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CONGRESSIONAL TESTIMONY

"Entrepreneurial Capital Formation"

Testimony before
The Committee on Banking, Housing and Urban Affairs
United States Senate
at a hearing on
"Keeping Markets Fair: Considering Insider Trading Legislation"
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My name is David R. Burton. I am Senior Fellow in Economic Policy at The Heritage Foundation. I would like to express my thanks to Chairman Brown, Ranking Member Toomey, and members of the committee for the opportunity to be here this morning. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

Because today is the 10th anniversary of the JOBS Act, a bi-partisan achievement of major significance, I have been asked to focus on entrepreneurial capital formation issues in my testimony. Specifically, my testimony addresses (1) the importance of the JOBS Act, (2) the importance of entrepreneurial capital formation to the economy and the American people, (3) the impact of regulatory impediments to entrepreneurial capital formation, (4) legislative proposals that have been introduced this Congress that promote capital formation and which have been incorporated into the Senate Banking Committee Republicans' JOBS Act 4.0 discussion draft, (5) additional statutory changes that would improve entrepreneurs' access to capital and (6) more fundamental reforms to our securities laws that would substantially improve the regulatory environment for both entrepreneurs and larger public companies and the returns to investors.

I would also like to note that the process that is underway should be a model of how to develop legislation. It has involved a request for detailed public input about how to solve evident problems,[1] followed by the release of a public discussion draft for people to evaluate and offer constructive feedback on actual legislative language. This will presumably be followed by actual legislation, hearings and a markup where amendments may be offered. This process will result in well thought out, publicly vetted legislation that has been improved by public input and will more effectively solve problems.

The Importance of the JOBS Act

Passed with large bipartisan majorities and signed into law by President Obama, the 2012 JOBS Act[2] was a bipartisan achievement of consequence.[3] It substantially improved the laws governing entrepreneurial capital formation.[4] As discussed throughout this testimony, the JOBS Act has had a measurable positive impact on entrepreneurial capital formation.

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[1] "Toomey Requests Proposals to Foster Economic Growth and Capital Formation," Press Release, February 2, 2021 https://www.toomey.senate.gov/newsroom/press-releases/toomey-requests-proposals-to-foster-economic-growth-and-capital-formation. See also, "Submissions," Committee on Banking, Housing and Urban Affairs, United States Senate https://www.banking.senate.gov/resources/data-submissions.

[2] Jumpstart Our Business Startups Act, Public Law 112–106, April 5, 2012, http://www.gpo.gov/fdsys/pkg/PLAW-112publ106/pdf/PLAW-112publ106.pdf.

[3] H.R. 3606 (112th Cong.) passed the House with overwhelming support, 390 to 23: Final Vote Results for Roll Call 110, H.R. 3606, Recorded Vote, March 8, 2012, https://clerk.house.gov/Votes/2012110?Page=1&RollCallNum=110, and passed the Senate by a wide margin, 73 to 26: U.S. Senate Roll Call Votes 112th Congress–2nd Session, H.R. 3606, March 22, 2012, http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=112&session=2&vote=00055.

[4] See, e.g., David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; Thaya Brook Knight, "A Walk Through the JOBS Act of 2012: Deregulation in the Wake of Financial Crisis," Cato Institute Policy Analysis 790, May 3, 2016 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2833877#.

Legislative changes as the bill progressed through Congress, however, limited the positive impact. Regulatory decisions by the SEC further limited the economic gains from the Act. A series of relatively modest improvements effective March 15, 2021[5] will reduce the adverse impact of these regulatory decisions to some degree over time. The most notable improvements by this rulemaking include the clarification of the integration doctrine and increases in the Regulation A, Regulation CF and Rule 504 offering limitation amounts but there were other improvements. The adverse impact of the original legislative decisions as the JOBS Act progressed through Congress and regulatory decisions made by the Commission when implementing the JOBS Act was particularly pronounced with respect to Title III crowdfunding but also substantial with respect to the small issues exemption (Regulation A) and what became Rule 506(c) relating to general solicitation in Regulation D offerings.

The changes made by the JOBS Act fall into five categories. Those relating to:

(1) smaller public "emerging growth companies" or EGCs (Title I),
(2) general solicitation under Regulation D (Title II),
(3) crowdfunding (Title III),
(4) an improved small issues exemption (often called Regulation A+) (Title IV), and
(5) changes to the registration threshold allowing more companies to remain private (Titles V and VI).

1. *Title I: Emerging Growth Companies*

Title I of the JOBS Act – sometimes called the IPO On-Ramp – created a new concept of "emerging growth companies (EGCs)."[6] Generally, a company qualifies as an emerging growth company if it has total annual gross revenues of less than $1.07 billion[7] during its most recently completed fiscal year and, as of December 8, 2011, had not sold common equity securities under a registration statement. For five years, EGC's are excused from complying with a number of onerous disclosure requirements and from Sarbanes-Oxley Act Section 404(b) internal control reporting requirements. Moreover, they are permitted to communicate with institutional accredited investors or qualified institutional buyers prior to or after the filing of the registration statement.[8] Title I also permitted EGCs to submit confidential draft registration statement to the SEC for

[5] "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets," Final Rule, Securities and Exchange Commission, *Federal Register*, Vol. 86, No. 9, January 14, 2021, pp. 3496-3605 https://www.govinfo.gov/content/pkg/FR-2021-01-14/pdf/2020-24749.pdf. A summary in reasonably plain English of the changes made by this rule is available at "A Small Entity Compliance Guide," Securities and Exchange Commission, March 10, 2021 https://www.sec.gov/corpfin/facilitating-capital-formation-secg.
[6] Section 2(a)(19) of the Securities Act of 1933 (15 USC 77b(a)(19)). See also, "Emerging Growth Companies," Securities and Exchange Commission https://www.sec.gov/smallbusiness/goingpublic/EGC.
[7] Originally $1 billion.
[8] Section 5(d) of the Securities Act of 1933.

review.[9] The ability to submit a confidential draft registration statement has now been generalized by the SEC.[10]

2. Title II: General Solicitation and Title II Secondary Markets

Title II eliminated the prohibition against general solicitation or general advertising for Regulation D Rule 506 offerings, provided that all purchasers of the securities are accredited investors and that the issuer takes "reasonable steps to verify" that purchasers of the securities are accredited investors.[11]

Title II also provided an exemption from broker-dealer registration for platforms that facilitate trading of Regulation D securities provided that the platforms meet certain requirements.[12] This provision is of limited value since the platforms are barred from taking compensation in connection with the purchase or sale of securities via the platform.[13] These platforms have grown rapidly since the passage of the JOBS Act although it is far from clear that this provision in the JOBS Act is the reason. Most are presumably relying on other exemptions (such as 4(a)(1-½) and the post JOBS Act Securities Act section 4(a)(7)).[14]

3. Title III: Crowdfunding

Title III established the framework for a new crowdfunding exemption.[15] Issuers may now offer up to $5 million in securities annually using this exemption. It was originally $1 million. Investors, other than accredited investors,[16] may not invest in any offering more than (i) the greater of $2,200 or 5 percent of the annual income or net worth of the investor if either the annual income or the net worth of the investor is less than $107,000[17] or (ii) 10 percent of the annual income or net worth of such investor if either the annual income or net worth of the investor is equal to or more

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[9] Section 6(e) of the Securities Act of 1933 (15 USC 77f(e)).
[10] "Draft Registration Statement Processing Procedures Expanded," Securities and Exchange Commission, June 29, 2017 [supplemented August 17, 2017 and June 24, 2020] https://www.sec.gov/corpfin/announcement/draft-registration-statement-processing-procedures-expanded.
[11] Securities Act section 4(b) [15 USC 77d(b)]; JOBS Act section 201(a)(1); "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," Final Rule, *Federal Register*, Vol. 78, No. 142, July 24, 2013, p. 44771 http://www.gpo.gov/fdsys/pkg/FR-2013-07-24/pdf/2013-16883.pdf. See also comment letter of David R. Burton regarding "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," October 5, 2012 http://www.sec.gov/comments/s7-07-12/s70712-118.pdf.
[12] Securities Act section 4(b) [15 USC 77d(b)]; JOBS Act section 201(c).
[13] Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act," Question 5, February 5, 2013, https://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm.
[14] Title LXXVI, Section 76001 of the Fixing America's Surface Transportation Act, Public Law 114–94, December 4, 2015, creates a new exemption at Securities Act, Section 4(a)(7).
[15] See Regulation CF for details.
[16] This non-application of the limitation with respect to accredited investors was not in the original JOBS Act as passed but was added by the 2021 Regulation CF amendments included in "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets," Final Rule, Securities and Exchange Commission, *Federal Register*, Vol. 86, No. 9, January 14, 2021, pp. 3496-3605 https://www.govinfo.gov/content/pkg/FR-2021-01-14/pdf/2020-24749.pdf.
[17] Securities Act section 4(a)(6)(B)(i). Note: This amount has been adjusted for inflation since the JOBS Act.

than $107,000.[18] The total amount invested may not exceed $107,000.[19] The crowdfunding offering must be conducted through a broker-dealer or funding portal. Both the issuer and intermediary must comply with numerous requirements. The disclosure requirements imposed by statute and the even more costly requirements imposed by the SEC are sufficiently costly that when the offerings were limited to $1 million, crowdfunding offerings were largely uneconomic and crowdfunding, as I and a few others predicted, did not achieve its promise.[20] Similarly, the regulatory imposition on crowdfunding portals has made the operation of such portals largely unprofitable. The 2021 revisions to Regulation CF may help alleviate these problems but the changes made were sufficiently modest that any kind of major increase in Title III crowdfunding is unlikely.

4. *Title IV: Regulation A Plus*

The Commission had very nearly killed Regulation A prior to the JOBS Act.[21] In 2011, the year before the JOBS Act, only one Regulation A offering was completed.[22] Title IV created what has come to be known as "Regulation A plus" or "Regulation A+." It added a new small issues exemption under which issuers could raise up to $50 million in a public offering and sell unrestricted securities subject to such initial and continuing disclosure requirements as the Commission may determine.[23] This has now been increased to $75 million for so-called Tier 2 offerings. The Commission in its implementation of this Title made some significant errors. The most notable is that blue sky registration and qualification requirements are only preempted for primary Tier 2 offerings.[24] Secondary offerings of securities purchased in Tier 2 offerings and all Tier 1 securities sales are subject to state registration and qualification requirements. As discussed more fully below, this seriously impedes the ability of secondary markets to develop in Regulation A securities. This harms investors by making Regulation A securities illiquid and reducing the price these securities can command when resold. This, in turn, has an adverse impact on primary offerings because investors know that reselling the securities will be more difficult.

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[18] Securities Act section 4(a)(6)(B)(ii). Note: This amount has been adjusted for inflation since the JOBS Act.
[19] Ibid. Note: This amount has been adjusted for inflation since the JOBS Act.
[20] Proposed Rules, "Crowdfunding," *Federal Register*, Vol. 78, No. 214, November 5, 2013, p. 66428 [Release Nos. 33-9470 and 34-70741; File No. S7-09-13] http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf; Comment letter of David R. Burton regarding Crowdfunding, February 3, 2014 http://www.sec.gov/comments/s7-09-13/s70913-192.pdf; Comment letter of Rutheford B Campbell, Jr., regarding Crowdfunding, February 14, 2014 http://www.sec.gov/comments/s7-09-13/s70913-278.pdf. See also, *Crowdfunding: A Guide to Raising Capital on the Internet*, Steven Dresner, Editor (Wiley: 2014).
[21] See Rutheford B Campbell, Jr., "Regulation A: Small Businesses' Search for a Moderate Capital," *Delaware Journal of Corporate Law*, Vol. 31, pp. 71-123 (2006) https://uknowledge.uky.edu/cgi/viewcontent.cgi?article=1125&context=law_facpub; Stuart R. Cohn and Gregory C. Yadley, "Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns," 4 *NYU Journal of Law and Business*, Vol 4, pp. 1-87 (Fall 2007) https://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1257&context=facultypub.
[22] "Factors That May Affect Trends in Regulation A Offerings," United States Government Accountability Office, July 2012 (GAO-12-839).
[23] JOBS Act section 401.
[24] 17 CFR § 230.256.

5. Allowing More Firms to Remain Private or Quasi-Public

Titles V and VI increased the number of holders of record a firm can have before being required to register under section 12(g) of the Securities Exchange Act from 500 persons to 2,000 investors or 500 non-accredited investors.[25] Title V also excluded from the count securities held by persons who received the securities pursuant to an employee compensation plan.[26] Some of these firms are "truly" private in that the shares are held primarily or entirely by accredited investors and the shares are restricted securities. Others are "quasi-public" in that the shares were sold to and are held by "the public" (i.e. many non-accredited investors) and the shares are not restricted securities although the issuer is not a reporting company.

6. Economic Impact of the JOBS Act

The JOBS Act has improved entrepreneurs' access to capital. But it has not been an unqualified success because mistakes were made in the legislative process. Additional mistakes were made by the SEC as it implemented the JOBS Act. Some, but by no means all, of these regulatory mistakes were corrected by the SEC in a rule effective March 15, 2021.[27]

As discussed below in detail, Title I of the JOBS Act has been a major contributing factor in arresting the precipitous decline in IPOs that was occurring prior to enactment of the JOBS Act. Title II of the JOBS Act (relating to general solicitation in Regulation D offerings) was one of the most underappreciated aspects, by many, of the JOBS Act. It is now legal for a company to put an advertisement in a newspaper or on-line indicating that the issuer is looking for rich people to invest in the issuer. It has been a major success. Title III Crowdfunding (Regulation CF) has been largely a failure. Only $55-65 million (with an 'm') are raised this way each year. That is 2/1000ths of a percent of the private capital raised each year. Given the piling on by Congress and the Commission of ever more regulatory requirements on these tiny issuers, this was entirely predictable and, in fact, was predicted by me and a few others.[28] Regulation A plus is a minor success. About a billion dollars annually is raised this way. But with some changes, it could become a major means of raising entrepreneurial capital.

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[25] JOBS Act section 501.

[26] JOBS Act sections 502-503.

[27] November 2, 2020
Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets Final rule
Federal Register / Vol. 86, No. 9 / Thursday, January 14, 2021 / 3496-3605

[28] Comment letter of David R. Burton regarding Crowdfunding, February 3, 2014 http://www.sec.gov/comments/s7-09-13/s70913-192.pdf ("If, however, the regulatory costs associated with crowdfunding are too high, then issuers will either use other means to raise capital or be unable to raise capital and ordinary investors will be denied the opportunity to make these investments. Firms using crowdfunding will almost invariably be the smallest of small businesses. More established firms or those seeking more than $1 million will use Regulation D or, perhaps, Regulation A+. If the Commission overregulates crowdfunding, it will frustrate the bi-partisan intention of Congress and the President and impede both the ability of small firms to raise the capital they need to create jobs, innovate and contribute to the prosperity of the country and the ability of small investors to invest in the firms with the most potential growth. This is no idle possibility."). See also Comment letter of Rutheford B Campbell, Jr., regarding Crowdfunding, February 14, 2014 http://www.sec.gov/comments/s7-09-13/s70913-278.pdf.

In all, as the tables below show, JOBS Act offerings amount to about three to seven percent of the private capital raised in the U.S. The Title I EGC provisions account for more (although raised in the public market). Although I do not have a good answer to how much additional capital was raised due to these EGC provisions, the graph in the EGC discussion below is quite remarkable. The number of public companies was in a free fall prior to the JOBS Act. Now that number is basically flat. The number of IPOs in the nine years after the JOBS Act has increased by 43 percent relative to the nine years before the JOBS Act and the amount raised has increased by 57 percent.[29] Precisely how much of that is attributable to Title I, I am not sure. See the Table in the EGC section below for the IPO data.

Amounts Raised in the Exempt Market in 2018 ($ billions)[30]

Exemption	Amount Raised	Percentage of Total
Rule 506(b) of Regulation D	$ 1,500	51.48%
Rule 506(c) of Regulation D	**$ 211**	**7.24%**
Rule 504 of Regulation D	$ 2	0.07%
Regulation D Subtotal	$ 1,713	58.79%
Regulation A: Tier 1	**$ 0.061**	**0.00%**
Regulation A: Tier 2	**$ 0.675**	**0.02%**
Regulation A Subtotal	**$ 0.736**	**0.03%**
Regulation Crowdfunding; Section 4(a)(6)	**$ 0.055**	**0.00%**
Other exempt offerings	$ 1,200	41.18%
Total	$ 2,913.791	100.00%
JOBS Act Offerings	**$ 211.791**	**7.27%**

Amounts Raised in the Exempt Market in 2019 ($ billions)[31]

Exemption	Amount Raised	Percentage of Total
Rule 506(b) of Regulation D	$ 1,492	54.73%
Rule 506(c) of Regulation D	**$ 66**	**2.42%**
Rule 504 of Regulation D	$ 0.228	0.01%
Regulation D Subtotal	$ 1,558.228	57.15%
Regulation A: Tier 1	**$ 0.044**	**0.00%**
Regulation A: Tier 2	**$ 0.998**	**0.04%**
Regulation A Subtotal	**$ 1.042**	**0.04%**
Regulation Crowdfunding	$ 0.062	0.00%
Other exempt offerings	$ 1,167	42.80%
Total	$ 2,726.332	100.00%
JOBS Act Offerings	**$ 67.104**	**2.46%**

[29] Jay R. Ritter, Initial Public Offerings: Updated Statistics, University of Florida, March 11, 2022 https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf.

[30] "Concept Release on Harmonization of Securities Offering," Securities and Exchange Commission, June 18, 2019, Table 2, p. 19 https://www.sec.gov/rules/concept/2019/33-10649.pdf.

[31] "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets," Proposed Rule, March 4, 2020, Table 1, p. 9 https://www.sec.gov/rules/proposed/2020/33-10763.pdf.

Capital Reported Raised under Regulation A
June 19, 2015 -December 31, 2019 ($ millions)[32]

	Tiers 1 & 2	Tier 1	Tier 2
Aggregate dollar amount reported raised	$ 2,445.9	$ 230.4	$ 2,215.6
Number of issuers reporting proceeds	183	39	144
Average dollar amount reported raised	$ 13.4	$ 5.9	$ 15.4

Among the largest reason for the relative unimportance of Tier 1 is the fact that the Commission chose to only preempt state blue sky registration and qualification requirements with respect to Tier 2. This has an obvious cure.

The Importance of Entrepreneurial Capital Formation

Entrepreneurship matters. It fosters discovery and innovation.[33] Entrepreneurs also engage in the creative destruction of existing technologies, economic institutions and business production or management techniques by replacing them with new and better ones.[34] Entrepreneurs bear a high degree of uncertainty and are the source of much of the dynamism in our economy.[35] New, start-up businesses account for much, if not most, of the net job creation in the economy.[36] Entrepreneurs innovate, providing consumers with new or better products. They provide other businesses with innovative, lower cost production methods and are, therefore, one of the key factors in productivity

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[32] "Report to the Commission, Regulation A Lookback Study and Offering Limit Review Analysis," Securities and Exchange Commission, March 4, 2020, Table 2, p. 8 https://www.sec.gov/files/regulationa-2020.pdf.

[33] Israel M. Kirzner, *Competition and Entrepreneurship* (University of Chicago Press: 1973); Israel M. Kirzner, "Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach," *Journal of Economic Literature*, Vol. 35, No. 1 (1997); Randall Holcombe, *Entrepreneurship and Economic Progress* (Routledge: 2006); William J. Baumol, *The Microtheory of Innovative Entrepreneurship* (Princeton University Press: 2010).

[34] See, e.g., Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (1942; Routledge: 1976), pp. 81-86 http://digamo.free.fr/capisoc.pdf; W. Michael Cox and Richard Alm, "Creative Destruction," *Concise Encyclopedia of Economics* (Liberty Fund: 2010) http://www.econlib.org/library/Enc/CreativeDestruction.html; Henry G. Manne, "The Entrepreneur in the Large Corporation," in *The Collected Works of Henry G. Manne*, Vol. 2 (Liberty Fund: 1996).

[35] Frank H. Knight, *Risk, Uncertainty, and Profit* (Houghton Mifflin: 1921) http://www.econlib.org/library/Knight/knRUP.html; Richard J. Cebula, Joshua C. Hall, Franklin G. Mixon Jr. and James E. Payne, *Economic Behavior, Economic Freedom, and Entrepreneurship* (Edward Elgar: 2015).

[36] Magnus Henrekson and Dan Johansson, "Gazelles as Job Creators: A Survey and Interpretation of the Evidence," *Small Business Economics*, Vol. 35 (2010), pp. 227–244 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1092938; Ryan Decker, John Haltiwanger, Ron Jarmin, and Javier Miranda, "The Role of Entrepreneurship in US Job Creation and Economic Dynamism," *Journal of Economic Perspectives*, Vol. 28, No. 3 (Summer 2014), pp. 3–24 http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.28.3.3; Salim Furth, "Research Review: Who Creates Jobs? Start-up Firms and New Businesses," Heritage Foundation Issue Brief No. 3891, April 4, 2013 http://www.heritage.org/research/reports/2013/04/who-creates-jobs-startup-firms-and-new-businesses. In terms of the neo-classical growth model, entrepreneurship is an important factor affecting the rate of technological change and the marginal productivity of capital. See, e.g., Robert M. Solow, *Growth Theory: An Exposition* (Oxford University Press: 2000). Legal institutions, human capital and other factors are also important determinants of economic growth. See N. Gregory Mankiw, David Romer and David N. Weil, "A Contribution to the Empirics of Economic Growth," *The Quarterly Journal of Economics*, Vol. 107, No. 2 (May, 1992), pp. 407-437 https://eml.berkeley.edu/~dromer/papers/MRW_QJE1992.pdf; Robert J. Barro, *Economic Growth*, 2nd edition (MIT Press: 2003).

improvement and real income growth.[37] The vast majority of economic gains from innovation and entrepreneurship accrue to the public at large rather than entrepreneurs.[38] Entrepreneurs are central to the dynamism, creativity and flexibility that enables market economies to consistently grow, adapt successfully to changing circumstances and create sustained prosperity.[39] Entrepreneurship promotes the common good, prosperity and a higher standard of living. Among the most important factors impeding entrepreneurship are securities laws that restrict entrepreneurs' access to the capital needed to launch or grow their businesses.[40] After all, without capital to launch a business, other impediments to entrepreneurial success are moot.

Sometimes, an entrepreneur has sufficient capital to launch and grow his or her business from personal savings, including profits from previous entrepreneurial ventures, and retained earnings. Often, however, an entrepreneurial firm will need capital from outside investors or lenders.[41] Other than friends or family, outside investors are typically described as "angel investors" or "venture capitalists."[42] Typically, "angel investors" are individuals who invest at the early "seed stage"

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[37] Ralph Landau, "Technology and Capital Formation," in *Technology and Capital Formation*, Dale W. Jorgenson and Ralph Landau, editors (MIT Press: 1989).

[38] Yale economist William Nordhaus has estimated that 98 percent of the economic gains from innovation and entrepreneurship are received by persons other than the innovator. See William D. Nordhaus, "Schumpeterian Profits in the American Economy: Theory and Measurement," NBER Working Paper No. 10433, April 2004 https://www.nber.org/papers/w10433.pdf.

[39] See, Decker *et al*, *supra*; C. Mirjam van Praag and Peter H. Versloot, "What is the Value of Entrepreneurship? A Review of Recent Research," *Small Business Economics*, Volume 29, Issue 4 (December 2007), pp 351-382 https://link.springer.com/content/pdf/10.1007%2Fs11187-007-9074-x.pdf; David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; Deirdre N. McCloskey *Bourgeois Equality: How Ideas, Not Capital or Institutions, Enriched the World* (University of Chicago Press: 2016); Adam Thierer, *Permissionless Innovation: The Continuing Case for Comprehensive Technological Freedom* (Mercatus Center: 2016); David R. Burton, "Building an Opportunity Economy: The State of Small Business and Entrepreneurship," Testimony before the Committee on Small Business, United States House of Representatives, March 4, 2015 https://www.heritage.org/testimony/building-opportunity-economy-the-state-small-business-and-entrepreneurship; George Gilder, "Capitalism is an Information and Learning System," Remarks, November 15, 2018 https://www.heritage.org/markets-and-finance/event/capitalism-information-and-learning-system; Friedrich A. Hayek, "The Use of Knowledge in Society," *The American Economic Review*, Vol. 35, No. 4 (September, 1945), pp. 519-530 https://www.econlib.org/library/Essays/hykKnw.html.

[40] Banking laws and practices are a contributing factor. For a short introduction to the problems, see SEC Commissioner Daniel M. Gallagher, "Whatever Happened to Promoting Small Business Capital Formation?," September 17, 2014 http://www.sec.gov/News/Speech/Detail/Speech/1370542976550#.VFfbI8mGklQ.

[41] See, e.g., "2013 State of Entrepreneurship Address: Financing Entrepreneurial Growth," Kauffman Foundation Research Paper, February 5, 2013 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2212743; *The Oxford Handbook of Venture Capital*, Douglas Cumming, Editor (Oxford: 2012).

[42] See Angel Capital Association http://www.angelcapitalassociation.org/ and National Venture Capital Association http://www.nvca.org/. See also Ibrahim, Darian M., "Should Angel-Backed Start-ups Reject Venture Capital?," *Michigan Journal of Private Equity & Venture Capital Law*, Vol. 2, pp. 251-269 http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=2734&context=facpubs; Abraham J.B. Cable, "Fending For Themselves: Why Securities Regulations Should Encourage Angel Groups," *University of Pennsylvania Journal of Business Law*, Vol. 13, No. 1, Fall 2010, pp. 107-172 https://www.law.upenn.edu/journals/jbl/articles/volume13/issue1/Cable13U.Pa.J.Bus.L.107%282010%29.pdf; Darian M. Ibrahim, "The (Not So) Puzzling Behavior of Angel Investors," *Vanderbilt Law Review*, Vol. 61, p. 1405-1452 (2008) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984899; Brent Goldfarb, Gerard Hoberg, David Kirsch and Alexander Triantis, "Does Angel Participation Matter? An Analysis of Early Venture Financing," Angel Capital Association, April 4, 2008

while "venture capitalists" are firms or funds that make investments later in the firms' life-cycle after "proof of concept." Firms seeking outside investors are often the most dynamic, high growth companies.[43] In principle, Regulation A and Regulation CF would allow ordinary investors to invest in young firms and for young firms to find a new source of capital. So far, Regulation CF has been of relatively minor importance largely due to the regulatory and statutory structure of these exemptions. Regulation A, while of some importance, has been hindered by the regulatory burden it imposes as well. Regulation D and other private offerings remain, by far, the most important source of capital for young, dynamic firms. It is no accident that Regulation D is the most lightly regulated of the three.

Legislative Analysis

Last February, Senator Toomey issued a request for proposals that would "accelerate economic growth and spur job creation by encouraging more companies to become publicly traded, improving the market for private capital, and enhancing retail investor access to investment opportunities."[45] To that end, Senate Banking Committee Republicans this Congress have introduced a number of pieces of legislation that would advance these priorities. This section analyzes a number of these legislative items. All bill numbers refer to bills in the 117th Congress unless specifically indicated otherwise.

1. *Middle Market IPO Cost Underwriting Act (S. 3980)*

This constructive bill introduced by Sen. Lummis,[46] would instruct the SEC, in consultation with FINRA, to carry out a study of the costs associated with small IPOs and Regulation A Tier 2, including how those costs have changed over time and the impact of these costs on capital formation. There is a serious need for better information regarding the costs of becoming and remaining a public company. The SEC has been largely unwilling to collect and publish this kind of information. It is as if the agency is genuinely oblivious to the costs it imposes on issuers and the impact its rules have on the cost of capital and the vibrancy of public capital markets. This bill would help correct the Commission's irresponsible neglect of this very important issue.

Although there may be some others, I am aware of only two instances in the past quarter century where the Commission has discussed *quantitatively* the costs associated with an IPO. The SEC certainly does not make a habit of it and the information available to policymakers is extraordinarily limited.

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http://www.angelcapitalassociation.org/data/ACEF/ACEFDocuments/Does%20Angel%20Participation%20Matter%20-%20Analysis%20of%20Early%20Venture%20Financing.pdf.

[43] Sampsa Samila and Olav Sorenson, "Venture Capital, Entrepreneurship, and Economic Growth, *Review of Economics and Statistics*, February, 2011, Vol. 93, No. 1, pp. 338-349; Dane Stangler, "High-Growth Firms and the Future of the American Economy, Kauffman Foundation, March 9, 2010 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568246.

[45] "Toomey Requests Proposals to Foster Economic Growth and Capital Formation," Press Release, February 2, 2021 https://www.toomey.senate.gov/newsroom/press-releases/toomey-requests-proposals-to-foster-economic-growth-and-capital-formation. See also, "Submissions," Committee on Banking, Housing and Urban Affairs, United States Senate https://www.banking.senate.gov/resources/data-submissions.

[46] Sens. Sinema, Warner and Hagerty are original cosponsors.

In 2013, in a proposing release for Regulation CF, the SEC referenced survey data[47] that indicated "the average cost of achieving initial regulatory compliance for an initial public offering is $2.5 million, followed by an ongoing compliance cost, once public, of $1.5 million per year."[48] In 1996, the *Report of the Advisory Committee on the Capital Formation and Regulatory Process* found that the costs associated with an initial public offering during the period 1993-1995 for those filing an S-1 was 16.4 percent of the amount raised and for those filing an SB-2[49] it was 28.9 percent of the amount raised.[50] Costs are almost certainly higher now, even in inflation adjusted terms, although the costs as a percentage of the amount of capital raised may not be because firms are going public much later in their life-cycle after they have achieved much larger size and, therefore, the offerings are larger.

The number of public companies was in steady decline. The number of listed companies declined from 8,090 in 1996 to 4,266 at the end of 2019, a decline of 47 percent.[51] The number of listed companies per million people declined from 30 in 1996 to 13 in 2019, a decline of 57 percent.[52] The number of listed companies per trillion dollars of real (inflation-adjusted) Gross Domestic Product declined from 733 to 224 or by 69 percent.[53] The precipitous decline stopped in 2012, the year that the JOBS Act was enacted. However, the number of listed companies has increased only four percent in the nine years since the JOBS Act was enacted. Thus, while there has not been a significant increase in the number of public companies in the U.S. since the JOBS Act, the decline has stopped.

[47] "Rebuilding the IPO On-Ramp Putting Emerging Companies and the Job Market Back on the Road to Growth," IPO Task Force, Chart H, p. 10, October 20, 2011 https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.

[48] "Crowdfunding," Proposed Rules, *Federal Register*, Vol. 78, No. 214 (November 5, 2013), p. 66509 (col. 2), http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf.

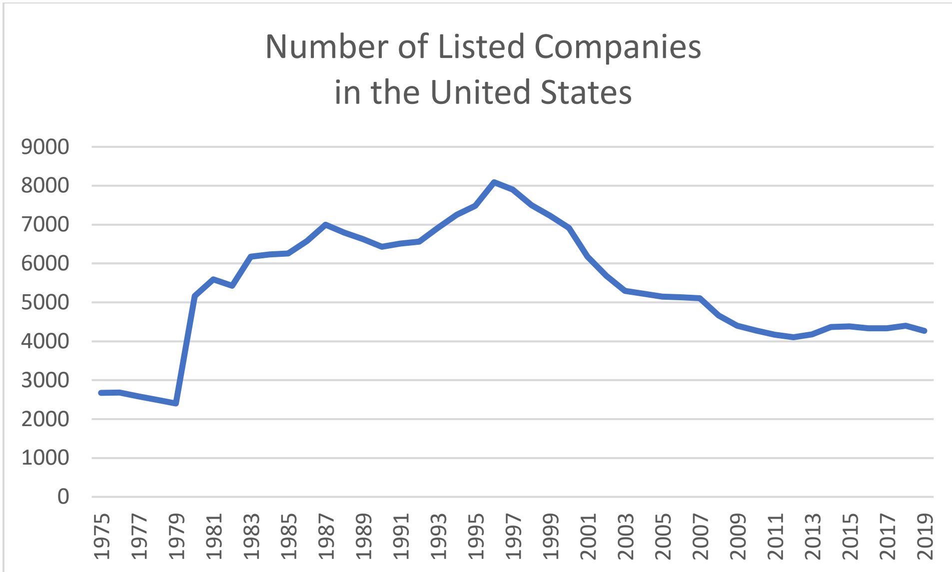
[49] In 2008, the Form SB-2 was retired in connection with the adoption of the smaller reporting company rules. See "Changeover to the SEC's New Smaller Reporting Company System by Small Business Issuers and Non-Accelerated Filer Companies: A Small Entity Compliance Guide," January 25, 2008 https://www.sec.gov/info/smallbus/secg/smrepcosysguid.pdf.

[50] *Report of the Advisory Committee on the Capital Formation and Regulatory Process*, Securities and Exchange Commission, July 24, 1996, Table 1 https://www.sec.gov/news/studies/capform/capffull.txt.

[51] Listed Domestic Companies, Total - United States, World Bank https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US.

[52] "Number of Listed Companies per Million People," Federal Reserve Board of Saint Louis https://fred.stlouisfed.org/series/DDOM01USA644NWDB.

[53] Author's calculations using World Bank and Bureau of Economic Analysis, National Income and Product Accounts data. 8,090 / $11,038.3 = 733; 4,266 / $19,032.7 = 224, a decline of 69 percent. See National Income and Product Accounts Table 1.1.6. Real Gross Domestic Product, Chained Dollars [Billions of chained (2012) dollars] for NIPA data.



Source: World Bank[54]

The regulatory costs of initial public offerings and of continued regulatory compliance, once public, are a major reason for the decline in the number of public companies.[55] The heightened litigation costs and risks of being a public company are another. Yet the SEC has made no serious effort to gauge the magnitude of these costs or the impact of these costs on capital formation. That needs to change. The Middle Market IPO Cost Underwriting Act would be an important step towards making the Commission confront the impact of the costs it imposes on issuers.

2. *Dodd-Frank Material Disclosure Improvement Act (S. 3923)*

This important bill, introduced by Sen. Cramer, would repeal the conflict minerals, mine safety, resource extraction, and pay ratio provisions the Dodd- Frank Wall Street Reform and Consumer Protection Act. Specifically, it would repeal section 953 (relating to executive compensation and so-called "pay versus performance"), section 1502 (relating to conflict minerals), section 1503 (relating to coal or other mine safety), or section 1504 (relating to resource extraction). These provisions are extremely expensive for issuers to comply with and provide no material information to investors seeking to make investment decisions. They are politically motivated disclosure requirements.[65] This bill would make a substantial contribution to the effort to reducing the cost of being a public company and be an important step to reorienting securities laws toward their fundamental purpose of providing investors with information material to their investment decisions.

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[54] The data used to generate the graph is available here: https://api.worldbank.org/v2/en/indicator/CM.MKT.LDOM.NO?downloadformat=excel

[55] David R. Burton, "Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth," Heritage Foundation Backgrounder No. 2924, June 20, 2014 https://thf_media.s3.amazonaws.com/2014/pdf/BG2924.pdf.

[65] David R. Burton, "How Dodd–Frank Mandated Disclosures Harm, Rather than Protect, Investors," Heritage Foundation Issue Brief No. 4526, March 10, 2016 http://thf-reports.s3.amazonaws.com/2016/IB4526.pdf.

3. Reporting Requirements Reduction Act of 2022 (S. 3919)

This bill, introduced by Sen. Tillis, would allow any issuer currently required to file quarterly reports to elect to file semi-annually. I am eager to read the comments on this bill, as I believe it starts an important discussion about the appropriate frequency of disclosures for public companies.

This bill would obviously reduce the frequency of reporting for electing issuers and therefore reduce costs. However, a well-functioning capital market requires timely information for securities to be priced properly. I am eager to read comments about whether only reporting twice annually may reduce the efficiency, liquidity and fairness of securities markets. However, Form 8-K current event reporting may be sufficient to compensate for the reduction in the frequency of periodic reporting (notably 10-Qs).

Appropriate mandatory disclosure requirements can promote capital formation, the efficient allocation of capital and the maintenance of a robust, public, and liquid secondary market for securities.[67] The reasons for this are that (1) the issuer is in the best position to accurately and cost-effectively produce information about the issuer;[68] (2) information disclosure promotes better allocation of scarce capital resources or has other positive externalities;[69] (3) the cost of

[67] Robert A. Prentice, "The Economic Value of Securities Regulation," *Cardozo Law Review*, Vol. 28, No. 1 (2006), pp. 333–389, http://cardozolawreview.com/Joomla1.5/content/28-1/cross.website.pdf; Bernard S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets," *UCLA Law Review*, Vol. 48 (2001), pp. 781–855, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=182169; and Luca Enriques and Sergio Gilotta, "Disclosure and Financial Market Regulation," Oxford Legal Studies Research Paper No. 68, 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2423768.

[68] Marcel Kahan, "Securities Laws and the Social Cost of 'Inaccurate' Stock Prices," *Duke Law Journal*, Vol. 41, No. 5 (1992), pp. 977–1044, http://scholarship.law.duke.edu/dlj/vol41/iss5/1/; John C. Coffee Jr., "Market Failure and the Economic Case for a Mandatory Disclosure System," *Virginia Law Review*, Vol. 70 (1984), pp. 717–753; and Joel Seligman, "The Historical Need for a Mandatory Corporate Disclosure System," *Journal of Corporation Law*, Vol. 9, No. 1 (1983), p. 1.

[69] Jeffrey Wurgler, "Financial Markets and the Allocation of Capital," *Journal of Financial Economics*, Vol. 58, No. 187 (2000), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1972124&download=yes; R. David Mclean, Tianyu Zhang, and Mengxin Zhao, "Why Does the Law Matter? Investor Protection and its Effects on Investment, Finance, and Growth," *The Journal of Finance*, Vol. 67, No. 1 (2012), pp. 313–350; Ronald A. Dye, "Mandatory versus Voluntary Disclosures: The Cases of Financial and Real Externalities," *The Accounting Review*, Vol. 65, No. 1 (1990), pp. 1–24; Brian J. Bushee and Christian Leuz, "Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board," *Journal of Accounting and Economics*, Vol. 39, No. 2 (2005), pp. 233–264, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=530963; Joseph A. Franco, "Why Antifraud Provisions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure," *Columbia Business Law Review*, Vol. 2002, No. 2 (2002), pp. 223–362, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=338560 or http://cblr.columbia.edu/archives/10795; Paul M. Healy and Krishna G. Palepu, "Information Asymmetry, Corporate Disclosure, and The Capital Markets: A Review of the Empirical Disclosure Literature," *Journal of Accounting and Economics*, Vol. 31 (2001), pp. 405–440, http://tippieweb.iowa.uiowa.edu/accounting/mcgladrey/winterpapers/kothari1.pdf; and Anat R. Admati and Paul C. Pfleiderer, "Forcing Firms to Talk: Financial Disclosure Regulation and Externalities," *Review of Financial Studies*, Vol. 13, No. 3 (2000), pp. 479–519, https://faculty-gsb.stanford.edu/admati/documents/Forcingfirmstotalk_research.pdf.

capital may decline because investors will demand a lower risk premium;[70] (4) disclosure makes it easier for shareholders to monitor management;[71] and (5) disclosure makes fraud enforcement easier because evidentiary hurdles are more easily overcome.[72]

On the other hand, mandatory disclosure laws often impose very substantial costs. Clearly this bill is designed to reduce these costs. These costs do not increase linearly with company size. Offering costs are larger as a percentage of the amount raised for small offerings. And continuing disclosure costs are higher as a percentage of revenues or earnings for smaller firms. The costs therefore have a disproportionate adverse impact on small firms. Moreover, the benefits of mandated disclosure are also less for small firms because the number of investors and amount of capital at risk is less. Since the costs are disproportionately high and the benefits lower for smaller firms, disclosure should be scaled so that smaller firms incur lower costs.

These considerations require a balancing by policymakers of competing concerns and are, to some degree, an empirical question.[73] One thing that commenters could consider is whether it might be better to revise this bill to, as part of a scaled disclosure regime, so that only smaller reporting companies and perhaps EGCs may elect to report less frequently. If it works well, in conjunction with current event reporting on Form 8-K, Congress could revisit the issue and expand the provision to all issuers.

4. *Restoring Shareholder Transparency Act (S. 3945)*

This constructive bill, introduced by Sen. Hagerty, also would start an important discussion. It would (1) provide explicit statutory authority for the SEC to regulate proxy advisory firms, (2) stop the new SEC practice of permitting shareholder proposals that would normally have been

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[70] Christine A. Botosan, "Evidence that Greater Disclosure Lowers the Cost of Equity Capital," *Journal of Applied Corporate Finance*, Vol. 12, No. 4 (2000), pp. 60–69, and Charles P. Himmelberg, R. Glenn Hubbard, and Inessa Love, "Investor Protection, Ownership, and the Cost of Capital," World Bank Policy Research Working Paper No. 2834, 2002, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303969.

[71] The interests of shareholders and management are often not coincident and may considerably conflict. Corporate managers often operate firms as much for their own benefit as that of shareholders, and shareholders may have difficulty preventing this in a cost-effective way. This incongruity of interest is often described as the agent-principal problem, or collective-action problem, and is significant in larger firms where ownership and management of the firm are separate, and ownership is widely held. See Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, Vol. 3, No. 4 (1976), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=94043; Paul G. Mahoney, "Mandatory Disclosure as a Solution to Agency Problems," *University of Chicago Law Review*, Vol. 62, No. 3 (1995), pp. 1047–1112; and Merritt B. Fox, "Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment," *Virginia Law Review*, Vol. 85, No. 7 (1999), pp. 1335–1419.

[72] Requiring certain written affirmative representations in public disclosure documents deters fraud because proving fraud becomes easier if the public, written representations are later found by a trier of fact to be inconsistent with the facts. Periodic reporting (such as 10-Ks, 10-Qs, and 8-Ks) can help police secondary-market manipulation by issuers and insiders.

[73] David R. Burton, "Securities Disclosure Reform," Chapter 5, *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, Editor (The Heritage Foundation: 2017) http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf or David R. Burton, "Securities Disclosure Reform," Heritage Foundation Backgrounder No. 3178, February 13, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3178.pdf.

excludable but now are permitted because they focus on a "significant social policy,"[74] (3) exempt all issuers from federal shareholder proposal regulations unless they opt-in[75] and (4) amend shareholder proposal regulations to require higher levels of share ownership. The bill would require shareholders seeking to make a proposal to hold one percent of the market value of the company's securities rather than various dollar amounts, the largest of which is currently $25,000 held for one year. Unlike current rules, it would impose no holding period and, also unlike current rules, the bill would allow the aggregation of two or more shareholders' holdings to meet the one percent threshold.[76]

The power wielded by the two dominant proxy advisory firms over huge segments of our economy is a problem that needs to be addressed but it needs to be addressed in a way that does not harm small shareholders. I intend to make specific recommendations on this within the next four to six weeks.

There is a balance that needs to be stuck by policymakers with respect to shareholder proposals. The principal-agent problem or collective action problem is very real. Management often acts in its own interest to the detriment of shareholders and widely dispersed share ownership makes it difficult for shareholders to monitor and police management. For that reason, policymakers do not want to make shareholder proposals so difficult that they cannot influence the Board of Directors or management of companies when that is necessary to protect shareholder value. That said, we do not want to make shareholder proposals so easy that one shareholder holding one share can year after year force votes on whether the company should support the restoration of the Bourbon monarchy in France or require all of its employees to wear tin foil hats. Securing shareholder votes on shareholder proposals involves considerable expense.

There is no doubt that there is a need to reign in politically motivated shareholder resolutions that are only tangentially related to an issuers' business. Ergo, reversing Staff Legal Bulletin No. 14L (CF) is warranted.

I am eager to read comments as to whether it is advisable to entirely exempt all issuers from federal regulatory requirements with respect to any shareholder proposal and whether that would inappropriately strengthen management vis a vis shareholders. Or would a state-based approach to shareholder proposal regulation allow for an appropriate balance between management and shareholders?

Requiring a larger securities position to make a shareholder proposal makes sense but I am also eager to read comments on whether one percent of a large corporation's market capitalization – a large amount of money – is the right level. Further, revisions to the legislation could explore whether and how shareholders can obtain information about other shareholders from the issuer, so that reaching the 1% threshold will not prove to be an insurmountable barrier to all but large RIAs

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[74] Staff Legal Bulletin No. 14L (CF), Securities and Exchange Commission, November 3, 2021 https://www.sec.gov/corpfin/staff-legal-bulletin-14l-shareholder-proposals ("Under this realigned approach, proposals that the staff previously viewed as excludable because they did not appear to raise a policy issue of significance for the company may no longer be viewed as excludable under Rule 14a-8(i)(7)")

[75] 17 CFR §240.14a–8.

[76] 17 CFR §240.14a–8(b)(1).

and investment companies. Commenters should also explore if such information cannot be obtained, revisions to this legislation should lower the threshold. Another thing that revisions could explore is whether the amount required should be scaled such that when an issue is being considered for the first time, the threshold is lower than if the same or substantially similar proposal has been voted down by shareholders previously.

5. *The Main Street Growth Act (S.3097)*

Improving the secondary markets for small capitalization firms will help investors achieve a higher return and reduce risk, improve entrepreneurs' access to capital and promote innovation, economic growth and prosperity.

There are three key steps to improving secondary markets for small firms. First, improve the regulatory environment for existing non-exchange over-the-counter (OTC) securities traded on alternative trading systems (ATSs), primarily by (a) providing the same reduced blue sky burden that large companies whose securities trade on exchanges currently enjoy, (b) re-establishing the list of marginable OTC securities and (c) removing impediments to market making caused by Regulation SHO. Second, improve the regulatory environment for secondary sales of private securities (Regulation D and other private securities), primarily by codifying the so-called section 4(a)(1-1/2) exemption and ensuring that platform traded securities are eligible for the exemption. JOBS Act 201(c) and Securities Act section 4(a)(7) and section 4(d) are attempts to address this problem. They need, however, serious improvement and simplification. Third, amend the Securities Exchange Act to establish venture exchanges.[77]

This important bill, introduced by Sen. Kennedy, would accomplish the third step by creating venture exchanges. Venture exchanges could prove to be a significant step towards promoting liquidity in the secondary market for relatively small issuers and, therefore, help investors in these companies achieve fair value for their securities when they choose to sell them. The Canadian TSX Venture Exchange and the United Kingdom's Alternative Investment Market appear to be working well but have undergone some adjustment over time. These markets appear to have had a positive economic impact in the U.K. and Canada. There are at least a dozen similar but smaller markets in various countries around the world.

I intend to make specific recommendations for how to improve this legislation within the next four to six weeks.

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[77] David R. Burton, "Legislative Proposals to Enhance Capital Formation and Reduce Regulatory Burdens: Venture Exchanges," testimony before the Capital Markets and Government Sponsored Enterprises Subcommittee, Committee on Financial Services, U.S. House of Representatives, May 13, 2015, http://www.heritage.org/research/testimony/2015/legislative-proposals-to-enhance-capital-formation-and-reduce-regulatory-burdens-venture-exchanges; Daniel M. Gallagher, "How to Reform Equity Market Structure: Eliminate "Reg NMS" and Build Venture Exchanges," Chapter 7 of *Prosperity Unleashed: Smarter Financial Regulation* (Washington, DC: Heritage Foundation, 2017), edited by Norbert J. Michel https://www.heritage.org/sites/default/files/2017-02/07_ProsperityUnleashed_Chapter07.pdf (the entire book is available at http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf); SEC Commissioner Luis A. Aguilar, "The Need for Greater Secondary Market Liquidity for Small Businesses," March 4, 2015 http://www.sec.gov/news/statement/need-for-greater-secondary-market-liquidity-for-small-businesses.html.

6. Expanding American Entrepreneurship Act (S. 3976)

This constructive bill, introduced by Sen. Moran, would amend the Investment Company Act such that qualifying venture capital funds could have aggregate capital contributions of $50 million rather than $10 million and increase the number of permitted beneficial owners from 250 to 500. It can be expected to increase the amount of capital available to entrepreneurs and to reduce the costs of providing them with capital. It will, therefore, have a positive economic impact.

7. Developing and Empowering our Aspiring Leaders Act of 2022 (S.3914)

This constructive bill, introduced by Sen. Rounds, would direct the Commission to amend its venture capital fund regulations[81] to allow secondary market acquisitions of qualifying portfolio companies, provide that investment in another venture capital fund is a qualifying investment, and make various conforming changes. This bill should have a positive impact on the ability of small firms to raise capital because, among other things, it should improve the secondary market for such securities which makes primary offerings more attractive.

8. Small Entrepreneurs' Empowerment and Development (SEED) Act of 2022 (S.3939)

This important bill, introduced by Sen. Scott,[82] is needed legislation. It would relieve the smallest businesses from having to worry about the complexity of the securities laws. It is simple, straight-forward and does the job. Specifically, the bill would exempt from registration requirements any issuer that sells less than $500,000 in securities of any type within a 12-month period and treat those securities as 'covered securities" thereby protecting against onerous state blue sky laws. It would make the exemption unavailable to certain designated bad actors. I have long been a strong proponent of this kind of exemption.[83]

Every business in the country should not be roped into dealing the securities laws and the SEC or the state equivalent. Some businesses are private enough, closely held enough and small enough that, absent fraud, the SEC or state securities regulators simply should not be involved. That is the point of this exemption. Any such exemption should contain bright lines that non-specialists can read and be sure that these businesses are okay. S. 3939 meets that test.

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[81] 17 CFR § 275.203(l)-1.

[82] Sen. Moran is an original cosponsor.

[83] David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017, p. 7 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; David Burton, "Starting a Small Business Could Break This Federal Law," *Daily Signal*, March 24, 2016 https://www.dailysignal.com/2016/03/24/how-starting-a-small-company-could-break-this-federal-law/; section II.G.1 of the SEC "Concept Release on Harmonization of Securities Offering Exemptions," *Federal Register*, Vol. 84, No. 123, June 26, 2019, pp. 30460-30522 https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13255.pdf; Comment Letter of David R. Burton regarding Concept Release on Harmonization of Securities Offering Exemptions, Micro-Offering Exemption, pp. 50-54 https://www.sec.gov/comments/s7-08-19/s70819-6193328-192495.pdf. See also, SEC Commissioner Daniel M. Gallagher, "Whatever Happened to Promoting Small Business Capital Formation?," September 17, 2014 https://www.sec.gov/news/speech/2014-spch091714dmg.

9. Unlocking Capital for Small Businesses Act (S.3922)

This important bill, introduced by Sen. Cramer, would help a great many small businesses that operate outside of affluent major metropolitan areas to find capital with the aid of finders and private placement brokers. It is important, well-drafted legislation that addresses a major problem that is under-appreciated in Washington. It would help the smallest entrepreneurs access capital found in money centers. It is hard to estimate the number of businesses that would be helped by this legislation but it will probably be in the many tens of thousands annually and potentially over a hundred thousand each year once it has been law for a reasonable period. The bill would reverse two decades of irresponsible policies pursued by the SEC.[84]

A "finder" is a person who is paid to assist small businesses to find capital from time to time by making introductions to investors. Usually, finders operate in the context of some other business (e.g., the practice of law, public accounting, insurance brokerage, etc.), as a Main Street[85] business colleague or acquaintance, or as a friend or family member of the business owner. They are sometimes called private placement brokers,[86] although this term is probably best used to describe people that are in the business of making introductions between investors and businesses. They are typically paid a small percentage of the amount of capital that they helped the business owner to raise.

Finders play an important role in introducing entrepreneurs to potential investors, thus helping them to raise the capital necessary to launch or grow their businesses. For regulatory purposes, neither finders nor private placement brokers should be treated the same as Wall Street investment banks (i.e., a large, registered broker-dealer). A business owner should be able to compensate people for helping him or her to find and raise capital. He should be able to offer, for example, a 2 percent finders' fee to those that help him identify investors. In the real world, people respond to incentives, and being able to offer a financial reward will make people more willing to take the time and effort necessary to help small business owners find the capital that they need.

In large metropolitan areas like New York, Washington, or San Francisco, there are many accredited investors and most entrepreneurs in those cities will know many accredited investors. There are also large informal networks of such investors. In the Midwest, South and Rocky Mountain West (with the exception of a few large cities) and in less developed rural areas throughout the country, accredited investors are few and far between. Most entrepreneurs in these

[84] David R. Burton, "Let Entrepreneurs Raise Capital Using Finders and Private Placement Brokers," Heritage Foundation Backgrounder No. 3328, July 10, 2018 https://www.heritage.org/sites/default/files/2018-07/BG3328.pdf; American Bar Association, "Report and Recommendations of the Task Force on Private Placement Broker–Dealers," June 20, 2005, http://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf; Gregory C. Yadley, "Notable by their Absence: Finders and Other Financial Intermediaries in Small Business Capital Formation," presentation to the Advisory Committee on Small and Emerging Businesses, U.S. Securities and Exchange Commission, June 3, 2015, http://www.sec.gov/info/smallbus/acsec/finders-and-other-financial-intermediaries-yadley.pdf.

[85] By Main Street business, I mean a privately held, non-financial business.

[86] Particularly by those familiar with the work and proposals of the American Bar Association Task Force on Private Placement Broker-Dealers. American Bar Association, "Report and Recommendations of the Task Force on Private Placement Broker–Dealers," June 20, 2005, http://www.sec.gov/info/smallbus/2009gbforum/abareport062005.pdf.

regions will only know a few accredited investors and informal investor networks do not exist or are very small. Finders represent an opportunity to enable entrepreneurs in these regions to find accredited investors from outside of their communities.

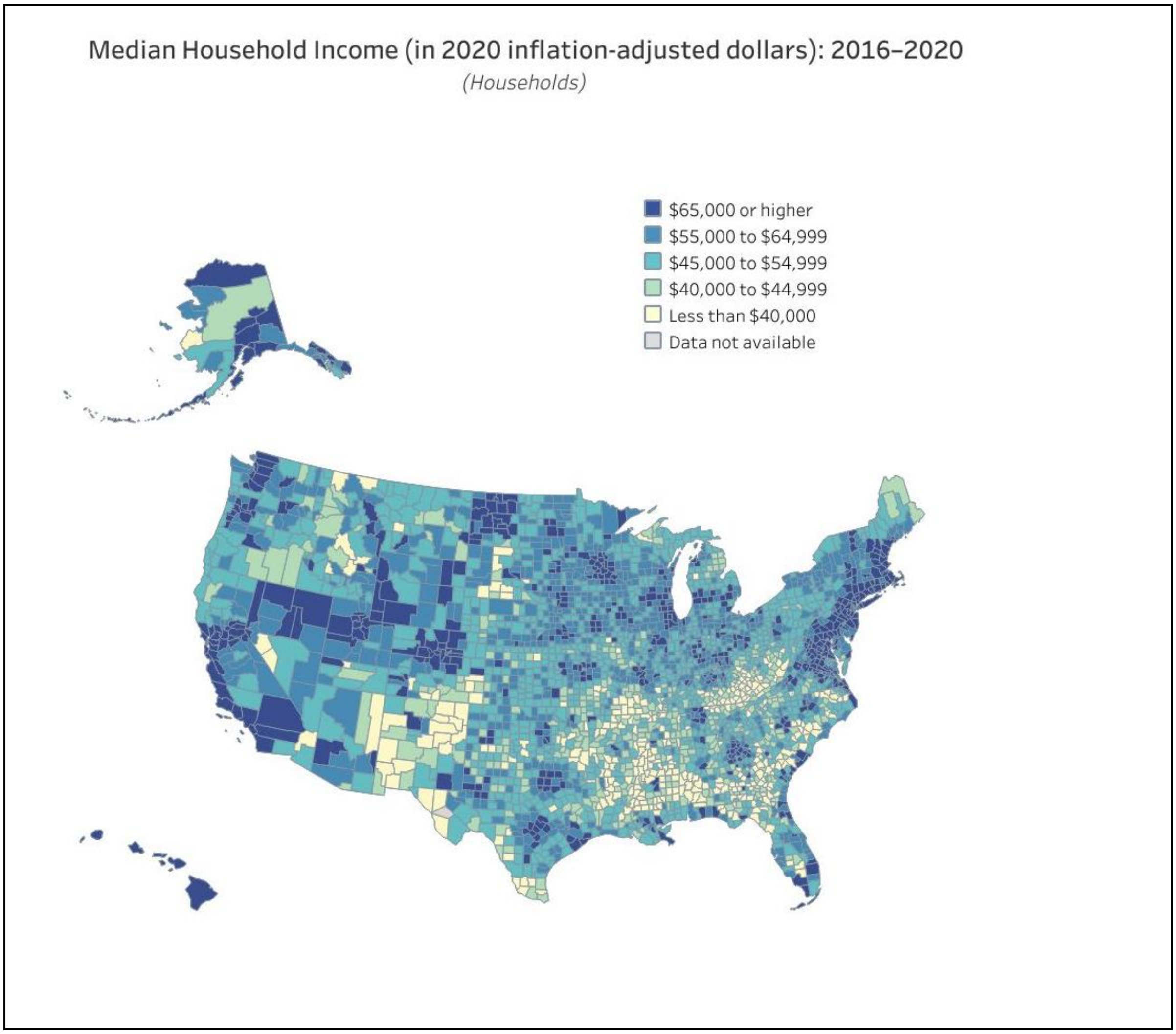
The map below illustrates this problem by mapping median household income.[87] The differences between the high-income areas designated by dark blue and low-income areas designated by yellow are differences of 65 percent or more. High incomes are very geographically concentrated on the coasts, a few other large cities and areas where the oil and gas industry is active. These later areas disappear from the map once the income threshold is lifted by about $25,000-$35,000 since even well-paying blue collar jobs do not generate household incomes over $100,000 in most parts of the country. Previous Census Bureau maps that used higher thresholds for their top bracket reflect this.

If the percentage of the population that qualified as an accredited investor were mapped by county, the differences would be even more dramatic. Even many of the places marked dark blue on this map (median household income >$65,000) will have a vanishingly small percentage of the population that have incomes high enough to qualify as accredited ($200,000 single, $300,000 joint). The Division of Economic and Risk Analysis (DERA) should obtain data from the Census Bureau (the American Community Survey and other data) or the Internal Revenue Service Statistics of Income public use file and map accredited investor data by state and county. Because, however, in many small or rural counties there are so few accredited investors, some county data may be masked. Thus, DERA may have to use core-based statistical areas[88] or metropolitan statistical areas to generate the map instead of county data.[89]

[87] "What Can You Learn About Counties From the American Community Survey?," Median Household Income (in 2020 inflation-adjusted dollars): 2016–2020 (Households), Census Bureau https://www.census.gov/library/visualizations/interactive/acs-counties-2016-2020.html.

[88] One or more adjacent counties or county equivalents that have at least one urban core area of at least 10,000 population. There are nearly 1,000 CBSAs.

[89] One or more adjacent counties or county equivalents that have at least one urban core area of at least 50,000 population, plus adjacent territory that has a high degree of social and economic integration with the core as measured by commuting ties. There are nearly 400 MSAs.



Source: Census Bureau

The current legal status of finders is a morass. It is a morass created by the Commission. It withdrew the guidance governing finders, various officials gave a series of speeches indicating that finders were probably unregistered broker-dealers, no addition guidance or rulemaking was forthcoming and selective regulation by enforcement was undertaken. The Commission articulated the view that even those tangentially involved in a transaction were finders, especially if they took "transaction-based compensation" or, in other words, if they took compensation for actually doing what they said they would do. This is not only bad public policy but significantly beyond the scope of the statutory definition of a broker, to wit, "any person engaged in the business of effecting transactions in securities for the account of others."[90]

After two decades of procrastination and neglect by the Commission and its staff, the Commission last Autumn proposed an exemptive order[91] that would improve the existing situation. The

[90] Securities Exchange Act, § 3(a)(4).

[91] Notice of Proposed Exemptive Order Granting Conditional Exemption From the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders," Notice of

proposed exemptive order is, however, markedly too narrow regarding the proposed Tier I finders category and should be improved.[92] Its fate at the Commission is now very much in doubt. Entrepreneurs cannot afford to wait another two decades for this problem to be favorably resolved by the Commission. Congress should Act.

10. Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2021 (S.3391)

This constructive bill, introduced by Sen. Kennedy, would substantially mitigate a long-standing problem. It would exempt certain M&A Brokers from the requirement to register as a broker-dealer subject to limitations on their activities.

Business brokers make the market for closely held small businesses more efficient, by helping entrepreneurs to sell their business for full value and by helping aspiring business owners find business opportunities that match their skills and financial resources.[93] Although, after many years of delay, the Securities and Exchange Commission issued in 2014 a no-action letter that improves the situation,[94] its position on who should be required to register as a securities broker-dealer remains overbroad and significantly exceeds the scope of the statutory requirement. Complying with the requirements of the no-action letter is far from simple.

The preferred solution is for business brokers helping to buy and sell small businesses to simply be exempt from the broker-dealer registration requirements. This bill is a major step in that direction. In 2017, the House unanimously passed the "Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act."[95] The Senate has failed to do so.

11. Gig Worker Equity Compensation Act (S.3931)

This constructive bill, introduced by Sen. Lummis, would extend Rule 701 provisions relating to compensatory benefit plans to "individuals (other than employees) providing goods for sale, labor, or services for remuneration to an issuer, or to customers of an issuer, to the same extent as that exemption applies to employees of the issuer."

Allowing independent contractors or "gig workers" to share in the financial success of the issuer that they work for and allowing the issuer to align their incentives with those of the issuer by

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Proposed Exemptive Order; Request for Comments, *Federal Register*, Vol. 85, No. 198, October 13, 2020, pp. 64542-64551 (Release No. 34-90112) https://www.govinfo.gov/content/pkg/FR-2020-10-13/pdf/2020-22565.pdf .

[92] Comment Letter of David R. Burton regarding the Proposed Exemptive Order for Certain Activities of Finders November 12, 2020 https://www.sec.gov/comments/s7-13-20/s71320-8011714-225387.pdf.

[93] David R. Burton, "Don't Overregulate Business Brokers," Heritage Foundation Backgrounder No. 2883, February 19, 2014 https://thf_media.s3.amazonaws.com/2014/pdf/BG2883.pdf.

[94] M & A Broker No Action Letter, January 31, 2014 [Revised: February 4, 2014] https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf.

[95] See H.R.609, 116th Congress, "The Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act" (Rep. Huizenga). On December 7, 2017, this bill passed the House by a vote of 426-0. It has yet to be enacted into law. See also section 401 of H.R.10, 115th Congress, the Financial CHOICE Act of 2017, passed by the House.

providing securities to the workers is laudable and deserves support. I will provide some suggestions regarding potential improvements in the next few weeks.

12. Increasing Investor Opportunities Act (S.3948)

This constructive bill could potentially have a significant positive impact on non-accredited investor returns by giving them access to professionally managed funds that invest in private offerings.

13. Improving Crowdfunding Opportunities Act (S.3967)

This constructive bill, introduced by Sen. Moran, would make significant improvements to crowdfunding, particularly the regulation of funding portals. It would broaden blue sky preemption, reverse a badly conceived SEC interpretation of its Regulation CF that treats crowdfunding portals as issuers for liability purposes, limits the Bank Secrecy Act requirements for funding portal requirements since funding portals are prohibited from holding customer funds by law and the investor funds held by banks are fully subject to AML-CFT Bank Secrecy Act requirements, and explicitly permit impersonal investment advice that does not purport to meet the objectives or needs of a specific individual or account. All of these are very helpful and will improve the attractiveness of crowdfunding. Given, however, the complexity and burden that Congress and then the SEC added to Title III, Congress should also consider whether more fundamental reforms will be necessary for equity crowdfunding to fulfill its promise.[98]

14. Equal Opportunity for all Investors Act (S.3921)

Regulation D investments are generally restricted to accredited investors, who are affluent individuals or institutions. The vast majority of Americans are effectively prohibited from investing in Regulation D securities. The SEC currently estimates that only about 16 million households (13 percent of the total) qualify as accredited.[99] Companies are going public much later than in the past, so those who invest in private offerings generally receive a higher share of returns generated by successful entrepreneurial ventures than those who invest in relatively late-stage public companies. Congress should democratize access to these private offerings so that they are available to more investors.[100]

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[98] See discussion above under the JOBS Act heading and David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; Thaya Brook Knight, "A Walk Through the JOBS Act of 2012: Deregulation in the Wake of Financial Crisis," Cato Institute Policy Analysis 790, May 3, 2016 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2833877#; Comment letter of David R. Burton regarding Crowdfunding, February 3, 2014 http://www.sec.gov/comments/s7-09-13/s70913-192.pdf;
Comment letter of Rutheford B Campbell, Jr., regarding Crowdfunding, February 14, 2014 http://www.sec.gov/comments/s7-09-13/s70913-278.pdf; Comment Letter of David R. Burton regarding Concept Release on Harmonization of Securities Offering Exemptions, Micro-Offering Exemption, pp. 50-54 https://www.sec.gov/comments/s7-08-19/s70819-6193328-192495.pdf.

[99] SEC "Concept Release on Harmonization of Securities Offering Exemptions," *Federal Register*, Vol. 84, No. 123, June 26, 2019, Table 3 — Households Qualifying Under Existing Accredited Investor Criteria, p. 30471.

[100] David R. Burton, "Congress Should Increase Access to Private Securities Offerings," Heritage Foundation Issue Brief No. 4899, August 29, 2018 https://www.heritage.org/sites/default/files/2018-08/IB4899.pdf; Thaya Brook Knight, "Your Money's No Good Here: How Restrictions on Private Securities Offerings Harm Investors," Cato

This important bill, introduced by Sen. Tillis,[101] would substantially democratize access to Regulation D private placements. It would allow people to test into accredited investor status by demonstrating their knowledge of investing. It would generally permit self-certification by investors as to whether they meet income or net worth requirements in all Rule 506 offerings. This is a particular step forward for Rule 506(c) offerings. Any natural person with at least $500,000 worth of investments would qualify. Any person investing no more than (a) 10 percent of the total investments of the person; (b) 10 percent of the annual income of the person or 10 percent of the annual combined income with that person's spouse; or (c) 10 percent of the net worth of the person excluding the value of the person's principal place of residence in private offerings would qualify. It would give millions of people access to Regulation D private offerings that are currently generally barred from investing in those offerings. Additional professional certification or educational attainment criteria could be added.

The final rule implementing Title II of the JOBS Act[102] created a safe harbor that inevitably, in practice, became the rule. Thus, "reasonable steps to verify" requirement for what became Rule 506(c) effectively means obtaining tax returns or comprehensive financial data proving net worth. Many investors are reluctant to provide such sensitive information to issuers with whom they have no relationship as the price of making an investment and, given the potential liability, accountants, lawyers and broker-dealers are unlikely to make certifications except perhaps for very large, lucrative clients. Issuers seek to avoid the compliance costs and regulatory risks.

Self-certification is the general, accepted practice for what is now known as Rule 506(b) offerings. That has been the case since the advent of Regulation D. Self-certification should be allowed for all Rule 506 offerings and obtaining an investor self-certification should be deemed to constitute taking "reasonable steps to verify that purchasers of the securities are accredited investors" as required by the JOBS Act. This is what the Equal Opportunity for all Investors Act.

Self-certification is permitted in the United Kingdom both for sophisticated investors and high net worth investors (income of £100,000 or more or net assets of £250,000 or more).[103] Neither in the

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Institute Policy Analysis No. 833, February 9, 2018 https://www.cato.org/sites/cato.org/files/pubs/pdf/pa833.pdf; David R. Burton, "Broadening Regulation D: Congress Should Let More People Invest in Private, High-Growth Companies," Heritage Foundation Backgrounder No. 3137. August 15, 2016 http://thf-reports.s3.amazonaws.com/2016/BG3137.pdf.

[101] Sen. Scott is an original cosponsor.

[102] Specifically, section 201(a)(1) of the Act.

[103] See *Conduct of Business Sourcebook*, United Kingdom Financial Conduct Authority, sections 4.12.6-4.12.11, https://www.handbook.fca.org.uk/handbook/COBS/4/12.html. A self-certified sophisticated investor is an individual who has signed, within the period of twelve months ending with the day on which the communication is made, a statement in the following terms:

"SELF-CERTIFIED SOPHISTICATED INVESTOR STATEMENT

I declare that I am a self-certified sophisticated investor for the purposes of the restriction on promotion of non-mainstream pooled investments. I understand that this means:

> (i) I can receive promotional communications made by a person who is authorised by the Financial Conduct Authority which relate to investment activity in non-mainstream pooled investments;

U.K. nor in 506(b) offerings (before and after the JOBS Act) has self-certification caused significant problems. The current 506(c) rules are a solution addressing a non-existent problem.

15. Facilitating Main Street Offerings Act (S.3966)

About $1 billion dollars annually is now raised using Regulation A.[104] It could and should be much more important.[105] One of the biggest things impeding the use of Regulation A is the fact that state blue sky laws are, under the Commission's implementing rule, preempted only with respect to Tier 2 primary offerings. All Tier 1 and Tier 2 secondary offerings are still subject to blue sky laws. NASAA's coordinated review program is an unmitigated failure and should be acknowledged as such.

This important bill, introduced by Sen. Moran, is meant to preempt blue sky laws for primary and secondary market for Regulation A Tier 2 securities. This would enable robust secondary markets in Regulation A securities to develop that would make Regulation A securities more liquid and enable investors to achieve better value when they sell their securities. It would also make primary offerings easier because investors buying from the issuer will know that they will be more easily able to sell their securities when they wish to do so.

I intend to make specific recommendations for improving the statutory text of this legislation, to ensure that it best meets its intended purpose – within the next four to six weeks.

(ii) the investments to which the promotions will relate may expose me to a significant risk of losing all of the property invested.

I am a self-certified sophisticated investor because at least one of the following applies:

(a) I am a member of a network or syndicate of business angels and have been so for at least the last six months prior to the date below;
(b) I have made more than one investment in an unlisted company in the two years prior to the date below;
(c) I am working, or have worked in the two years prior to the date below, in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises;
(d) I am currently, or have been in the two years prior to the date below, a director of a company with an annual turnover of at least £1 million.

I accept that the investments to which the promotions will relate may expose me to a significant risk of losing all of the money or other property invested. I am aware that it is open to me seek advice from someone who specialises in advising on non-mainstream pooled investments.

[104] "Facilitating Capital Formation and Expanding Investment Opportunities by Improving," Proposed Rule, March 4, 2020, Table 1: Overview of amounts raised in the exempt market in 2019, p. 9.

[105] David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; Comment Letter of David R. Burton regarding Concept Release on Harmonization of Securities Offering Exemptions, Micro-Offering Exemption, pp. 50-54 https://www.sec.gov/comments/s7-08-19/s70819-6193328-192495.pdf; Comment Letter of David R. Burton regarding Proposed Rule "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets," June 1, 2020 https://www.sec.gov/comments/s7-05-20/s70520-7261535-217655.pdf.

Additional Steps to Improve Access to Capital for Entrepreneurs

The legislation discussed in the previous section would constitute a genuinely major step forward. There are, however, a number of important reforms not addressed by these bills. The Emerging Growth Company Extension Act is expected to become a part of the JOBS Act 4.0.

Emerging Growth Company Extension Act

As discussed above, Title I of the JOBS Act created the Emerging Growth Company (EGC) status to reduce the cost of initial public offerings and of early continuing compliance costs. This aspect of the JOBS Act appears to have been a success. The number of IPOs has been trending upwards and roughly four-fifths of issuers conducting IPOs appear to be taking advantage of EGC status.[106] The number of IPOs in the nine years after the JOBS Act has increased by 43 percent relative to the nine years before the JOBS Act and the amount raised has increased by 57 percent.[107]

IPOs Before and After the JOBS Act

Year	Number of IPOs	Aggregate Proceeds ($ billions)
2004	173	$31
2005	159	$28
2006	157	$30
2007	159	$36
2008	21	$23
2009	41	$13
2010	91	$30
2011	81	$27
2012	93	$31
2013	158	$42
2014	206	$42
2015	118	$22
2016	75	$13
2017	106	$23
2018	134	$33
2019	112	$39
2020	165	$62
2021	311	$119
2004-2012 (Average)	108	$28
2013-2021 (Average)	154	$44

Data Source: Jay R. Ritter, Initial Public Offerings: Updated Statistics, University of Florida

[106] "Update on Emerging Growth Companies and the JOBS Act," PwC Deals, April 2018, Table: Total IPOs filed as EGCs in the United States, p. 7 https://www.pwc.com/us/en/deals/assets/pwc-deals-update-on-the-JOBS-act.pdf.
[107] Jay R. Ritter, Initial Public Offerings: Updated Statistics, University of Florida, March 11, 2022 https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf.

Nevertheless, the number of IPOs is still *dramatically* fewer than in the 1990s and the amounts raised, particularly when adjusted for inflation, are not impressive.[108] IPOs are barely keeping pace with exits (either through mergers or delisting due to financial failure or going private transactions).[109]

The EGC provisions of JOBS Act 4.0 would extend the period that a company could retain its Emerging Growth Company status from five to ten years. This would reduce the cost of being a public company until substantial size is achieved and will, therefore, make IPOs more attractive. It is part of a well-conceived scaled disclosure regime.

The ever-increasing regulatory burden on public companies means that companies are going public much later in their life cycle. This, in turn, means that a disproportionate share of the gains from successful entrepreneurial ventures accrues to accredited investors buying private placements rather than ordinary investors who own publicly traded shares.[110] Policymakers should seek to reduce the burden on public companies so that ordinary American investors can share in these gains.

I have two suggestions about how to improve this very constructive section of the bill. First, I would suggest that EGC status be made indefinite rather than limiting it to 10 years. Second, I would recommend amending the Securities Act and the Securities Exchange Act so that EGCs (and smaller reporting companies) are exempt from (1) climate change or greenhouse gas emissions reporting,[111] (2) diversity, equity and inclusion reporting[112] and (3) human capital management reporting.[113] Of course, it would be preferable to simply define materiality so that such reporting is not required of any issuer.

The proposed climate change rule alone has been estimated by the SEC to increase the costs of being a public company by an astounding 165 percent, by $6,378,073,242 in the aggregate from $3,856,958,756 to $10,235,031,998.[114] And this is a massive underestimate because huge swaths of the costs imposed by scope 3 are not counted. In other words, the proposed climate change rule will nearly triple the costs of being a public company. With one regulation, the Commission is considering adding more costs on issuers than all of the regulations promulgated in the previous

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[108] Ibid.

[109] Listed Domestic Companies, Total - United States, World Bank https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US. The number of listed companies has been essentially flat since 2012, increasing by less than ½ of one percent annually.

[110] For an analysis of the higher returns of private equity see, for example, Jeroen Cornel and Kyle McDermott, "On the Historical Outperformance of Private Equity," BlackRock Private Equity Partners, July 2021 https://www.blackrock.com/institutions/en-us/literature/whitepaper/historical-outperformance-of-private-equity.pdf.

[111] "The Enhancement and Standardization of Climate-Related Disclosures for Investors," Proposed Rule, Securities and Exchange Commission March 21, 2022 https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

[112] See, for example, Corporate Board Diversity [RIN: 3235-AL91], Fall 2021 Unified Agenda of Regulatory and Deregulatory Actions, Securities and Exchange Commission https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202110&RIN=3235-AL91.

[113] Human Capital Management Disclosure [RIN: 3235-AM88], Fall 2021 Unified Agenda of Regulatory and Deregulatory Actions, Securities and Exchange Commission https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202110&RIN=3235-AM88.

[114] "The Enhancement and Standardization of Climate-Related Disclosures for Investors," Proposed Rule, Securities and Exchange Commission March 21, 2022, pp. 455-456 https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

nine decades. It is difficult to conceive of a more destructive policy and, if promulgated, it will dwarf the positive impact of this legislation. The DEI and human capital management reporting requirements will just make the problem worse.

Small Business Audit Correction Act

The number of broker-dealers has declined by about 30 percent over the past 15 years. A large reason for this decline is the ever-increasing regulatory burden that crushes the profitability of small broker-dealers. Regulatory costs do not increase linearly with size, so heavy regulation accords a competitive advantage to large firms. The decline in small broker-dealers harms small entrepreneurs because small broker-dealers are more likely to assist them to raise capital than large investment banks.

This constructive bill[115] would exempt privately-held, non-custodial broker-dealers from the requirements to use a Public Company Accounting Oversight Board (PCAOB) registered firm for their audits. These small firms are not public companies and do not generally hold customer securities or funds. They pose no risk to the financial system as a whole. It is appropriate to allow them to comply only with normal audits rather than the more expensive PCAOB compliant audits. They would still be subject to the full panoply of both SEC and FINRA rules governing broker-dealers.[88]

Additional Proposals Relating to Entrepreneurial Capital Formation

See my submission to the Committee for details regarding the proposals in this section, including an analysis of why they are desirable and, in many cases, proposed statutory language.[116]

<u>Proposals Relating to Substantive Changes to the Securities Laws</u>

1. Congress should codify and broaden the exemption from the section 12(g) holder-of-record limitations for Regulation A securities.

2. Congress should eliminate the income and net worth limitations imposed by Regulation A (although not by Securities Act section 3(b)).

3. Congress should exempt P2P lending from federal and state securities laws.

4. Congress should amend Title III of the JOBS Act to create a category of crowdfunding security called a "crowdfunding debt security" or "peer-to-peer debt security" with lesser continuing reporting obligations.

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[115] S.2724, 116th Congress (Sen. Cotton).

[116] David R. Burton and Norbert J. Michel, Proposals to Foster Economic Growth and Capital Formation, March 18th, 2021 https://www.banking.senate.gov/imo/media/doc/David%20Burton%20and%20Norbert%20Michel%20-%202021-3-18.pdf. Note: Dr. Michel authored the proposed banking reforms.

5. Congress should statutorily define materiality in terms generally consonant with Supreme Court holdings on the issue but should specifically excludes social and political objectives unrelated to investors' financial, economic or pecuniary objectives.

6. Congress should amend the Securities Act and the Securities Exchange Act to reflect the principles of the Civil Rights Act by prohibiting securities regulators, including SROs, from promulgating rules or taking other actions that discriminate on the basis of race, color, religion, sex, or national origin of such individual or group. Legal discrimination or quotas on the basis of race or sex should be a relic of the past.

7. Congress should terminate the Consolidated Audit Trail program

<u>Proposals Relating to Studies or Data Improvement</u>

1. Congress should require the Division of Economic and Risk Analysis at the SEC to conduct a study mapping and reporting accredited investor data by state and county but permitting the use of core-based statistical areas or metropolitan statistical areas if data masking by the Census Bureau or the IRS Statistics of Income effectively requires their use.

2. Congress should require the SEC to publish better data on securities offerings, securities markets and securities law enforcement and to publish an annual data book of time series data on these matters (as outlined below). The Division of Economic and Risk Analysis (DERA) should publish annual data on:

> (1) the number of offerings and offering amounts by type (including type of issuer , type of security and exemption used);
> (2) ongoing and offering compliance costs by size and type of firm and by exemption used or registered status (e.g. emerging growth company, smaller reporting company, fully reporting company) including both offering costs and the cost of ongoing compliance;
> (3) enforcement (by the SEC, state regulators and SROs), including the type and number of violations, the type and number of violators and the amount of money involved;
> (4) basic market statistics such as market capitalization by type of issuer and type of security; the number of reporting companies, Regulation A issuers, crowdfunding issuers and the like; trading volumes by exchange or ATS; and
> (5) market participants, including the number and, if relevant, size of broker-dealers, registered representatives, exchanges, alternative trading systems, investment companies, registered investment advisors and other information.

This data should be presented in time series over multiple years (including prior years to the extent possible) so that trends can be determined.

3. Congress should require an annual SEC and one-time GAO study that collects and reports data from state regulators on the fees or taxes they collect from issuers. These studies should collect data from at least the years 2017-2020 and classify the fees and taxes collected from issuers by offering type.

4. Congress should require an SEC study reporting the annual costs relating to Sarbanes-Oxley internal control reporting and the amounts paid by issuers each year to accounting firms in connection with compliance.

Fundamental Reforms to Securities Law

Ideally, Congress and the Commission would be willing to fundamentally rethink the regulation of small company capital formation. The complex, hodge-podge matrix of exemptions and disclosure requirements that has developed over the past nine decades needs to be rethought. A coherent, scaled, simplified disclosure regime with a limited number of exemptions should be developed and implemented by Congress and the Commission. It should govern both initial and continuing disclosure and be integrated across the various exemptions and categories of reporting company such that larger firms with more investors and more capital at risk have greater disclosure obligations. Policymakers should consider the cost of compliance, the investor protection benefits of the added disclosure, the cost to investors of being denied investment opportunities by investment restrictions and the cost to the public of lost economic growth, capital formation, innovation, and job creation caused by the regulation of issuers. Such an approach offers the potential to substantially improve the environment for entrepreneurial capital formation and to improve investor understanding of the capital markets primarily at the expense of attorneys, compliance advisors and, to a lesser extent, accountants who live off the complexity of the current system.

There are effectively at least 13 categories of firms issuing securities. They are:

> (1) private companies using section 4(a)(2);
> (2)-(5) private companies using Regulation D (Rule 504 and Rule 506 (with and without non-accredited investors);[117]
> (6)-(7) small issuer Regulation A companies (two tiers);
> (8)-(10) crowdfunding companies (three tiers);
> (11) smaller reporting companies;
> (12) emerging growth companies; and
> (13) fully reporting public companies.

Each of these categories has different initial and continuing disclosure obligations, different classes of investors that can invest in the offering, different offering caps, different maximum investment restrictions and a host of other differences. The existing disclosure regime is not coherent in that in many cases smaller firms have greater disclosure requirements and the degree and type of disclosure differs significantly by the type of offering even for firms that are otherwise comparable in all meaningful respects.

[117] Rule 502(b) imposes significantly greater disclosure requirement on issuers that sell to non-accredited investors in a Rule 506(b) offering. The rules governing 506(c) offerings have a different set of rules but those differences do not primarily affect verification of accredited investor status and bad actor disqualification rather than disclosure requirements.

It is worth considering a simplified set of exemptions.[118] One possibility would be to establish three categories as follows:

A Proposal for a Reformed Exemption and Disclosure Regime

Type of Issuer	Type of Solicitation		Size (Public Float/ Number of Beneficial Owners or Holders of Record)		Secondary Market Status
Private	Private	and	Below specified threshold A	and	Neither National Securities Exchange nor Venture Exchange[119] traded (but some organized secondary market permitted).
Quasi-Public ("Venture Firms")	General	or	Above specified threshold A	and	Both Venture Exchange and ATS trading permitted. National Securities Exchange traded.
Public (Registered)	General	and	Above specified threshold B	or	Both National Securities Exchange and ATS traded.

In such a regime, private companies would have no legally mandated disclosure requirements. Disclosure requirements would be negotiated by the private parties involved much as they usually are now. The private exemption here is effectively the same as Rule 506(b) or section 4(a)(2) offerings.[120] A company would be deemed private if it did not engage in general solicitation, was below some specified number of beneficial owners,[121] holders of record or, perhaps, some measure

[118] David R. Burton, "Securities Disclosure Reform," Chapter 5, *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, Editor (The Heritage Foundation: 2017) http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf or David R. Burton, "Securities Disclosure Reform," Heritage Foundation Backgrounder No. 3178, February 13, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3178.pdf.

[119] A "Venture Exchange" is conceived of here as an exchange that is regulated in a fashion more appropriate for an exchange populated by small capitalization issuers (Regulation NMS requirements would be relaxed, market makers would be allowed and other changes). See, for example, David R. Burton, "Legislative Proposals to Enhance Capital Formation and Reduce Regulatory Burdens: Venture Exchanges," Testimony before the Capital Markets and Government Sponsored Enterprises Subcommittee of the Committee on Financial Services before the United States House of Representatives on May 13, 2015 https://www.heritage.org/testimony/legislative-proposals-enhance-capital-formation-and-reduce-regulatory-burdens-venture . See also, Daniel M. Gallagher, "How to Reform Equity Market Structure: Eliminate "Reg NMS" and Build Venture Exchanges" Chapter 7, *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, Editor (The Heritage Foundation: 2017) http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf.

[120] A decision would need to be made regarding the Rule 502(b) disclosure requirements with respect to sales to non-accredited investors if the accredited investor concept is retained.

[121] There would need to be reasonable, administrable look-through rules if beneficial ownership were to replace the holder of record threshold. This problem has largely been solved by the tax system with respect to income reporting.

of non-insider share value (analogous to public float) – call this threshold A – and its shares were not traded on a venture exchange, alternative trading system (ATS) or national securities exchange. Secondary sales would be restricted.[122]

Public companies could engage in general solicitation and would be (1) above a specified measure of size (threshold B) or (2) have shares traded on a national securities exchange (or, at the issuer's option, an ATS). Disclosure obligations would be scaled based on some measure of size (probably public float). This is the category that most companies that are full reporting companies, smaller reporting companies, emerging growth companies and perhaps the largest Regulation A companies would fall into.

Companies that were neither "public" nor "private" would be intermediate "quasi-public" or "venture" companies. They could engage in general solicitation and sell to the public. Disclosure obligations would be scaled based on some measure of size (perhaps public float if traded on a venture exchange (or an ATS) or the number of beneficial owners or holders of record otherwise). These are the kind of companies that are meant to use the crowdfunding and Regulation A exemptions and would probably include some companies that are smaller reporting companies today.

Blue sky laws regarding registration and qualification would be preempted in all cases. State anti-fraud laws would remain operative.[123]

Companies would report based on the category they were in (private, quasi-public/venture or public). Disclosure obligations would be scaled within the quasi-public and public category. Registration statements should be dramatically simplified, describing the security being offered but the quarterly (10-Q), annual (10-K) and major event (8-K) reporting would become the core of the disclosure system rather than registration statements (except in the case of initial quasi-public or venture offerings (transitioning from private company status) or initial public offerings (transitioning from private or quasi-public/venture status)).

Although it is far from clear that it should be retained,[124] some accredited investor limitations measuring wealth, income or sophistication could be applied to private offerings should policy

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Moreover, in the contemplated regulatory regime, the impact of the step up from private to quasi-public status would not be so discontinuous as the step-up from private to public today, this break point would be of less importance.

[122] Attention should be paid to improving private secondary markets. If the accredited investor concept were retained, secondary sales should be fostered by an improved version of 4(a)(7). Enabling investors to realize the full value of their shares in secondary sales and promoting liquidity is an important aspect of investor protection.

[123] Blue Sky registration and qualification requirements are highly counterproductive. Capital routinely seeks to avoid the substantial delay, costs and regulatory risk of state registration and qualification requirements (especially in merit review states). There is little actual evidence that blue sky registration and qualification requirements materially improve investor protection. For a discussion of these issues, see Rutheford B. Campbell Jr., "The Case for Federal Pre-Emption of State Blue Sky Laws," Chapter 6, *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, Editor (The Heritage Foundation: 2017) http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf. See also "Blue Sky Preemption and Covered Securities" section below.

[124] See, for example, Thaya Brook Knight, "Your Money's No Good Here: How Restrictions on Private Securities Offerings Harm Investors," Cato Institute Policy Analysis No. 833, February 9, 2018 https://www.cato.org/sites/cato.org/files/pubs/pdf/pa833.pdf; David R. Burton, "Broadening Regulation D: Congress

makers wish to limit those who may invest in private companies. In that case, however, something similar to the current section 4(a)(2) exemption or a statutory exemption for micro issuers would need to remain. Otherwise, a few people starting a bar, restaurant, retail store or service business would run afoul of the securities laws.

To accomplish disclosure reform while maintaining the basic current exemption structure, Congress would need to amend:

1. Securities Act Schedule A (which currently contains a list of 32 disclosure requirements and is about 5 pages in length)
2. Securities Act sections 4A (crowdfunding), 7 and 10 (relating to registration statements and prospectuses)
3. Securities Exchange Act sections 13, 14, 14A, 16 and 21E (relating to periodic and other reports, proxies, shareholder approvals, disclosure concerning directors, officers and principal shareholders and the safe harbor relating to forward looking statements)[125]

A revised Schedule A would list all disclosure requirements applicable to a fully reporting public company and also indicate which provisions did not apply to smaller reporting companies and companies falling into other categories. It would, in effect, become the roadmap to which companies had to comply with which disclosure requirements.

Implementing the complete reform program outlined above would involve substantial changes to other provisions in the law, notably sections 3, 4 and 4A of the Securities Act (relating to exempted securities, exempted transactions and crowdfunding, respectively). This would replace the current patchwork of 13 different exemptions, each with a different set of exemption and disclosure rules, with three major issuer categories (private, quasi-public ("venture") and public) and two scaled disclosure categories (larger and smaller) within the quasi-public ("venture") and public exemption categories.

Should Let More People Invest in Private, High-Growth Companies," Heritage Foundation Backgrounder No. 3137. August 15, 2016 http://thf-reports.s3.amazonaws.com/2016/BG3137.pdf; David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf.

[125] In addition, conforming amendments elsewhere in the Securities Act and the Securities Exchange Act would need to be made.