

In 1997, the Small Business Administration's Office of Advocacy, working in consultation with the Securities and Exchange Commission, the North American

[3] *Private Capital Markets Project Survey Report 2011-2012*, Private Capital Markets Project, Pepperdine University's Graziadio School of Business and Management (www.bschool.pepperdine.edu/privatecapital).

Securities Administrators Association, and the University of New Hampshire's Whittemore School of Business and Economics, launched the Angel-Capital Electronic Network, more commonly known as "ACE-Net."[4] It was an Internet-based matching service for accredited investors and entrepreneurs seeking up to $1 million in seed funding. The network was to be operated by local nonprofit entities and universities.

Although ACE-Net provided a mechanism through which entrepreneurs could conduct a general solicitation of their offering, ACE-Net was not successful, in part, because sophisticated investors simply did not identify investment candidates by searching companies at random over the ACE-Net portal. Without an active connection between entrepreneurs and the investment community, deals did not get done.

[4] ACE-Net received a no-action letter from the staff of the Commission (Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996)), a key no-action letter that many have relied on for guidance on the issue of whether organizers of Internet-based matching services are required to register as broker-dealers or investment advisers. In determining that ACE-Net was not required to register, the Commission staff emphasized that ACE-Net and the local operators did not provide advice about the merits of particular investments, did not participate in negotiations for transactions between participants, did not receive compensation from ACE-Net users, other than flat fees to cover administrative costs (which were not contingent on the completion of any transactions), did not hold themselves out as providing securities-related services other than operating ACE-Net.

After several years, the Office of Advocacy transferred ACE-Net to a non-profit organization in an attempt to "privatize" it. My law partner, Lee Petillon, served as counsel *pro bono* to the non-profit organization, and we worked closely with Terry E. Bibbens, Entrepreneur in Residence in the Office of Advocacy, U.S. Small Business Administration, who was instrumental in ACE-Net's formation and continued to work *pro bono* to create a viable internet securities intermediary.

Although, today, many more people are connected through social media, a passive portal, or even several of them, through which an investor may access potentially hundreds of investment opportunities, may not be the catalyst to spur seed-round capital formation. The old adage that securities are sold…rarely are they purchased, especially by non-professional investors…was as true in 1997, as it was in 1933, and as it likely is today.

We learned that more sophisticated individual investors invest when the investment has, in some sense, been validated. Although this validation may come in the form of participation in the offering by recognized investors, most often it is based on a recommendation from a trusted financial advisor. [5]

In the light of this reality, we realized that the active involvement of securities professionals in the capital raising process is critical to capital formation. I believe the challenge in adopting new legislation to stimulate early-stage capital formation is to maintain effective regulation over those professionals, while not imposing too high a regulatory barrier to entry, and to ensure that incentives are not inadvertently created that lead to the formation of unregulated securities markets.

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[5] Recommendations to purchase securities are, and should, be regulated. The staff of the SEC rejected an ACE-Net proposal to permit it to highlight to potential investors those offerings in which a venture fund or organized Angel group participated. The SEC staff deemed such activity constituted investment advice that was beyond the scope of the staff's no-action letter, in which the staff agreed not to take Enforcement action against ACE-Net for not registering as a broker-dealer.

Lessons Learned From Unregistered Finders – The Potential For Abuse

Since the enactment of the Securities Act of 1933, the most common exemption from the requirement to register the offer and sale of securities with the Securities and Exchange Commission is the so-called "private offering" exemption found in Section 4(2) of the Act. The hallmark of the private offering is that a general solicitation of securities is prohibited. One method for the issuer to satisfy this requirement is for the issuer to show that it had a pre-existing relationship with the investor. Although the staff has stated that this is not exclusive, neither it nor the courts have defined clear boundaries around the general solicitation issue.

However, in recognition of the importance of securities intermediaries to facilitate private offerings, since the 1980s, the Commission staff has made clear through its no-action letters, that issuers may engage a registered broker-dealer as placement agent and, in effect, use the registered broker-dealers' "pre-existing relationships" with the broker-dealers' existing customers.

With one exception, this staff position, however, did not extend to pre-existing relationships between investors and "finders," who are non-registered securities intermediaries. The exception was for the unusual facts in the case of the entertainer Paul Anka. Anka, who obtained a commission for providing names of certain of his acquaintances to an issuer, obtained a no-action letter, as he clearly was not in the business of effecting securities transactions, and this was viewed by the staff as a one-time occurrence. Unfortunately, many incorrectly interpreted the Paul Anka no-action letter and relied upon it to create the so-called "finders" exception to the broker-dealer registration requirement.

As a result, in Southern California, as well as in other places around the country, "boiler rooms" emerged…a class of unregulated securities salespersons who worked to develop relationships with individuals, many of whom were at home and retired. Although oftentimes the individual solicited appeared on a list of purportedly "pre-qualified" investors, in most cases investors were solicited by telephonic cold-calls.

Eventually, the experienced unlicensed salesperson, indeed, developed "pre-existing" relationships with these investors, as many of the investors serially invested in deals offered by the salesperson. For the unlicensed securities intermediary, this investor pool served as the wellspring for unregistered intermediaries who continued to tap it, and generate hundreds of millions of dollars in commissions, throughout the internet boom and beyond.[6]

<u>The Crowdfunding Bills (S.1791 and S.1970)</u>

I fully support the intent behind the crowdfunding bills. However, I share Professor Coffee's concerns that unregistered salespersons may abuse the broker-

[6] Last year, the Commission staff issued a no-action letter, Brumberg, Mackey & Wall, P.L.C. (May 17, 2010), stating that, "A person's receipt of transaction-based compensation in connection with [securities sales] activities is a hallmark of broker-dealer activity.")

dealer registration exemption set forth in Section 7 of the bill. Unregistered salepersons of the sort that I described will, with little effort, satisfy the requirements for the exemption in Section 7 of S.1791.

On the other hand, S.1970, adopts a regulatory regime for intermediaries that requires them either to elect to register with the Commission as a broker-dealer or as a newly defined "funding portal," subject to several definitional proscriptions.

S.1970 appropriately limits the scope of permissible activity of a funding portal by prohibiting it from:

- offering investment advice or recommendations;
- soliciting purchases, sales, or offers to buy the securities offered or displayed on its website or portal; and
- compensating employees, agents, or other third parties for such solicitation or based on the sale of securities displayed or references on its website or portal.

S.1970 also provides reasonable limits on maximum individual investment limits. By including an aggregate limit applicable to all crowdfunded investments, in addition to dollar investment limits per company, S.1970 addresses a concern known as "stacking," whereby an individual investor invests in successive offerings but manages to satisfy the requirements of each individual offering.

Finally, the $1 million exemption limit under S.1970 may be adjusted by the Commission to reflect the annual change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics. If the Commission were permitted by rule to increase the exemption limit, the exemption, if successful for seed offerings up to $1 million, could be scaled to cover an even greater portion of the funding gap.

In summary, S.1970 balances the need to facilitate access to critical seed capital with important investor safeguards.