Investor-Friendly Securities Reform To Increase Economic Growth

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This submission responds to the invitation from Senators Crapo and Brown for legislative proposals to increase economic growth. I teach securities regulation at the University of Virginia School of Law and am a former Deputy General Counsel of the Securities and Exchange Commission and a former partner in the securities enforcement practice at Wilmer Cutler Pickering Hale and Dorr LLP.

For years the federal securities laws have burdened the process of raising funds with intricate sets of rules that do little to advance the cause of investor protection. The time is now right for a critical reassessment in three areas:

- the steps companies must follow to sell securities to the public,
- exemptions from the public offering process, and
- the prescribed disclosures for companies selling new securities and periodically reporting on their business.

In each area, the rules have multiplied over time, become encrusted and labyrinthine, and added sizable expense.

Genuine reform in these areas would reduce the cost of raising capital, feed economic growth, and enable job creation. In recent years, the total amount of capital raised annually in securities sales regulated by the SEC was approximately $3 trillion.[1] If the cost of raising that capital could be reduced by just one percent, the economy would have $30 billion more each year to devote to new drugs, renewable energy research, new production plants, and more jobs.

The first area to re-think is the cumbersome and costly method for registering securities with the SEC for a public offering. The registration process often takes about six months for emerging companies. A 2012 study by an accounting firm found that total costs for an initial public offering were approximately 8 percent of gross offering proceeds, with smaller offerings

[1] Scott Bauguess, Rachita Gullapalli & Vladimir Ivanov, Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009–2014 at 6 (October 2015) ("In 2014, registered offerings accounted for $1.35 trillion of new capital compared to $2.1 trillion reported raised through all private offering channels.") (SEC staff paper), available at http://www.sec.gov/dera/staffpapers/white-papers/unregistered-offering10-2015.pdf. See also SEC Chair Mary Jo White, The SEC in 2014, Speech at the 41st Annual Securities Regulation Institute (January 27, 2014) ("In 2013, according to our estimates, capital raised in public offerings totaled $1.3 trillion, as compared to $1.6 trillion raised in offerings not registered with the SEC, with over 65% raised in new and ongoing Rule 506 offerings."), available at https://www.sec.gov/News/Speech/Detail/Speech/1370540677500.

incurring a higher percent of costs.[2] Paying $8 million to raise $92 million in cash is not the best of deals.

Legal requirements are a large part of the problem. The need to prepare a set of complete and accurate disclosures for investors is settled, but other restrictions create a maze with traps. Eminent writers in the field called the statute a "scheme of involuted drafting" that "does not facilitate comprehensibility."[3]

For example, while a company is working on its formal disclosure documents, the law gags it. Senior executives may not make public comments that could be seen to arouse the interest of potential buyers in the securities to be sold. After filing a draft of the formal disclosure documents with the SEC, a company is freer to communicate with potential investors, but the rules are byzantine. Some written communications are permitted; some are not; some must have warnings or be accompanied by the SEC filing; some do not; some must be filed with the SEC; some do not. The legal restrictions are so convoluted that even well-intentioned and well-advised companies such as Google and Groupon tripped over them.

A company may avoid the public registration process by taking advantage of exemptions for private or smaller sized offerings. In concept, the exemptions were a welcome relief valve from the more formal registration system, but they too have become gummed up over time with restrictive interpretations or complicated regulatory obligations that have increased costs.

An example is the creative idea of crowdfunding start-up businesses with small amounts from many investors. The idea grew to pages and pages of statutes and regulations that, among other things, require a broker or "funding portal" intermediary and oblige the intermediary to "ensure that each investor" reviews investor education material and answers questions demonstrating an understanding of investment risk.[4]

The third area needing attention is the list of mandatory disclosures for companies that issue securities or make regular formal reports to investors. The core rules, called Regulation S-K, now take 214 pages in the Code of Federal Regulations,[5] and the print is small. The rules for financial statements, called Regulation S-X, are another 100 pages.[6]

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2 PricewaterhouseCoopers, Considering an IPO? The costs of going and being public may surprise you 7 (2012), available at https://www.pwc.com/us/en/deals/publications/assets/pwc-cost-of-ipo.pdf.

