Proposals to Foster Economic Growth and Capital Formation

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We submit[1] the following proposals to foster economic growth and job creation by facilitating capital formation in response U.S. Senate Banking Committee Ranking Member Pat Toomey's February 2, 2021 request for proposals.[2] In his request, Ranking Member Toomey sought (1) a brief description of the proposal and how it will encourage companies to be publicly traded, improve the market for private capital, and/or enhance retail investor access to investment opportunities; (2) a description of the impact on economic growth and investor protection; (3) legislative language; and (4) other appropriate background material.

Collectively, the recommendations in this submission represent an opportunity to markedly strengthen economic growth, foster entrepreneurship, enhance economic opportunity, improve productivity, increase the wages of ordinary Americans, regain prosperity, democratize access to capital and reduce the cronyism in the economy. Were our recommendations adopted by Congress, the only clear losers would be lawyers and others that provide regulatory compliance services. In some cases, large incumbent firms would be harmed by renewed competition and regulators would see some reduction in their power and importance. Consumers, investors, workers and most businesses, especially smaller and younger firms, would benefit.[3]

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[1] The views we express in this submission are our own and should not be construed as necessarily representing any official position of The Heritage Foundation.
[2] "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.
[3] For collections providing a general introduction to many of the issues discussed in this submission, see (1) *Prosperity Unleashed: Smarter Financial Regulation* (Washington, DC: Heritage Foundation, 2017), edited by Norbert J. Michel http://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf; (2) *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans* (Washington, DC: Heritage Foundation 2016), edited by Norbert J. Michel http://thf-reports.s3.amazonaws.com/2016/The%20Case%20Against%20Dodd-Frank.pdf; and (3) *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers* (Arlington, VA: Mercatus Center at George Mason University, 2016), edited By Hester Peirce And Benjamin Klutsey https://www.mercatus.org/system/files/peirce_reframing_web_v1.pdf.

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Proposals and Analysis

I. Introduction

The discussion below is divided into six parts addressing:

(1) entrepreneurial capital formation,
(2) improved public markets,
(3) anti-money laundering (AML), combating the financing of terrorism (CFT), know your customer (KYC) and Bank Secrecy Act (BSA) rules,
(4) banking regulation,
(5) alternative, virtual or crypto currencies, and
(6) the Employee Retirement Income Security Act (ERISA).[4]

With the exception of the introductory section to each of these six parts, most sections are organized as follows:

(1) Under the heading "Summary of the Problem and Policy Analysis" is a reasonably short description of the problem and policy analysis;
(2) Under the heading "Recommendations" are short, actionable recommendations or proposals for Congressional action;
(3) Under the heading "For Further Information" are citations to papers, studies or documents that provide additional background information. In addition, the footnotes in the description of the problem and policy analysis section provide additional sources of more detailed information;
(4) Under the heading "Legislative Language" are citations to bills or recommendations regarding statutory language.

We plan to provide additional recommendations over the next several months particularly with respect to:

(1) scaled disclosure and simplification for reporting companies,
(2) secondary markets for private securities,
(3) enforcement against large institutions
(4) market manipulation
(3) ESG/CSR,
(4) banking regulation,
(5) AML/CFT, and
(6) alternative currencies.

The views we express in this submission are our own and should not be construed as necessarily representing any official position of The Heritage Foundation.

[4] The primary author of the entrepreneurial capital formation, improved public markets, and ERISA sections was David Burton. The primary author of the banking section was Norbert Michel. The AML and alternative currency sections were jointly written.

II. Entrepreneurial Capital Formation

a. Introduction

Entrepreneurship matters. It fosters discovery and innovation.[5] 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.[6] Entrepreneurs bear a high degree of uncertainty and are the source of much of the dynamism in our economy.[7] New, start-up businesses account for much, if not most, of the net job creation in the economy.[8] 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 improvement and real income growth.[9] The vast majority of economic gains from innovation and entrepreneurship accrue to the public at large rather than entrepreneurs.[10] 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.[11] Entrepreneurship

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[5] 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).

[6] 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).

[7] 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).

[8] 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).

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

[10] 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.

[11] 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

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.[12] 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.[13] Other than friends or family, outside investors are typically described as "angel investors" or "venture capitalists."[14] Typically, "angel investors" are individuals who invest at the early "seed stage" 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.[15] 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, they have been of relatively minor importance largely due to the regulatory and statutory structure of these exemptions. Regulation D and other private offerings remain the most important source of capital for young, dynamic firms.

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.

[12] 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.

[13] 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).

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

[15] 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.

The 2012 JOBS Act[16] was a bipartisan achievement of consequence.[17] It substantially improved the laws governing entrepreneurial capital formation.[18] Although the implementation of the JOBS Act by the Commission was unnecessarily heavy-handed, the SEC has made some improvements in the regulatory environment for entrepreneurial capital formation over the past several years. Much more needs to be done by Congress, the Commission and other regulators.

b. Fundamental Reform

Summary of the Problem and Policy Analysis

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 improving 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);[19]
(6)-(7) small issuer Regulation A companies (two tiers);

[16] Jumpstart Our Business Startups Act, Public Law 112–106, April 5, 2012, http://www.gpo.gov/fdsys/pkg/PLAW-112publ106/pdf/PLAW-112publ106.pdf.
[17] 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, http://clerk.house.gov/evs/2012/roll110.xml, 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.
[18] 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#.
[19] 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.

(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.

Recommendations

It is worth considering a simplified set of exemptions. 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[20] traded (but some organized secondary market permitted).[21]
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.

[20] 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.

[21] See the discussion of secondary markets in the Regulation D section below.

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.[22] A company would be deemed private if it did not engage in general solicitation, was below some specified number of beneficial owners,[23] holders of record or, perhaps, some measure 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.[24]

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.[25]

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

[22] 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.

[23] 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. 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.

[24] 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.

[25] 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.

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,[26] some accredited investor limitations measuring wealth, income or sophistication could be applied to private offerings should policy 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.

For Further Information

1. David R. Burton, "Securities Disclosure Reform."[27]
2. David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth."[28]
3. Concept Release on Harmonization of Securities Offering Exemptions, Securities and Exchange Commission.[29]

Legislative Language

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)

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[26] 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 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.

[27] 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.

[28] 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.

[29] See the discussion of micro-offerings in 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.

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)[30]

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.

c. Finders and Private Placement Brokers

Summary of the Problem and Policy Analysis

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[31] business colleague or acquaintance, or as a friend or family member of the business owner. They are sometimes called private placement brokers,[32] 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 (e.g., 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.

[30] In addition, conforming amendments elsewhere in the Securities Act and the Securities Exchange Act would need to be made.
[31] Main Street business refers to a privately held, non-financial business.
[32] 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.

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 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.

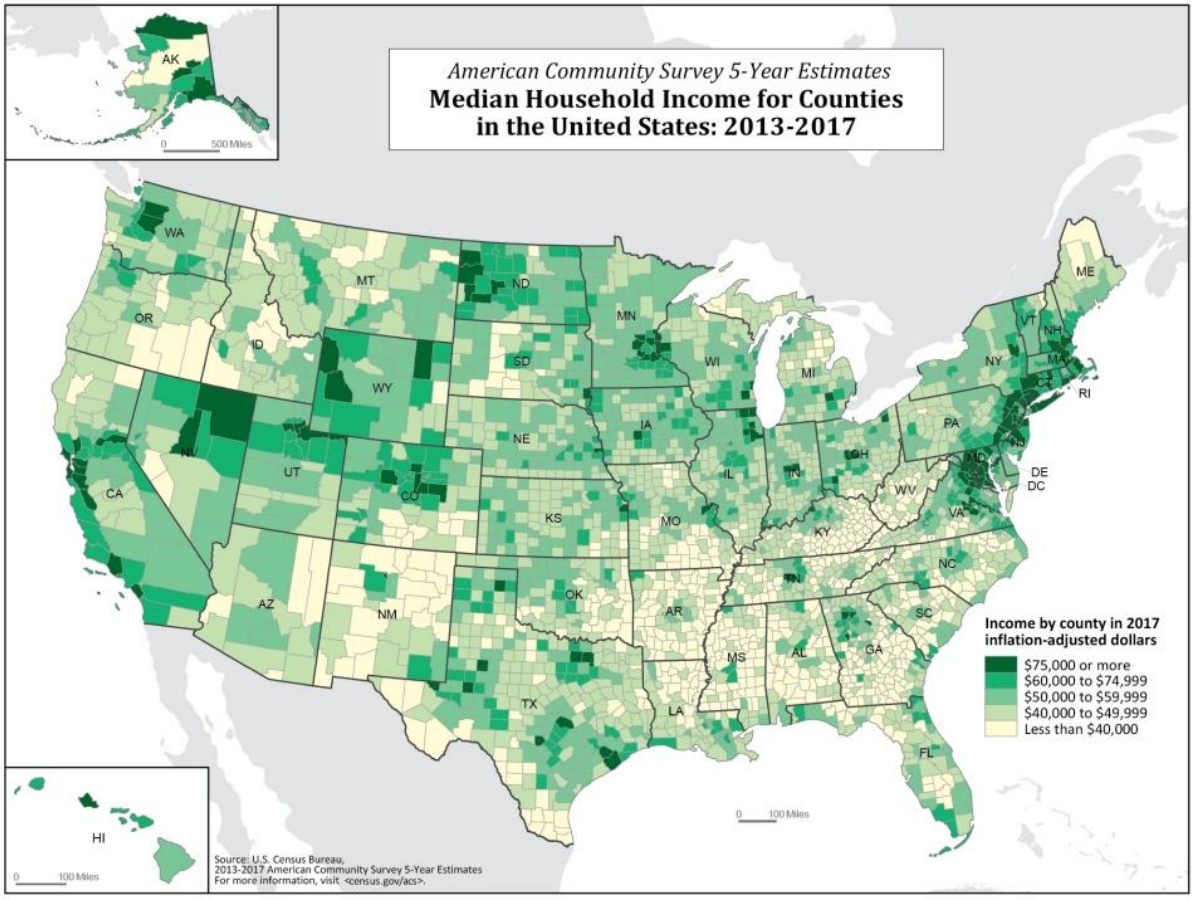
The map below illustrates this problem by mapping median household income. The differences between the high-income areas designated by dark green and low-income areas designated by yellow are differences of approximately 100 percent – a factor of two. High incomes are very geographically concentrated on the coasts and a few other large cities.

If the percentage of the population that qualified as an accredited investor were mapped by county, the differences would almost certainly be even more dramatic. Even many of the places marked dark green on this map (median household income >$75,000) 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[33] or metropolitan statistical areas to generate the map instead of county data.[34]

[33] 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.

[34] 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.

Figure 1



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."[35]

After two decades of procrastination and neglect by the Commission and its staff, the Commission last Autumn proposed an exemptive order[36] that would improve the existing situation. The proposed exemptive order is, however, markedly too narrow regarding the proposed Tier I finders category and should be improved. Its fate at the Commission is very much in doubt. Entrepreneurs

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

[36] 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; 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 .

cannot afford to wait another two decades for this problem to be favorably resolved. Congress should Act.

Recommendations

1. Enact legislation substantially along the lines of the "Unlocking Capital for Small Businesses Act."[37]

2. 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.

For Further Information

1. David R. Burton, "Let Entrepreneurs Raise Capital Using Finders and Private Placement Brokers.[38]
2. Comment Letter of David R. Burton regarding the Proposed Exemptive Order for Certain Activities of Finders.[39]
3. American Bar Association, "Report and Recommendations of the Task Force on Private Placement Broker–Dealers.[40]
4. Gregory C. Yadley, "Notable by their Absence: Finders and Other Financial Intermediaries in Small Business Capital Formation."[41]
5. 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," Securities and Exchange Commission.[42]

[37] The Unlocking Capital for Small Businesses Act of 2019 (H.R.3768, 116th) (Rep. Budd) https://www.congress.gov/116/bills/hr3768/BILLS-116hr3768ih.pdf.
[38] 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.
[39] 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.
[40] 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.
[41] 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.
[42] 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; 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 .

Legislative Language

The Unlocking Capital for Small Businesses Act of 2019 (H.R.3768, 116th Congress) introduced by Rep. Budd contains well-crafted statutory language that would solve the problem.[43]

d. Micro-offerings

Summary of the Problem and Policy Analysis

Section 4(a)(2) of the Securities Act exempts "transactions by an issuer not involving any public offering." There is no definition of a public offering or, conversely, of what is not a public offering (that is, a private placement) in the Securities Act or, for that matter, in the securities regulations. Thus, in principle, a few guys forming a small little business (such as a local restaurant) who are a little too public in seeking investors (for example, telling a local reporter about their plans when they run into him at the local high school football game, or standing up at the local Rotary Club meeting seeking partners) can run afoul of the securities laws.[44]

Every business in the country should not be roped into dealing the securities laws and the SEC. Some businesses are private enough, closely held enough and small enough that, absent fraud, the SEC simply should not be involved. That should be the point of this exemption. And there should be bright lines that non-specialists can read and be sure that these businesses are okay.

In this hyper-litigious country, given the potentially catastrophic impact that unjust enforcement of the law would entail, it is appropriate to create a bright-line safe harbor for very small offerings. If you are raising a small amount of money from a few people most of whom you know already, you should not have to hire a securities lawyer, do a private placement offering memorandum, and file a Form D or otherwise risk being pursued by federal or state regulators, or more likely, being successfully sued by disgruntled investors if the business fails or does not have the hoped for returns.

Recommendations

1. Congress should amend the Securities Act section 4 by adding a new subsection (f) to create a safe harbor under section 4(a)(2) for micro-offerings.

2. Alternatively, Congress should create a new exemption for micro-offerings under section 4(a) of the Securities Act by enacting a new section 4(a)(8).

[43] The Unlocking Capital for Small Businesses Act of 2019 (H.R.3768, 116th) https://www.congress.gov/116/bills/hr3768/BILLS-116hr3768ih.pdf.

[44] Assuming they do not have a substantial pre-existing relationship with everyone in the room. Now, if they comply with the investor verification procedures and make a compliant Rule 506(c) offering (by selling only to accredited investors), they could perhaps save their situation. The odds are, however, they will not even have heard of Rule 506 and not have the vaguest idea that their actions would be a violation of the securities laws. Getting a small investment from Uncle Fred who lives in the next state would mean than even the intrastate exemption would be unavailable.

For Further Information

1. David Burton, "Starting a Small Business Could Break This Federal Law."[45]
2. Concept Release on Harmonization of Securities Offering Exemptions, Securities and Exchange Commission.[46]
3. Comment Letter of David R. Burton regarding Concept Release on Harmonization of Securities Offering Exemptions.[47]
4. JD Alois, "Micro-Offering Exemption Passes House of Representatives, Next Up the Senate."[48]
5. Commissioner Daniel M. Gallagher, "Whatever Happened to Promoting Small Business Capital Formation?"[49]

Legislative Language

1. Congress should amend the Securities Act section 4 [15 U.S. Code § 77d] by adding a new subsection (f):

   "(f) Micro-Offerings.
   (1) Micro-Offering Safe Harbor. With respect to an exempted transaction described under subsection (a)(2), an offering shall be deemed not to involve a public offering for purposes of subsection (a)(2) if that offering involves the sale of securities by an issuer –

      (A) exclusively to people with whom the issuer (or its officers, directors, or 10 percent or more shareholders or ownership-interest holders) has a substantial pre-existing relationship; or
      (B) to 35 or fewer persons; or
      (C) the aggregate amount of which sold to all investors by the issuer within the prior 12-month period in reliance on the exemption provided by subsection (a)(2) does not exceed $500,000.

   (2) Micro-Offering Safe Harbor Non-Exclusive. The safe harbor provided by this subsection (f) shall not be the exclusive means for establishing that an offering does not involve a public offering for purposes of subsection (a)(2)."

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[45] 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/.
[46] See the discussion of micro-offerings in 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.
[47] 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.
[48] JD Alois, "Micro-Offering Exemption Passes House of Representatives, Next Up the Senate," *Crowdfund Insider*, November 9, 2017 https://www.crowdfundinsider.com/2017/11/124358-micro-offering-exemption-passes-house-representatives-next-senate/.
[49] Commissioner Daniel M. Gallagher, "Whatever Happened to Promoting Small Business Capital Formation?," September 17, 2014 https://www.sec.gov/news/speech/2014-spch091714dmg#.VFfbI8mGklQ.

2. Alternatively, Congress should create a new exemption under section 4(a) of the Securities Act by enacting a new section 4(a)(8):

"(8) transactions involving sales by an issuer –

(A) exclusively to people with whom the issuer (or its officers, directors, or 10 percent or more shareholders or ownership-interest holders) has a substantial pre-existing relationship; or
(B) to 35 or fewer persons; or
(C) the aggregate amount of which sold to all investors by the issuer within the prior 12-month period in reliance on the exemption provided by this paragraph does not exceed $500,000.

The *original* Micro Offering Safe Harbor Act (H.R. 4850, 114th Congress) introduced by Rep. Emmer contains statutory language that would solve the problem.[50] *The version reported out of committee and passed by the House (as Title II of the Accelerating Access to Capital Act of 2016 (H.R. 2357)) is much too narrow, imposes various conditions on the exemption and would do little to address the problem.* H.R. 4850 creates a separate micro-offering exemption rather than a safe harbor under the section 4(a)(2) private offering exemption. Either approach would work but the safe harbor approach is conceptually stronger.

e. Improvements to Regulation D

i. Introduction

Section 4(a)(2) of the Securities Act exempts "transactions by an issuer not involving any public offering."[51] Prior to the JOBS Act, the exemption was in §4(2). This exemption is typically called the "private placement" or "private offering" exemption.

Private offerings are the most important source of capital for American businesses, accounting for *at least* $2.9 trillion in raised capital annually.[52] By comparison, registered (public) offerings raised less than half of that amount ($1.4 trillion).[53] Regulation D is the most important means of raising private capital amounting to approximately $1.7 trillion in 2018.[54] Regulation D is lightly regulated and a tremendous success. The SEC adopted Regulation D in 1982 during the Reagan

[50] Micro Offering Safe Harbor Act (H.R. 4850, 114th Congress) https://www.congress.gov/114/bills/hr4850/BILLS-114hr4850ih.pdf.
[51] 15 U.S. Code § 77d(a)(2)
[52] SEC "Concept Release on Harmonization of Securities Offering Exemptions," *Federal Register*, Vol. 84, No. 123, June 26, 2019, p. 30466, Table 2 — Overview of Amounts Raised in the Exempt Market in 2018 https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13255.pdf.
[53] SEC "Concept Release on Harmonization of Securities Offering Exemptions," *Federal Register*, Vol. 84, No. 123, June 26, 2019, p. 30465, Figure 1: Capital Raised in Exempt and Registered Capital Markets, 2009-2018 https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13255.pdf.
[54] Ibid., p. 30466, Table 2. See also David R. Burton, "Don't Crush the Ability of Entrepreneurs and Small Businesses to Raise Capital," Heritage Foundation Backgrounder No. 2874, February 5, 2014 https://thf_media.s3.amazonaws.com/2014/pdf/BG2874.pdf.

Administration.[55] It is not an overstatement to say that our economy would not be recognizable without Regulation D. Damaging Regulation D would harm the dynamism of our economy in incalculable ways and have an adverse impact on tens of millions of working men and women and consumers.

The estimates for section 4(a)(2) below are almost certainly substantially lower than the actual amount because the SEC used Thomson Financial's SDC Platinum,[56] which uses information from underwriters, issuer websites, and issuer SEC filings, to quantify section 4(a)(2) raises. It will not capture the amounts raised by typical small businesses throughout the country from family, friends and angel investors. These small business owners raise capital using the section 4(a)(2) exemption – usually without knowing the exemption even exists. Also, while Regulation A and crowdfunding are "exempt offerings" in the sense that they are not "registered offerings" they are not really private offerings either. They are best thought of as quasi-public offerings.

Table 1
Amounts Raised in the Exempt and Registered Market in 2018 ($ billions)

Offering Type	Amount Raised	Amount Raised (Subcategories)
Registered (Public)	$1,400	
Exempt (Private)	$2,912	
Rule 506(b) of Regulation D		$1,500
Rule 506(c) of Regulation D		$211
Regulation A: Tier 1		$0.061
Regulation A: Tier 2		$0.671
Regulation Crowdfunding		$0.055
Rule 504 of Regulation D		$0.002
Other exempt offerings (section 4(a)(2), Regulation S, and Rule 144A offerings)		$1,200

Source: Securities and Exchange Commission, *Concept Release on Harmonization of Securities Offering Exemptions*

There is no definition in the Securities Act or the Securities Exchange Act or, for that matter, in the securities regulations, of a "public offering" or, conversely, of what is not a public offering. Investors and their attorneys must rely on various court cases, SEC interpretive releases, SEC concept releases, SEC policy statements, SEC staff interpretations, SEC staff legal bulletins, and SEC "no action" letters to make judgments about what will be deemed a public offering. The leading Supreme Court case interpreting this statutory provision is *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). In that 1953 case, the court held that "the applicability of §4(1) [now §4(a)(2)] should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'" This "fend for themselves" formulation is highly suspect in that, whether or

[55] "Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers of Sales" (Release No. 33-6389), *Federal Register*, No. 47 (March 16, 1982), p. 11251. Regulation D is found at 17 C.F.R. §230.500 through §230.508. See "Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1993 for Transactions Involving Limited O ers of Sales" (Release No. 33-6339), *Federal Register*, No. 46 (August 18, 1981), p. 41791, for the original proposed rule.
[56] Ibid p. 30466, at footnote 41.

not an offering is "public" is analytically unrelated to whether or not the investors in the offering can "fend for themselves." For example, an offering to one utterly unsophisticated person wholly incapable of fending for himself with whom there is a substantial pre-existing relationship is not public in any meaningful sense. (For instance, when the CEO's never-employed son who was a poetry major in college is the sole offeree.) Conversely, an offering limited to those demonstrably able to "fend for themselves" (by whatever measure) conducted on national television and with whom there was no pre-existing relationship is certainly public in the ordinary sense of the term (and the authors of the Securities Act of 1933 undoubtedly intended for it to be treated as such).

Although private offerings do not necessarily have to be in compliance with Regulation D, Regulation D provides a regulatory safe harbor such that if an issuer meets the requirements of Regulation D, the issuer will be treated as having made a private offering. Because it is a relatively easy, straight-forward means of ensuring that an offering will be deemed a private placement and because Rule 506 offerings do not need to comply with state blue sky registration and qualification rules, Regulation D Rule 506 offerings have become the most common choice for those raising significant amounts of private capital.

ii. Democratize Access to Regulation D (Accredited Investor Definition)

Summary of the Problem and Policy Analysis

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.[57] 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.

Recommendation

Congress should provide that a natural person is an accredited investor for purposes of Regulation D who has:

> (1) passed a test demonstrating the requisite knowledge, such as the General Securities Representative Examination (Series 7), the Securities Analysis Examination (Series 86), or the Uniform Investment Adviser Law Examination (Series 65)[58]or a newly created accredited investor examination testing for substantive investment knowledge;
>
> (2) met relevant educational requirements, such as an advanced degree in finance, accounting, business, economics or entrepreneurship; or

[57] 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.
[58]Financial Industry Regulatory Authority, "Series 7 Exam – General Securities Representative Examination (GS)," http://www.finra.org/industry/compliance/registration/qualificationsexams/qualifications/p011051.

(3) acquired relevant professional certification, accreditation, or licensure, such as being a certified public accountant, chartered financial analyst, certified financial planner, registered representative or registered investment advisor representative.[59]

For Further Information

1. David R. Burton, "Congress Should Increase Access to Private Securities Offerings."[60]
2. Thaya Brook Knight, "Your Money's No Good Here: How Restrictions on Private Securities Offerings Harm Investors."[61]
3. David R. Burton, "Broadening Regulation D: Congress Should Let More People Invest in Private, High-Growth Companies."[62]

Legislative Language

Amend Securities Act of 1933 section 2(a)(15) [15 U.S. Code §77b(a)(15)] by adding new paragraphs (iii) through (vi) as follows:

"(iii) any natural person who is currently licensed or registered as a broker, dealer, registered representative, investment adviser, or investment adviser representative by the Commission, the Financial Industry Regulatory Authority, or another self-regulatory organization, as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)), or the securities division of a State or the equivalent State division responsible for licensing or registration of individuals in connection with securities activities;

(iv) any natural person who has passed an examination demonstrating sufficient knowledge in financial and business matters to evaluate the merits and risks of a prospective investment, including but not limited to –

(A) the examination administered by the Financial Industry Regulatory Authority for an individual to qualify as a registered representative,[63] and

(B) an examination created by the Financial Industry Regulatory Authority or another self-regulatory organization, as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) which any natural person may take to

[59] The Commission recently took a potentially important step in this direction. See 17 CFR § 230.501(a)(10) and "Order Designating Certain Professional Licenses as Qualifying Natural Persons for Accredited Investor Status," Securities and Exchange Commission, *Federal Register*, Vol. 85, No. 197, October 9, 2020 pp. 64234-64278 https://www.govinfo.gov/content/pkg/FR-2020-10-09/pdf/2020-19189.pdf. Time will tell whether the Commission takes significant steps to allow sophisticated persons with private credentials to qualify as accredited.

[60] 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.

[61] 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.

[62] 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.

[63] Financial Industry Regulatory Authority, "Series 7 Exam – General Securities Representative Examination (GS)," http://www.finra.org/industry/compliance/registration/qualificationsexams/qualifications/p011051.

demonstrate sufficient knowledge of financial and business matters to evaluate the merits and risks of a prospective investment.

(v) any natural person upon whom has been conferred –

(A) a graduate degree from an accredited educational institution in finance, accounting, business, business management, business administration, economics or entrepreneurship, or

(B) any other degree from an accredited educational institution that the Commission may designate under this paragraph as demonstrating sufficient knowledge of financial and business matters to evaluate the merits and risks of a prospective investment;

(vi) any natural person who has acquired professional certification, designation, accreditation, credential or licensure as –

(A) a certified public accountant,

(B) other professional certification, designation, accreditation, credential or licensure that --

(1) arises out of an examination or series of examinations administered by --

(i) a self-regulatory organization,

(ii) a private professional organization or industry body,

(iii) an accredited educational institution, or

(iv) a government;

(2) the examination or series of examinations is designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing;

(3) persons obtaining such professional certification, designation, accreditation, credential or licensure can reasonably be expected to have sufficient knowledge in financial and business matters to evaluate the merits and risks of a prospective investment; and

(4) An indication that an individual holds the certification, designation accreditation, credential or licensure is either made publicly available by the relevant self-regulatory organization, private professional organization or industry body, accredited educational institution or government or is otherwise independently verifiable."

See also S. 2756, 115th Congress (Sen. Tillis).

iii. Self-Certification

Summary of the Problem and Policy Analysis

Rule 506(c) accounts for only about 12 percent of the capital raised using Regulation D.[64] The primary impediment to the use of Rule 506(c) is probably the income verification requirements.

[64] See Table 1 above.

The final rule implementing Title II of the JOBS Act[65] created a safe harbor that inevitably, in practice, became the rule. Thus, "reasonable steps to verify" 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.

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).[66] Neither in the 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.

Should policymakers choose not to allow simple self-certification, it would be possible to remove many of the problems associated with the SEC rule while still addressing unease that traditional

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

[66] 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;
> (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.

self-certification is inadequate. This would be accomplished by requiring investors to make their self-certifications under penalty of perjury. This would make investors less willing to lie on their certifications to issuers since a criminal penalty for doing so would attach to their fraudulent behavior.

Section 1746 of Title 28 authorizes this approach. It reads:

> 28 USC §1746
>
> Unsworn declarations under penalty of perjury. Wherever, under any law of the United States or under any rule, regulation, order, or requirement made pursuant to law, any matter is required or permitted to be supported, evidenced, established, or proved by the sworn declaration, verification, certificate, statement, oath, or affidavit, in writing of the person making the same (other than a deposition, or an oath of office, or an oath required to be taken before a specified official other than a notary public), such matter may, with like force and effect, be supported, evidenced, established, or proved by the unsworn declaration, certificate, verification, or statement, in writing of such person which is subscribed by him, as true under penalty of perjury, and dated, in substantially the following form:
>
> (1) If executed without the United States: "I declare (or certify, verify, or state) under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on (date).
> (Signature)
> (2) If executed within the United States, its territories, possessions, or commonwealths: "I declare (or certify, verify, or state) under penalty of perjury that the foregoing is true and correct. Executed on (date).
> (Signature)

Recommendation

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 for Rule 506(c) offerings.

Legislative Language

Amend Securities Act section 4(b) [15 U.S. Code § 77d(b)] by adding at the end thereof a sentence reading:

"Unless the issuer knows or has reason to know that a purchaser is not an accredited investor, obtaining a self-certification from the purchaser that the purchaser meets the income or net worth requirements of Rule 501 of Regulation D shall constitute reasonable steps to verify that purchasers of the securities are accredited investors."

or

"Unless the issuer knows or has reason to know that a purchaser is not an accredited investor, obtaining a self-certification from the purchaser under penalty of perjury (in conformance with the requirements of section 1746 of Title 28) that the purchaser meets the income or net worth requirements of Rule 501 of Regulation D shall constitute reasonable steps to verify that purchasers of the securities are accredited investors."

iv. Secondary Markets

There is a strong need to improve the secondary market for Regulation D and other private securities. JOBS Act 201(c) and Securities Act section 4(a)(7) and section 4(d) are attempts to address this problem. They need improvement and simplification. We will provide specific suggestions to the Committee at a later date.

f. Improvements to Regulation CF

i. Introduction

The story of the investment crowdfunding exemption (Title III of the JOBS Act implemented by Regulation CF) is an object lesson in how a simple, constructive idea can be twisted by the Washington legislative process into a complex morass. Representative Patrick McHenry introduced his Entrepreneur Access to Capital Act on September 14, 2011.[67] It was a mere three pages and less than one page if the actual legislative language were pasted into a Word document. It would have allowed issuers to raise up to $5 million, and limited investors to making investments of the lesser of $10,000 or 10 percent of their annual income.[68] The exemption would have been self-effectuating, requiring no action by the SEC in order to be legally operative. The bill that was reported out of Committee and ultimately passed by the House was 14 pages long.[69] By the time the Senate was done with it, it had grown to 26 pages.[70] Many of the additions were authorizations for the SEC to promulgate rules or requirements that it do so. The bill was incorporated into the JOBS Act as Title III of the Act. The PDF of the October 23, 2013, proposed crowdfunding rule was 585 pages (although double spaced) and sought public comments on well over 300 issues raised by the proposed rule.[71] The PDF of the final rule (effective May 16, 2016) was 685 pages long.[72] This is far from the simple, straight-forward means of raising capital for small businesses laid out in Representative McHenry's original bill.

University of Florida law professor Stuart Cohn put it this way:

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[67] H.R. 2930, 112th Congress, http://www.gpo.gov/fdsys/pkg/BILLS-112hr2930ih/pdf/BILLS-112hr2930ih.pdf.
[68] It also excluded crowdfunding investors from the holders of record count, pre-empted blue sky laws, and entitled issuers to rely on investor self-certification for income level.
[69] H.R. 2930, 112th Congress.
[70] Senate Amendment to Title III of H.R. 3606, http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606eas/pdf/BILLS-112hr3606eas.pdf.
[71] There were 284 requests for comment, but many of them are multipart requests. Securities and Exchange Commission, "Proposed Rules: Crowdfunding," October 23, 2013, http://www.sec.gov/rules/proposed/2013/33-9470.pdf.
[72] Securities and Exchange Commission, Final Rule, "Crowdfunding," *Federal Register*, Vol. 80, No. 220 (November 16, 2015), https://www.sec.gov/rules/final/2015/33-9974.pdf.

> Is there any regulatory burden left unchecked by this supposedly favorable-to-small-business legislation? If so, Congress put icing on the cake by authorizing the SEC to make such other requirements as the Commission prescribes for the protection of investors .... Opportunity knocked, but what began as a relatively straightforward approach to assist small business capital formation ended with a regulatory scheme laden with limitations, restrictions, obligations, transaction costs and innumerable liability concerns.[73]

The primary advantage of crowdfunding is that it enables small firms to access small investments from the broader public (that is, from non-accredited investors) and that resale of the stock will not be restricted after one year. In addition, crowdfunding shareholders are excluded from the count for purposes of the section 12(g) limitation relating to when a company must become a reporting company and crowdfunding securities are treated as covered securities (that is, blue sky registration and qualification laws are pre-empted for crowdfunding offerings).

In 2017 one of us (David Burton) expressed these concerns:

> If, however, the regulatory costs associated with crowdfunding are too high, issuers will either use other means to raise capital or be unable to raise capital at all. Moreover, ordinary investors will be denied the opportunity to make these investments. This is no idle possibility. The history of the small-issues exemption (Regulation A), and Regulation D Rule 504 and Rule 505, demonstrates that overregulation can destroy the usefulness of an exemption. Given the structure of the underlying statute and the proposed rule, there is strong reason to doubt whether Title III crowdfunding will achieve the promise of the original idea.[74]

These concerns were well founded. In 2018, as shown in Table 1 above, only $55 million was raised using crowdfunding. The Senate amendment to Title III of the JOBS Act and the Commission's enthusiasm for adding ever more rules virtually killed Title III crowdfunding. Earlier this year, the SEC, using its generally exemptive authority, took some steps that may improve the situation.[75] These new rules were effective a few days ago -- March 15, 2021.

The final rule increased the maximum amount companies can raise from $1.07 million to $5 million. It removed investment limits for accredited investors and liberalized the investment limits for non-accredited investors by using the greater of their annual income or net worth when calculating the limit. The rule also permits "test-the-waters" communications in crowdfunding offerings.

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[73] Stuart R. Cohn, "The New Crowdfunding Registration Exemption: Good Idea, Bad Execution," *Florida Law Review*, Vol. 64, No. 5 (October 2012), pp. 1143 and 1145, http://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1032&context=flr.

[74] 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

[75] "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets," 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.

ii. Statutory Limit

Under section 4(a)(6) of the Securities Act, the statutory crowdfunding exemption is $1 million adjusted periodically for inflation. Under Regulation CF, as amended, the maximum offering limit is $5 million during any 12-month period.[76] This amount reflects the recent amendments to Regulation CF under the Commission's general exemptive authority. The statutory limit should be conformed to the new limit in Regulation CF.

iii. Audit Requirements

Similarly, under section 4A(b)(1)(D) of the Securities Act, those issuers raising more than $500,000 during any 12-month period must produce audited financial statements. Under Regulation CF, as amended, the requirement to produce audited financial statements does not apply until more than $1,070,000 during any 12-month period.[77] Audited financial statements can be quite expensive and requiring audited rather than reviewed financial statements for very small issuers should not be required. The statutory audit requirement should be conformed to the new limit in Regulation CF.

iv. Funding Portal Liability for Issuer Misstatements

Summary of the Problem and Policy Analysis

Funding portals are not issuers and should not be required to become general insurers liable for the misstatements of issuers using their funding portal. SEC staff have indicated that Regulation CF, presumably Rule 301, treats funding portals as issuers, effectively turning the funding portals into insurers of issuers against fraud by issuers that use their funding portal. This dramatically increases the risk that funding portals face and makes funding portals a much less viable alternative to a broker-dealer. Funding portals are intermediaries not issuers. Funding portals should only be liable for fraud or misrepresentation if they participated in the fraud or were negligent in discharging their due diligence obligations.

Recommendation

Clarify funding portal liability for the misstatements of issuers.

Legislative Language

> "1. Liability of Funding Portals
>
> LIABILITY OF FUNDING PORTALS. — For purposes of this subsection, an intermediary shall not be considered an issuer unless, in connection with the offer or sale of a security, an intermediary knowingly —

[76] 17 CFR §227.100(a)(1).
[77] 17 CFR §227.201(t)(3).

(A) made any untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

(B) engaged in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.".

This language is from section 3 of H. R. 4855, 114th Congress, the Fix Crowdfunding Act (Rep. McHenry) *as introduced*, with one change.[78]

2. Definition of Issuer

Amend section 4A(c)(3) [15 U.S. Code § 77d–1(c)(3)] of the Securities Act by adding at the end:

"As used in this subsection, the term "issuer" does not include any person who is a broker or funding portal except with respect to securities of the entity (or its parents, subsidiaries, affiliates or other related parties) operating the broker or funding portal."

v. Funding Portal Anti-Money Laundering Compliance

Summary of the Problem and Policy Analysis

Funding portals do not handle customer funds; the JOBS Act prohibits them from doing so.[79] The banks and broker-dealers that do handle customer funds must comply with AML rules. Requiring funding portals to also do so is duplicative and unnecessary. At various times, three agencies have proposed imposing AML requirements on funding portals even though they are prohibited from holding customer funds: (1) Treasury's Financial Crimes Enforcement Network (FinCEN), (2) the Financial Industry Regulatory Authority (FINRA) and (3) the SEC.[80] FINRA and the SEC originally proposed requiring funding portals to comply with the anti-money-laundering rules but did not include the requirement in their final rules. The proposed FinCEN rule has never been finalized.

AML compliance is complex and expensive. Requiring funding portals to comply AML rules would be duplicate and wasteful. It would have a substantial adverse impact on the economics of operating a funding portal.

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[78] H. R. 4855, 114th Congress https://www.congress.gov/bill/114th-congress/house-bill/4855/text/ih.
[79] Securities Exchange Act, Section 3(a)(80)(D).
[80] Proposed Rule, "Amendments to the Definition of Broker or Dealer in Securities," Federal Register, Vol. 81, No. 64 (April 4, 2016), pp. 19086–19094 https://www.fincen.gov/sites/default/files/federal_register_notices/2017-03-29/FINCEN%20Definition%20of%20Broker%20Dealer%20%28Crowdfunding%29.pdf. Regulatory Notice 13-34, "FINRA Requests Comment on Proposed Funding Portal Rules and Related Forms," October 2013, and 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.

For Further Information

1. Comment Letter of David R. Burton regarding Proposed FINRA Funding Portal Rules.[81]
2. Comment Letter of David R. Burton regarding Proposed SEC Crowdfunding Rule.[82]
3. Comment Letter of David R. Burton regarding FinCEN Proposed Amendments to the Definition of Broker or Dealer in Securities.[83]

Recommendation

Congress should make it clear that funding portals need not comply with AML rules because they do not hold customer funds.

Legislative Language

Amend Securities Act section 4A(a) [15 U.S. Code § 77d–1(a)] to add a new paragraph:

"(13) not be required to maintain the records and make the reports relating to monetary instruments transactions required by Subchapter II of Chapter 53 of Subtitle IV of Title 31."

Amend the Bank Secrecy Act such that 31 U.S. Code §5312(a)(2) (relating to the definition of financial institution) is amended by adding at the end thereof:

"and does not include funding portals (as defined by Securities Exchange Act, Section 3(a)(80))."

vi. Funding Portal Curation

Summary of the Problem and Policy Analysis

Funding portals are prohibited under Regulation CF from offering "investment advice or recommendations."[84] Moreover, funding portals are required to "take such measures to reduce the risk of fraud with respect to such transactions, as established by the Commission, by rule."[85] How, exactly, the portals are to reduce the risk of fraud and limit their own liability without adopting a position on the merit or lack thereof of any potential offerings is a congressionally created mystery that the SEC attempts to solve in Regulation CF. As much as we all like a good mystery, in this case Congress should dispense with the mystery by making it clear that funding portals may curate their offerings.

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[81] Comment Letter of David R. Burton regarding proposed FINRA Funding Portal Rules, February 3, 2014 https://www.finra.org/sites/default/files/NoticeComment/p443447.pdf

[82] Comment Letter of David R. Burton regarding Crowdfunding Proposed Rule, February 3, 2014, p.10 https://www.sec.gov/comments/s7-09-13/s70913-192.pdf

[83] Comment Letter of David R. Burton regarding Amendments to the Definition of Broker or Dealer in Securities, June 3, 2016 https://downloads.regulations.gov/FINCEN-2014-0005-0006/attachment_1.pdf

[84] Securities Exchange Act, Section 3(a)(80)(A); 17 CFR §227.300(c)(2)(i). For a discussion of issues surrounding the provision of investment advice, see Securities and Exchange Commission, "Study on Investment Advisers and Broker-Dealers," January 2011, http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[85] Securities Act, Section 4A(a)(5).

Assuming that policymakers want to retain the prohibition on personalized "investment advice," a potential solution to the existing statutory cross purposes would be to allow funding portals to provide "impersonal investment advice" as defined in the investment advisers Rule 203A, to wit, "investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts."[86] Applying the distinction between "impersonal" and "personalized" investment advice in the funding portal context would permit responsible curation where a funding portal chose to exclude certain offerings from its platform but did not suggest specific investments. Congress should either repeal the restriction on providing investment advice entirely or explicitly permit "impersonal investment advice."

It should also be clear that a portal may bar an issuer from its platform if the portal deems an offering to be of inadequate quality without fear of liability to issuers or investors, and that this would not constitute providing prohibited investment advice.

Recommendations

1. Allow curation by funding portals by repealing restrictions on investment advice.
2. Alternatively, allow "impersonal investment advice" by funding portals.

Legislative Language

1. Amend Securities Act section 4A(a)(5) by adding at the end thereof:

"and bar an issuer from the intermediary's funding platform (as defined in Securities Exchange Act section 3(a)(80)) that in the judgement of the intermediary poses a heightened risk of fraud or non-compliance with the securities laws.

2a. Repeal Securities Exchange Act section 3(a)(80)(A).[87]

or

2b. Amend section 3(a)(80)(A) to read:

"offer personalized investment advice or recommendations provided, however, that investment advisory services by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts may be provided;"

See also section 3 of H. R. 4855, 114th Congress, the Fix Crowdfunding Act (Rep. McHenry) *as introduced*.[88] See also, for less desirable statutory language, subtitle P of H.R.10, 115th Congress, the Financial CHOICE Act of 2017, passed by the House.

[86] § 275.203A-3(a)(3)(ii).
[87] Because of a drafting error in the JOBS Act, there are two sections 3(a)(80). The one to be amended is the section relating to funding portals.
[88] H. R. 4855, 114th Congress https://www.congress.gov/bill/114th-congress/house-bill/4855/text/ih.

vii. S Corporations and Title III Crowdfunding (and Regulation A)

Summary of the Problem and Policy Analysis

If an S corporation is raising small amounts of capital from a large number of investors using either the crowdfunding exemption or Regulation A, it will quickly have more than 100 shareholders and be disqualified as an S corporation. That means the corporation will be taxed at both the entity level and the shareholder level. A company that raises $1,000 each from 101 shareholders will have raised only $101,000 but no longer be eligible for S corporation status.

Well-advised S corporations cannot practically use crowdfunding or Regulation A. They will then have to either use less attractive means of raising capital or do without the investment altogether. Less well-advised S corporations will use crowdfunding to raise capital and then find, when they consult with an accountant to file their tax return, that they are no longer qualified to be an S corporation and may owe a large amount of tax.

Recommendation

1. Amend Section 1361(c) of the Internal Revenue Code to disregard crowdfunding and Regulation A shareholders for purposes of the 100 shareholder limit for Subchapter S corporations.

For Further Information

1. David Burton, "The Tax Law Makes It Almost Impossible for 'S Corporations' to Use Equity Crowdfunding."[89]

Legislative Language

See H.R.4831, 114th Congress (Rep. Hill).

g. Improvements to Regulation A

i. Introduction

The Securities Act section 3(b) small issues exemption is implemented by Regulation A.[90] Prior to passage of the 2012 JOBS Act, the Commission had very nearly killed Regulation A.[91] In 2011,

[89] David Burton, "The Tax Law Makes It Almost Impossible for 'S Corporations' to Use Equity Crowdfunding," *Daily Signal*, April 19, 2016 https://www.dailysignal.com/2016/04/19/the-tax-law-makes-it-almost-impossible-for-s-corporations-to-use-equity-crowdfunding/.

[90] Regulation A - Conditional Small Issues Exemption (17 CFR §230.251 et seq.).

[91] 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*

only one Regulation A offering was completed.[92] Title IV of the JOBS Act gave it new life with what is sometimes known as Regulation A plus. Yet the amount raised using Regulation A is a disappointment – albeit a predictable one.[93] In 2018, Regulation A accounted for less than 1/10 of one percent of the capital raised in the exempt market.[94] Two Commission decisions have been the primary reason. Probably the most important reason was the Commission's decision to not preempt blue sky laws for Tier 1 offerings or Tier 2 secondary offerings. Tier 2 primary offerings, however, are not subject to blue sky qualification requirements. This decision to not preempt has meant that secondary markets have largely failed to develop, making the exemption relatively unattractive because investors have no cost-effective means of selling their investment. It has had a very substantial negative impact on Tier 1 offerings (only $61 million in 2018) and hurt Tier 2 ($675 million in 2018).[95] The fact that even relatively small offerings use Tier 2, that 2/3 of the offerings are Tier 2 and that about 90 percent of the capital is raised using Tier 2 all point to the negative impact of the Commission's decision regarding blue sky laws.[96] The NASAA coordinated review program is a failure and should be acknowledged as such. A secondary reason is the Commission's decision to add, on its own initiative, bureaucratic and costly rules limiting the amount an investor may invest in a Regulation A offering by income or net worth.

It is no accident that the vast majority of capital raised in the U.S. is raised in offerings where blue sky registration and qualification requirements are preempted (i.e. where the securities offered are covered securities).[97]

If the blue sky preemption issues and the income or net worth limitations were addressed, Regulation A could become a leading means for ordinary investors to invest in entrepreneurial companies.

ii. Protecting Investors with Primary and Secondary Offering Blue Sky Preemption

Summary of the Problem and Policy Analysis

See the previous section and the "For Further Information" section below for a discussion of the damage done by blue sky registration and qualification requirements.

The NASAA coordinated review program is a failure and should be acknowledged as such. It introduces substantial costs and delays and key states do not participate. The Commission should review the offering and there is no need for multitudinous state regulator reviews, many of whom engage in merit review. Blue sky laws relating to qualification and registration should be

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Journal of Law and Business, Vol 4, pp. 1-87 (Fall 2007) https://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1257&context=facultypub.

[92] "Factors That May Affect Trends in Regulation A Offerings," United States Government Accountability Office, July 2012 (GAO-12-839) https://www.gao.gov/assets/gao-12-839.pdf.

[93] David R. Burton, Comments, "Proposed Rule Amendments for Small and Additional Issues Exemptions under Section 3(b) of the Securities Act," March 21, 2014 https://www.sec.gov/comments/s7-11-13/s71113-52.pdf.

[94] See Table 1 above.

[95] Concept Release, Table 2.

[96] For statistics, see Concept Release, Table 8.

[97] Securities Act section 18(b)(4)(C) [15 U.S. Code § 77r(b)(4)(C)].

preempted. And the states should get out of the business of imposing fees on entrepreneurs seeking to raise capital.

Most states do an exceeding good job of hiding the revenue they receive from issuers from fees or taxes associated with registration and qualification. The amounts are usually not to be found in budgets presented to the legislature or on the state securities commission websites. This is deeply ironic given state regulators' role in ensuring that issuers fairly disclose material information. State regulators impose billions of dollars in costs on entrepreneurs and other issuers, costs that are ultimately borne by investors and the public at large. The public and federal policymakers should know how much. Undoubtedly one of the reasons – probably the most important reason by far – that state regulators resist preemption so vehemently is that it will cost them money. Congress should mandate two studies, an annual report by the SEC and a one-time study by the GAO. These studies should collect and report data from state regulators on the fees or taxes they collect from issuers. These studies should collect data from at least 2017-2020 and classify the fees and taxes collected from issuers by offering type.

Recommendations

1. Blue sky registration and qualification requirements for all primary and secondary offerings of any Regulation A offering should be preempted.
2. 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 2017-2020 and classify the fees and taxes collected from issuers by offering type.

For Further Information

1. David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth."[98]
2. Concept Release on Harmonization of Securities Offering Exemptions, Securities and Exchange Commission.[99]
3. Comment Letter of David R. Burton regarding *Concept Release on Harmonization of Securities Offering Exemptions*.[100]
4. Comment Letter of David R. Burton regarding Proposed Rule "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets."[101]

[98] 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.

[99] See the discussion of micro-offerings in 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.

[100] 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.

[101] 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.

5. Rutheford B Campbell, Jr., "Regulation A: Small Businesses' Search for a Moderate Capital."[102]
6. Rutheford B. Campbell Jr., "The Case for Federal Pre-Emption of State Blue Sky Laws."[103]
7. Stuart R. Cohn and Gregory C. Yadley, "Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns."[104]
8. Comment Letter of David R. Burton regarding Proposed Rule "Amendments for Small and Additional Issues Exemptions under Section 3(b) of the Securities Act.".[105]

Legislative Language

1. Amend Securities Act section 18(b)(4)(C) [15 U.S. Code § 77r(b)(4)(C)] by adding a new subparagraph (H):

"(H) section 15 U.S. Code §77c(b) of this title."

2. Amend Securities Act section 18(b)(1) by adding a new subparagraph (C):

"(C) a security that was offered pursuant to –

(i) section 3(b) of the Securities Act of 1933 [15 U.S. Code §77c(b)][106] (or is the same class of security in all respects as said security), or
(ii) section 4(a)(6) of Securities Act of 1933 [15 U.S. Code §77d(a)(6)][107] (or is the same class of security in all respects as said security)

and is listed, authorized for listing, or otherwise traded on –

(i) a national securities exchange (or tier or segment thereof), or
(ii) an alternative trading system (as defined in 17 CFR §242.300).

Note: See discussion below under the section heading "Better Public Markets, Blue Sky Pre-emption and Covered Securities" regarding a new subparagraph (D).

3. 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

[102] 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.
[103] 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.
[104] 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.
[105] Comment Letter of David R. Burton regarding Proposed Rule "Amendments for Small and Additional Issues Exemptions under Section 3(b) of the Securities Act." March 21, 2014 https://www.sec.gov/comments/s7-11-13/s71113-52.pdf.
[106] The Small Issues Exemption (Regulation A).
[107] Crowdfunding (Regulation CF).

from at least the years 2017-2020 and classify the fees and taxes collected from issuers by offering type.

iii. Exemption from the Section 12(g) Holder-of-record Limitations

Summary of the Problem and Policy Analysis

17 CFR § 240.12g5-1(a)(7) (relating to the definition of securities "held of record") generally excludes shareholders from Tier 2 Regulation A offerings from the holder of record count for purposes of Securities Exchange Act section 12(g). This provision should be broadened to include all Regulation A offerings (i.e. both Tier 1 and Tier 2). This provision prevents small companies that raised capital from a large number of small investors investing small amounts from having to "go public" and become a fully registered company and incur the massive expense involved in doing so. The Securities Exchange Act section 12(g)(1)(A)(ii) limit is 500 persons who are not accredited investors.

Recommendation

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

For Further Information

See section "Improvements to Regulation A, Protecting Investors with Primary and Secondary Offering Blue Sky Preemption" above.

Legislative Language

Securities Exchange Act section 12(g)(6) should be amended to read as follows:

"(6) EXCLUSION FOR PERSONS HOLDING CERTAIN SECURITIES. —
The Commission shall, by rule, exempt from the provisions of this subsection securities acquired pursuant to an offering made under —
(A) section 4(a)(6) of the Securities Act of 1933, or
(B) section 3(b) of the Securities Act of 1933."

iv. Investor Limitations

Summary of the Problem and Policy Analysis

Notwithstanding the absence of such a requirement in Securities Act section 3(b), when the Commission adopted post JOBS Act Regulation A amendments it imposed on Tier 2 offerings an investor limitation such that the maximum investment by non-accredited investors was limited. It is now ten percent of the greater of such purchaser's annual income or net worth (see 17 CFR § 230.251(d)(2)(i)(C)). This limit is paternalistic and imposes significant costs on issuers. It is not

warranted by the underlying statute. It harms investors by limiting their freedom of choice and their ability to invest in potentially higher return (albeit often higher risk) issuers.

Recommendation

The income and net worth limitations imposed by Regulation A (although not by Securities Act section 3(b)) should be eliminated.

For Further Information

See section "Improvements to Regulation A, Protecting Investors with Primary and Secondary Offering Blue Sky Preemption" above.

Legislative Language

Securities Act section 3(b) [15 U.S. Code § 77c(b)] should be amended by adding a new paragraph (H) to section 3(b)(2) as follows:

"(H) The Commission may not impose a limitation on the aggregate purchase price to be paid by the purchaser for the securities based on income, net worth or any another factor."

h. P2P Lending or "Marketplace Lending"

Summary of the Problem and Policy Analysis

Peer-to-peer (P2P) lending represents a way of making financial intermediation for consumer loans much more efficient to the benefit of consumers and small lenders. Via a P2P lending portal on the internet, small lenders can loan small amounts to many borrowers, diversifying risk. These amounts are aggregated by the platform, so borrowers can get the full amount they seek to borrow from many different lenders. Often, borrowers can borrow at lower costs and lenders can receive a higher return than at traditional lenders. Because of the Securities and Exchange Commission (SEC), this form of lending is largely unavailable to small business. Regulatory impediments to small business P2P lending need to be removed.

The key substantive, non-legal point here is that a loan is a loan, not a security.[108] Whether that loan is from a bank, a credit union, a non-bank lender, or an individual via a P2P lending portal should not matter. Under the current regulatory regime and SEC practice, the SEC adopts the position that virtually anything that earns a return is a security unless there is a specific statutory

[108] For a discussion of some of the legal issues involved in drawing lines between loans (or notes or investment contracts) and securities (bonds or debentures), see Andrew Verstein, "The Misregulation of Person-to-Person Lending, University of California–Davis Law Review, Vol. 45, No. 2 (2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1823763; Elisabeth de Fontenay, "Do the Securities Laws Matter? The Rise of the Leveraged Loan Market," Journal of Corporation Law, Vol. 39 (2014), pp. 725–768 http://scholarship.law.duke.edu/faculty_scholarship/3258/ . See Securities Act, Section 3 for a veritable laundry list of exemptions for securities involving banks. See *Reves v. Ernst & Young*, 494 U.S. 56 (1990) for the Supreme Court's adoption and application of the highly amorphous four-part "family resemblance" test, drawing the distinction between notes that are and are not securities.

exemption. Thus, loans to small businesses by banks, credit unions, finance companies, or individuals in private transactions not using a P2P lending platform are almost always treated as exempt from registration requirements. Loans via P2P lending platforms are not. This fundamentally irrational disparity in treatment creates a major regulatory impediment to both consumer and small-business lending using P2P lending platforms, harming both small-business and consumer borrowers, as well as investors seeking a better return. It also protects banks from competition from non-bank financial intermediation. This impediment has proved, in practice, virtually insurmountable unless the regulatory regime governing P2P loans is improved.

There are three means of eliminating, or reducing, the regulatory impediments to P2P lending generally, and P2P small-business lending in particular.

First, Congress should exempt P2P lending from federal and state securities laws. Perhaps surprisingly, the House-passed version of the Dodd-Frank bill in 2010 would have taken this approach.[109] The provision, which was not included in the bill that was ultimately enacted into law, provided "primary" jurisdiction to the Consumer Financial Protection Bureau (CFPB).[110] It exempted "any consumer loan, and any note representing a whole or fractional interest in any such loan, funded or sold through a person-to-person lending platform." It defined a consumer loan as a "loan made to a natural person, the proceeds of which are intended primarily for personal, family, educational, household, or business use." This provision should be adopted and expanded to explicitly exempt small business loans (as opposed to only those made to natural persons).

The House-passed version of Dodd-Frank did not explicitly preempt state securities laws. The preemption of blue sky registration and qualification provisions is critical to success because state laws substantially increase costs and introduce major regulatory delays. This is particularly true in the two-fifths of states that are "merit review" states. In these states, state officials decide whether an investment is a fair or good investment rather than simply ensuring that the terms of the deal are adequately disclosed. Any preemption of state blue sky laws should not, however, preempt state antifraud provisions.

This is the preferred approach. To the extent that Congress wishes to have a federal regulator overseeing this market, lawmakers could assign that task to one of the bank regulators, the CFPB, the SEC or the Federal Trade Commission. But involving a federal regulator and creating a new federal regulatory regime is probably unnecessary since *fraudulent* transactions would be a violation of countless existing federal laws,[111] state blue sky laws governing fraud, state consumer protection laws, state banking laws, and the common law of fraud.

Second, 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." Title III of the JOBS Act, which provides an exemption from registration for securities offerings, was intended

[109] Section 4315 of H.R. 4173, 111th Cong. (House-passed version), http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173eh/pdf/BILLS-111hr4173eh.pdf.
[110] The provision provided "primary" jurisdiction to the CFPB. It did not explicitly pre-empt blue sky laws. Any pre-emption of state blue sky laws should not pre-empt state antifraud provisions.
[111] The banking and securities laws in addition to the prohibition on "unfair or deceptive acts or practices in or affecting commerce," 15 U.S. Code §45, enforced by the Federal Trade Commission.

to help small businesses raise capital from the securities markets in a cost-effective manner. As discussed above, results have so far been disappointing. Part of the reason is likely that the disclosure requirements of the law – which can be very burdensome, particularly for small businesses – apply to both debt offerings as well as equity offerings. Many of these disclosure requirements make more sense for equity offerings because they provide an ownership interest in the company. They make a lot less sense for debt offerings because, as is generally the case with loans, there is no ownership interest. This problem is magnified by the fact that small business are much more likely to raise money through debt than equity offerings.

Title III disclosures are designed to provide investors with the information they need to make an informed decision on whether to buy, as well as ongoing disclosures that allow the investor to monitor the health of their investment. Herein lies the rub. The type of information an equity investor needs to monitor their investment is far more expansive than a debt investor. The value of an equity investment frequently relies on the company becoming more successful, and therefore valuable, over time. If this happens, and subject to some limitation, the original investor may be able to sell their ownership stake in a company that is more valuable than when the investor obtained it, with the increase in profit realized from the sale being the investor's return. The value of a company is, in principle, equal to the present discounted value of its expected after-tax income. Thus, equity investors need to know detailed information that enables them to form those expectations. Title III addresses this concern by imposing initial and ongoing disclosure requirements on companies that use it to sell securities. Under Regulation CF, these ongoing disclosure requirements are expensive to comply with.

Companies that make debt offerings are bound to the same disclosure requirements, even if much of the information is far less relevant. What matters for debt offerings is whether the company can make good on repaying what is effectively a loan. The company doesn't need to get massively more profitable to have a successful investment, and the securities are self-liquidating (i.e. the investor doesn't need to sell them to get value, the debt payments provide the value until the debt is repaid and the loan or bond retired).

The expense of initial and ongoing disclosure requirements that aren't needed for debt offerings makes Title III a poor fit for companies who want to get loans via the public. However, Congress could fix this and create a more viable option.

What would the reform look like? First, a debt security would be defined "as any contract that (1) provides no ownership stake in the issuing company, (2) provides for the repayment of the principal amount over a definite period together with interest, and (3) provides no payments to the holder other than principal payments, interest payments and penalties for late payments." The issuer offering these securities pursuant to Securities Act section 4(a)(6)—the Title III crowdfunding exemption—would be exempt from many of the continuing disclosure requirements.

The crowdfunding debt security exemption should include special-purpose entities created by a lead investor for the sole purpose of allowing individuals to invest in an entity that holds the debt securities of a single issuer. This will be attractive to issuers because they will not be required to deal with potentially hundreds of very small investors. Instead, they will simply have to deal with

the manager of the special-purpose entity. This crowdfunding approach, along with exempting P2P lending from state securities laws, might give some vitality to lending via crowdfunding platforms. The statutory P2P debt security exemption should be self-effectuating and not require the SEC to issue rules to become effective.

Third and finally, Congress could adopt an alternative regulatory regime for P2P lending.[112] It would require some regulatory agency (usually the CFPB is suggested although the Federal Trade Commission may be better) to promulgate rules and create a division to regulate P2P lending. This is the least attractive approach because it will likely lead to even more bureaucratic complexity. It is, however, still better than the current regulatory situation, which simply makes P2P lending to small firms effectively impossible because of high regulatory costs.

Recommendations

1. Exempt P2P lending from federal and state securities laws.
2. 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.
3. Congress could adopt an alternative regulatory regime for P2P lending.

For Further Information

1. David R. Burton, "Making Small Business Investment Easier: Congress Should Reduce the Oppressive Regulatory Burden on Peer-to-Peer Lending."[113]
2. David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth."[114]

Legislative Language

Regarding the first approach, see section 4315 of H. R. 4173 111th Congress (the Financial Stability Improvement Act of 2009) which passed the house December 11, 2009.[115] This provision was not included in the final Dodd-Frank Wall Street Reform and Consumer Protection Act.[116]

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[112] See, for example, Eric C. Chaffee and Geoffrey C. Rapp, "Regulating Online Peer-to-Peer Lending in the Aftermath of Dodd–Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry," *Washington and Lee Law Review*, Vol. 69, No. 2 (2012), pp. 485–533 http://scholarlycommons.law.wlu.edu/wlulr/vol69/iss2/4/ and Andrew Verstein, "The Misregulation of Person-to-Person Lending, *University of California–Davis Law Review*, Vol. 45, No. 2 (2011) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1823763.

[113] David R. Burton, "Making Small Business Investment Easier: Congress Should Reduce the Oppressive Regulatory Burden on Peer-to-Peer Lending, *Discourse Magazine*, October 22, 2020 https://www.discoursemagazine.com/economics/2020/10/22/making-small-business-investment-easier/.

[114] 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.

[115] H. R. 4173 111th Congress (the Financial Stability Improvement Act of 2009) which passed the house December 11, 2009 https://www.govinfo.gov/content/pkg/BILLS-111hr4173eh/pdf/BILLS-111hr4173eh.pdf.

[116] Public Law No: 111-20 (July 21, 2010).

To implement the second approach, amend section 4A of the Securities Act [15 U.S. Code § 77d–1] by adding a new subsection (i) at the end.

"(i) Crowdfunding Debt Securities.

(1) Crowdfunding Debt Security. 'Crowdfunding debt security' means any contract that –

(A) provides for the repayment of the principal amount over a definite period together with interest, and

(B) provides no payments to the holder other than principal payments, interest payments and penalties for late payment.

(2) Crowdfunding Debt Security Issuer. 'Crowdfunding Debt Security Issuer' means an issuer of one or more crowdfunding debt securities issued using the exemption provided by section 4(a)(6) and that has no other class of securities outstanding that were issued using the exemption provided by section 4(a)(6).

(3) Crowdfunding Debt Security Issuer Exemptions. Crowdfunding debt security issuers are exempt from the requirements of –

(A) section 4A(b)(1)(D)(ii)-(iii);

(B) section 4A(b)(1)(G);

(C) section 4A(b)(1)(H);

(D) section 4A(b)(4); and

(E) section 4A(b)(5)."

Language explicitly permitting SPVs should probably be added. See discussion above for details.

i. Business Brokers and Merger and Acquisition Brokers

Summary of the Problem and Policy Analysis

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. Although the Securities and Exchange Commission issued in 2014 a no-action letter that improves the situation,[117] its position on who should be required to register as a securities broker-dealer remain overbroad and significantly exceeds the scope of the statutory requirement. Complying with the requirements of the letter is far from simple. Business brokers helping to buy and sell small businesses should simply be exempt from the broker-dealer registration requirements. Proposals to register and reasonably regulate business brokers are constructive, but not the best solution. In 2017, the House unanimously passed the "Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2019." The Senate has failed to do so.

Recommendations

1. Exempt business brokers from the broker-dealer registration requirements.
2. Alternatively, register and reasonably regulate business brokers.

[117] 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.

For Further Information

David R. Burton, "Don't Overregulate Business Brokers."[118]

Legislative Language:

See H.R.609, 116th Congress, "The Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2019" (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.

[118] 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.

III. Better Public Markets

a. Introduction

The market capitalization of U.S. public companies is on the order of $50 trillion.[119] These markets play a critical role in allocating capital in the U.S. economy, funding growth and funding the retirement of millions of Americans. Unfortunately, being a public company has become increasingly costly because of a vast array of costly regulations and regulatory risk. The number of public companies has declined by almost half over the past quarter century[120] despite the real GDP growing by about 80 percent[121] and the population increasing by about 26 percent.

A large number of poor regulatory decisions has made companies go public later or not at all and many public companies have gone private. Regulators appear to think that they can pile ever-increasing regulatory burdens on firms without any adverse impact. This has an adverse impact on investors because the large gains from entrepreneurship now accrue to relatively wealthy accredited investors operating in private markets and has an adverse impact on young, dynamic and growing companies because they cannot access public capital markets cost-effectively. It also reduces economic growth and economic dynamism to the detriment of the broader public.

The core objective of securities law should be deterring and punishing fraud and fostering reasonable, limited, scaled disclosure by firms for the purpose of providing material information to investors. Statutory provision and regulations that do not meet these objectives should be discarded. Just because somebody somewhere or a small group of investors or non-investors wants free information at the expense of shareholders does not mean regulators should mandate it. And requirements to provide information that has a political purpose unrelated to investors' returns should be particularly suspect.

b. Scaled Disclosure and Simplification

<u>Summary of the Problem and Policy Analysis</u>

Fraud

Fraud is the misrepresentation of material facts or the misleading omission of material facts for the purpose of inducing another to act, or to refrain from action, in reliance on the misrepresentation or omission.[122] A transaction induced by fraud (misrepresentation) is not

[119] Total Market Capitalization of Public U.S. Companies (USD, millions) as of December 31, 2020 https://siblisresearch.com/data/us-stock-market-value/.
[120] See, for example, Les Brorsen, "Looking Behind the Declining Number of Public Companies," *Harvard Law School Forum on Corporate Governance*, May 18, 2017 https://corpgov.law.harvard.edu/2017/05/18/looking-behind-the-declining-number-of-public-companies/; Craig Doidge, G. Andrew Karolyi and René M. Stulz, "The U.S. Listing Gap," NBER Working Paper 21181, May 2015 http://www.nber.org/papers/w21181.
[121] Real Gross Domestic Product, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/GDPC1.
[122] *Restatement of the Law Second, Torts*, Vol. 3 (Philadelphia, PA: American Law Institute, 1977), § 525 Liability for Fraudulent Misrepresentation; § 526 Conditions Under Which Misrepresentation Is Fraudulent (Scienter); § 529 Representation Misleading Because Incomplete; and §551 Liability for Nondisclosure.

voluntary or welfare enhancing in that it would not be entered into in the absence of the fraud (or would be entered into at a different price).[123] Federal law prohibits fraudulent securities transactions.[124] So do state "blue sky" laws.[125] Protecting citizens, including investors, from fraud or misrepresentation is a fundamental function of government and should be the first order of business for securities regulators.

Mandatory and Voluntary Disclosure

The second important purpose of securities laws is to foster disclosure to investors by firms that sell securities of material facts about the company needed to make informed investment decisions.[126] 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.[127] The reasons for this are that:

(1) the issuer is in the best position to accurately and cost-effectively produce information about the issuer;[128]
(2) information disclosure promotes better allocation of scarce capital resources or has other positive externalities;[129]

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[123] Securities fraud was illegal long before New Deal–era federal securities laws or even earlier state blue sky laws were enacted. Stuart Banner, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690–1860* (Cambridge, MA: Cambridge University Press, 2002). See also Frank H. Easterbrook and Daniel R. Fischel, "Mandatory Disclosure and the Protection of Investors," *Virginia Law Review*, Vol. 70 (1984), p. 669, http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2176&context=journal_articles; Gordon Walker, "Securities Regulation, Efficient Markets and Behavioural Finance: Reclaiming the Legal Genealogy," *Hong Kong Law Journal*, Vol. 36, No. 3 (2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1099512; and Paul G. Mahoney, *Wasting a Crisis: Why Securities Regulation Fails* (Chicago: University Of Chicago Press, 2015).
[124] Securities Exchange Act of 1934 section 10(b) [15 U.S. Code § 78j(b)], regulation of the use of manipulative and deceptive devices. See also 17 C.F.R. 240.10b-5, Employment of manipulative and deceptive devices.
[125] For a discussion of the history of blue sky laws, see Jonathan R. Macey and Geoffrey P. Miller, "Origin of the Blue Sky Laws," *Texas Law Review*, Vol. 70, No. 2 (1991), pp. 347–397, http://digitalcommons.law.yale.edu/fss_papers/1641/, and Paul G. Mahoney, "The Origins of the Blue Sky Laws: A Test of Competing Hypotheses," UVA *Law & Economics Research Paper* No. 01-11, December 2001, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=296344. See, for instance, section 501 of the 2002 Uniform Securities Act (as amended), https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=9b2b8f23-651c-c727-e234-3af8b5ab1b6e&forceDialog=0 .
[126] For a general introduction, see Richard A. Posner, "Financial Markets," in *Economic Analysis of the Law*, 9th ed. (Wolters Kluwer Law & Business, 2014).
[127] Robert A. Prentice, "The Economic Value of Securities Regulation," *Cardozo Law Review*, Vol. 28, No. 1 (2006), pp. 333–389; 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 .
[128] 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.
[129] 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,

(3) the cost of capital may decline because investors will demand a lower risk premium;[130]
(4) disclosure makes it easier for shareholders to monitor management;[131] and
(5) disclosure makes fraud enforcement easier because evidentiary hurdles are more easily overcome.[132]

The baseline for measuring the benefits of mandatory disclosure is not zero disclosure. Firms would disclose considerable information even in the absence of legally mandated disclosure. It is, generally, in their interest to do so.[133] Even before the New Deal securities laws mandating disclosure were enacted, firms made substantial disclosures, and stock exchanges required disclosure by listed firms.[134] Firms conducting private placements today make substantial

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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 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=258514; 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://papers.ssrn.com/sol3/papers.cfm?abstract_id=103968.

[130] 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.

[131] 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. The conflicts can be particularly acute when managers are defending themselves at shareholder expense against regulators for wrongful acts by management. In large corporations, it is common to see large fines imposes on the corporation (i.e. shareholders) but comparatively rare to see individual managers bear the burden individually for their unlawful acts. 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.

[132] 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.

[133] Roberta Romano, *The Advantage of Competitive Federalism for Securities Regulation* (Washington, DC: AEI Press, 2002), and Healy and Palepu, "Information Asymmetry, Corporate Disclosure, and the Capital Markets," *op. cit*.

[134] Frank Easterbrook and Daniel Fishel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press, 1991); Michael J. Fishman and Kathleen M. Hagerty, "Disclosure Decisions by Firms and the Competition for Price Efficiency," *The Journal of Finance*, Vol. 44, No. 3 (1989), pp. 633–646, http://www.jstor.org/stable/pdfplus/2328774.pdf; George J. Stigler, "Public Regulation of the Securities Markets," *The Business Lawyer*, Vol. 19, No. 3 (April 1964), pp. 721–753; and George J. Benston, "Required Disclosure and

disclosures notwithstanding the general absence of a legal mandate to do so.[135] The reason is fairly straightforward. In the absence of meaningful disclosure about the business and a commitment, contractual or otherwise, to provide continuing disclosure, few would invest in the business and those that did so would demand substantial compensation for the risk they were undertaking by investing in a business with inadequate disclosure.[136] Voluntary disclosure allows firms to reduce their cost of capital and, therefore, they disclose information even in the absence of a legal mandate to do so. Mandatory disclosure laws often impose very substantial costs. These costs do not increase linearly with company size. Offering costs are larger as a percentage of the amount raised for small offerings. They 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.[137] The same basic analysis applies to continuing periodic reporting costs.

Disclosure also has a dark side in countries with inadequate property-rights protection. In a study examining data from 70,000 firms, the World Bank found that, in developing countries, mandatory disclosure is associated with significant exposure to expropriation, corruption, and reduced sales growth.[138] In the developed world, much of the impetus behind ESG or CSR disclosure under securities laws or beneficial ownership reporting under the AML laws is the desire to politically or otherwise intimidate corporate management.

Nor should it be forgotten that many large businesses and large broker-dealers are quite comfortable with high levels of regulation because regulatory compliance costs constitute a barrier to entry, limiting competition from smaller, potentially disruptive, competitors.

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the Stock Market: An Evaluation of the Securities Exchange Act of 1934," *American Economic Review*, Vol. 63 No. 1 (March 1973).

[135] The Regulation D safe harbor imposes certain additional requirements if the issuer sells securities under 506(b) to any purchaser that is not an accredited investor. See 17 C.F.R. §230.502(b).

[136] See, for instance, Maureen O'Hara and David Easley, "Information and the Cost of Capital," *Journal of Finance*, Vol. 59, No. 4 (August 2004) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=300715.

[137] Craig M. Lewis, "The Future of Capital Formation," speech by chief economist and director of the Division of Economic and Risk Analysis at MIT Sloan School of Management's Center for Finance and Policy's Distinguished Speaker Series, April 15, 2014, http://www.sec.gov/News/Speech/Detail/Speech/1370541497283; Jeff Schwartz, "The Law and Economics of Scaled Equity Market Disclosure," *Journal of Corporation Law*, Vol. 39 (2014), p. 347; and C. Steven Bradford, "Transaction Exemptions in the Securities Act of 1933: An Economic Analysis," *Emory Law Journal*, Vol. 45 (1996), pp. 591–671, http://digitalcommons.unl.edu/cgi/viewcontent.cgi?article=1088&context=lawfacpub. There is a strong argument that scaling should also be a function of the age of the firm, so that relatively young firms with limited compliance experience and, typically, limited cash flow and resources, should have lesser disclosure requirements than more mature firms. See Table 3.3 in Susan M. Phillips and J. Richard Zecher, *The SEC and the Public Interest* (Cambridge, MA: MIT Press, 1981). See also Securities and Exchange Commission, "Economic Analysis, Proposed Rule, Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act," *Federal Register*, Vol. 79, No. 15 (January 23, 2014), pp. 3972–3993 [Release Nos. 33-9497, 34-71120, and 39-2493; File No. S7-11-13], http://www.gpo.gov/fdsys/pkg/FR-2014-01-23/pdf/2013-30508.pdf.

[138] Tingting Liu et al., "The Dark Side of Disclosure: Evidence of Government Expropriation from Worldwide Firms," World Bank Policy Research Working Paper No. 7254, May 2015, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2602586.

Investor Protection

"Investor protection" is a central part of the SEC's mission.[139] However, it is quite clear that many existing regulations, usually imposed in the name of investor protection, actually harm investors by increasing costs, and reducing investor returns and freedom. They certainly go beyond those necessary to deter fraud and achieve reasonable, limited, scaled disclosure for small firms.

A main problem is that the term "investor protection" is a very ambiguous term that can cover, at least, four basic ideas. The first is protecting investors from fraud or misrepresentation. This is a fundamental function of government. The second is providing investors with adequate information to make informed investment decisions. