



**Comments of Engine Advocacy to the Securities and Exchange Commission regarding Proposed  
Rule: Facilitating Capital Formation and Expanding Investment Opportunities by Improving  
Access to Capital in Private Markets**

**File Number: S7-05-20**

Engine is a non-profit technology policy, research, and advocacy organization that bridges the gap between policymakers and startups. Engine works with government and a community of thousands of high-technology, growth-oriented startups across the nation to support the development of technology entrepreneurship. To that end, we appreciate the opportunity to comment on the Securities and Exchange Commission’s (SEC) proposed amendments to the exempt offering framework.

Access to capital is a primary concern for startups. Regulation Crowdfunding (Reg CF) presents a new avenue for startups to raise capital from investors who have historically been unable to fund early stage companies. However, it has been underutilized, likely because the upfront compliance costs associated with Reg CF are significant and too expensive to justify for raising such a relatively small amount of available capital. From 2016-2018, just over one-third of the 1,351 offerings initiated under Regulation Crowdfunding were completed, raising approximately \$108 million.<sup>1</sup> The costs associated with a Reg CF raise can exceed \$20,000, with marketing, legal, and accounting expenses, for example, but the costs of SEC-required disclosures are by far the most expensive component.<sup>2</sup> These costs comprise about 10% of an average successful offering, but about a third of the target amount for abandoned offerings.<sup>3</sup> Worse, these become sunk costs for failed offerings. This is an extremely high cost of capital.

These proposed changes attempt to lower the cost of capital for issuers in relative terms by increasing the amount an entity can raise, thereby allowing costs to be spread across a larger amount of capital. Similarly, by increasing the caps for individual investors, the changes theoretically increase the supply of capital available to be invested in Reg CF offerings. Finally, these changes seek to reduce the risk of Reg CF for both issuers and investors by introducing a “testing the waters” provision and allowing special purpose vehicles (SPVs), respectively.

Accordingly, these proposed changes are much needed first steps toward unlocking the startups’ potential to raise capital through Regulation Crowdfunding. However, for Reg CF to truly reach its potential, the SEC should consider also lowering the cost of using the exemption in absolute terms by cutting back on unnecessary paperwork obligations.

## **Positive Changes to Regulation Crowdfunding**

### Offering Limit

Increasing the amount of capital that issuers may raise is a welcome change. The current offering limit is capped at \$1.07 million over a 12-month period, which does not reflect the true fundraising potential of most startups. While this proposed increase would be beneficial, a \$5

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<sup>1</sup> Report to the Commission: Regulation Crowdfunding (June 18, 2019) at 15.  
[https://www.sec.gov/files/regulation-crowdfunding-2019\\_0.pdf](https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf)

<sup>2</sup> Report, at 25, 26.

<sup>3</sup> Report, at 15, 25. Calculations own.

million limit may still be too low, because of the high cost of capital—an estimated average of 10% to over 30%.<sup>4</sup> Increasing the offering limit approaches a solution to this high cost problem. Under the higher offering limit, though the cost of capital is still high, startups may dilute the costs over a larger amount of capital, decreasing the cost of capital in relative terms. Thus, by increasing the cap to \$5 million, the proposed change would increase the number of startups that find it economically worthwhile to use Reg CF to raise capital. Further increases, however, would make Reg CF more attractive to a broader range of issuers.

### Individual Investor Limit

Likewise, the proposed changes to investment limits for accredited and non-accredited investors will likely benefit startups. By removing limits for accredited investors and increasing investment limits for some non-accredited investors, the proposed changes increase the amount of capital eligible for investment, thereby theoretically increasing investment in startups. These changes also help to solve the cost of capital problem by increasing the likelihood of a successful raise. Further, increasing individual investment limits can help drive more capital to underserved startups by broadening the pool of potential investors to include people from a broader range of geographies who are more likely to support local companies.

### “Testing-the-Waters”

The “testing-the-waters” exemption introduced for Reg CF by these proposed rules is an important change for startups. By allowing entrepreneurs to assess interest before undertaking expensive filing costs, this amendment will reduce the threat of incurring huge sunk costs from a failed offering. These costs are not trivial either, as they can exceed \$20,000.<sup>5</sup> Thus, a failed raise can spell doom for some startups.

At present, Title III of the JOBS Act forbids companies wishing to participate in investment crowdfunding campaigns from communicating with investors to assess interest before incurring filing and preparation costs. This stands in contrast with other JOBS Act provisions that already allow companies to “test the waters” before pursuing other types of offerings, such as in Title I (for companies pursuing IPOs)<sup>6</sup> and Title IV (for companies raising funds under Regulation A).<sup>7</sup>

Expanding this provision to Reg CF makes sense given Title III crowdfunding issuers’ high failure rate of around two-thirds.<sup>8</sup> The impact of this would benefit issuers and investors alike; first, companies could determine whether their campaigns are viable and ready for investment,

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<sup>4</sup> Report, at 15, 25. Calculations own.

<sup>5</sup> Report at 25, 26.

<sup>6</sup> 15 U.S.C. 77e(d).

<sup>7</sup> 17 CFR § 230.255.

<sup>8</sup> Report, at 15.

and second, would-be investors would be protected from committing equity to failure-prone campaigns.

### Special Purpose Vehicles (SPVs)

Special Purpose Vehicles, eligible for use in Reg CF under these proposed rules, will help investors (particularly less sophisticated retail investors) diversify and benefit from experts that might now be able to lead syndicate investments. The present absence of SPVs, coupled with investment limits, means non-accredited investors are effectively limited to direct investment in a few startups and are unable to substantively diversify their portfolios to mitigate investment risk. Allowing SPVs would likely make investment crowdfunding safer and more profitable for investors, attracting more capital to Reg CF, thereby offering more opportunities for startups.

### **Suggested Changes**

While the above highlighted changes are marked improvements in Regulation Crowdfunding, the SEC should undertake further changes to lower the cost of conducting an offering under Reg CF. Financial statement disclosure obligations dramatically increase the cost of capital under investment crowdfunding, but without any real investor protection benefit. Reg CF is designed for small companies looking for seed capital, but the current disclosure obligations impose prohibitive costs on low value raises. Further, the small startup issuers most likely to seek relatively low amounts of capital through investment crowdfunding are the least likely to have significant financial histories to report. Thus, the SEC should eliminate these requirements and thereby lower the cost of using Reg CF.

The wisdom of the crowd and portals' vested interest in providing quality investment opportunities to users deter fraud far better than access to relatively uninformative financial statements from new enterprises. As such, eliminating mandatory disclosure obligations (both pre-listing and ongoing requirements) and allowing portals to formulate and compete based on their own protocols for vetting companies and educating investors will likely increase the efficacy and safety of investment crowdfunding.

While the mandatory disclosure of audited financial statements is expensive for issuers of any size, it is particularly unnecessary for small raises and will likely only serve to make equity crowdfunding impossible for seed-stage companies. However, if transferring responsibility to portals to determine what disclosures are appropriate for the customers that invest on their sites is impossible, at the very least the disclosure burden on new companies and small issuers should be lowered. Because a startup will, by definition, have almost no financial history to speak of,

financial statements will be difficult to produce and virtually useless to investors. Any mandatory disclosures should reflect this reality.

A more sensible approach could entail requiring companies less than three years old seeking crowdfunded capital to fill out a form disclosure with more relevant and less onerous information, such as the company's projected future revenues, addressable market, capital structure, and burn rate. Or, for small volume raises, companies could disclose recent tax returns to the extent that any such returns exist. Ultimately, removing mandatory issuer disclosures would be ideal in maximizing the potential of investment crowdfunding, but altering the disclosure regime to remove the need to produce expensive and possibly irrelevant reports for investors will be an improvement on the current Title III framework.

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Engine appreciates the opportunity to provide these comments on the Securities and Exchange Commission's proposed changes to the exempt offering framework. As in all policy areas, Engine strives to seek solutions and work with policymakers to promote innovation, entrepreneurship, and healthy startup ecosystems across the country. We appreciate the Commission's interest in bettering the exempt offering framework to ensure greater capital access for growing businesses, and hope the final rule reflects the experiences and needs of startups as relayed in these comments.

Respectfully Submitted,

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