3 Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 93 (4th ed. 2004).

4 See sections 4(a)(6) and 4A of the Securities Act and 17 C.F.R. pt. 227.

5 17 C.F.R. pt. 229.

6 Id. pt. 210.

The extent of the required disclosures has made corporate reports prolix, impenetrable, and expensive. Important information is buried with trivia, making disclosures less useful for both institutional and individual investors. In addition, the expenses of being a publicly reporting company easily run into millions of dollars every year.[7] One company in a survey estimated that the incremental recurring annual costs related to being a public company are approximately $38 million.

On occasion, Congress has acted to address some of these problems,[8] but a fresh and more thoroughgoing effort is needed. A place to begin is the process for offering securities to the public. The main priority of Congress should be to reduce the cost of preparing the disclosure document and eliminate constricting conditions so that the public registration process is as or more efficient than using an exempt offering under the current system. The main elements of the reform would be to free issuers to communicate about the offering at any time, shorten SEC staff review of a draft registration statement, and promote disclosure to potential buyers before an investment decision is made. Details of a new approach to registered offerings are in the Appendix.

A second feature of reform should be to tailor the information disclosure obligations of issuing and reporting companies to the size of the company. Size could be determined by the value of outstanding securities or total revenue or assets. Newly formed or small companies should need to make only basic disclosures about the company and the securities. Several parts of the existing securities laws already have models for such short-form documents.[9] Large and established companies should make the full range of disclosures, although that full range must be cut back. Medium-sized companies would have disclosure obligations in between the other two categories. The new categories would replace the different disclosure systems under current law (Forms S-1, S-3, 10-K, 10-Q, Regulation D, Rule 144, Rule 144A, Form 1-A for Regulation A, section 4A(b)(1) (crowdfunding), and Rule 15c2-11).

If the public offering process and the extent of mandatory disclosures were significantly streamlined, the need for exemptions would disappear. The existing complicated and confusing set of exemptions could be swept away with issuing companies using the registration system for all securities sales. A new statute could repeal section 4(a) through (d) and section 4A of the Securities Act, the parts of the JOBS Act on emerging growth companies, Regulation D, and

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7 PricewaterhouseCoopers, Considering an IPO? The costs of going and being public may surprise you 12-25 (2012), available at https://www.pwc.com/us/en/deals/publications/assets/pwc-cost-of-ipo.pdf.

8 For example, at the end of 2015, Congress ordered the SEC to revise Regulation S-K to reduce the disclosure burden on emerging growth companies and small issuers. Fixing America's Surface Transportation Act, Pub. L. No. 114-94, § 72002, 129 Stat. 1784 (December 4, 2015).

9 Examples are section 4(d)(3) or section 4A(b)(1)(A)-(H) of the Securities Act or current Rule 15c2-11(a)(5) of the Exchange Act.

crowdfunding and invalidate the current SEC rules with issuer exemptions, including Regulation D, Regulation A, and crowdfunding.

The exemptions usually restrict resales. For example, the securities in a Rule 506 transaction are restricted securities whose resale is subject to the confusing provisions of Rule 144. The approach here would dispense with the resale restrictions. A company that had sold securities would need to continue to provide sufficient current information to the market to permit reasonable investment decisions and secondary trading, and the securities would be freely tradable by one buyer to another.

The securities laws should have one exemption from the public registration process for issuers, and it should be for very small start-up companies. An issuer should be able to sell securities for total proceeds of up to a small amount (such as $250,000 or $500,000) to a small number of offerees and buyers (such as no more than ten offerees and no more than five buyers including the founders) with no need to comply with any obligation under federal or state securities laws. The exemption should explicitly pre-empt state law. Investors would be protected because the founder would be able to provide information about the business to the small number of possible buyers and because the possible buyers would be in discussions with the founder and could request any further information they wanted. Such an exemption would benefit a large number of entrepreneurs.

A simplified public offering process with reduced disclosure obligations needs a strong private liability system. For registered public offerings, sections 11 and 12 of the Securities Act are a starting point. Issuers should have strict liability for a failure to comply with the public offering rules, for any material statement that is false or misleading, or for any failure to make a required material statement. Others responsible for a misstatement should have a defense of due diligence and reasonable care. The tracing requirement for section 11 should be eliminated. Only the initial buyer from the issuer or underwriter should have the claim. The remedy should be rescission or actual loss from the failure to register or from the misstatement.

Substantial reform of these three parts of the securities laws would reduce the costs and delays in raising capital and contribute to economic gains and more jobs. The changes could be achieved while preserving meaningful investor protection and therefore should appeal to Democrats and Republicans alike.

APPENDIX

A new approach to the public offering of securities would have these features:

1. An issuer would file a complete draft of a registration statement except for final pricing information in confidence with the SEC,[10] receive one set of comments from the SEC staff within a fixed time period, publicly file a revised draft that is complete except for pricing information,[11] wait at least three to five business days, file a complete registration statement, including all pricing information, and go effective immediately on this filing.[12] No sales could occur until a registration statement became effective.[13] The public draft and final registration statement would be available electronically from the SEC, issuer, and underwriter.[14]

2. A company's obligation to make disclosures in the registration statement would be tailored to the company's size, as discussed in the main text. A small company would have limited disclosure obligations in line with the limited disclosure obligations they have now under parts of existing law.[15] Larger companies would need to make more extensive disclosures. As under current law, a company that was already a publicly reporting company would need to bring earlier disclosures current and add disclosures about the securities offering.[16]

3. The law would not restrict any written or oral communications from the issuer or underwriter about a possible securities offering. At any time, the issuer and underwriter could make statements that would

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[10] Emerging growth companies and new issuers using Regulation A may do this now. See section 6(e)(1) of the Securities Act; Rule 252(d).

[11] Id.

[12] This would eliminate the complexity of filing a registration statement without pricing information, going effective, and then filing a complete final statutory prospectus. See Rules 172, 430A, 424. It also would dispense with the need for a rule on immediate effectiveness of a registration statement. See Rule 462.

[13] Section 5(a) of current law contains this prohibition.

[14] Current law generally takes this same approach. See Rules 134, 424, 172, 173.

[15] See, e.g., section 4(d)(3) or section 4A(b)(1)(A)-(H) of the Securities Act or current Exchange Act Rule 15c2-11(a)(5).

[16] See Form S-3.

constitute an "offer" under current law.[17] Issuers, underwriters, and others would have liability as discussed in the main text for communications that were not complete and accurate.

4. A new approach would follow the current system of making efforts to notify potential buyers of the availability of the pre- or post-effective registration statement before an investor enters into a contract to buy.

   (a) In a communication from the issuer or underwriter to a potential buyer seeking an indication of interest before the registration statement is effective or seeking a decision to buy after the registration statement is effective, the issuer or underwriter would need to inform the person of the availability of the disclosure document at internet sites of the SEC, issuer, and underwriter.[18]

   (b) If the issuer or underwriter received an offer to buy from a person who had not already received a communication about the availability of the registration statement, the issuer or underwriter would not be able to accept the offer to buy until the seller notified the person of the availability of the disclosure document and the person later confirmed the purchase order.

5. The issuer and underwriter would have no further obligation to deliver the final registration statement.[19]

6. Securities sold in a public offering would be freely tradable by one buyer to another. A new statute should make this explicit; section 4(a)(1) should be repealed.[20]

7. A company issuing securities should have an obligation to continue providing periodic disclosures to investors and the market for a minimum period of time, such as two years. A company could stop making periodic disclosures after two years if it ceased doing

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[17] This would be a major change from current law and would require amendments to section 5(b) and (c) and the definitions of "offer" and "prospectus." The change would allow the elimination of Rules 134, 135, 163, 163A, 164, 168, 169, 433.

[18] Current Rule 134 has a similar requirement.

[19] This change would be consistent with current law under Rules 172, 173, and 174 and would allow repeal of sections 5(b)(2) and 4(a)(3) of the Securities Act and invalidation of Rules 172, 173, and 174.

[20] The definition of a control person as an issuer in the definition of underwriter in the Securities Act would be eliminated. See section 2(a)(11) of the Securities Act.

business or it had a small number of shareholders, such as fewer than 100.[21]

[21] This would be similar to the current approach in sections 12(g) and 15(d) of the Exchange Act with some variations.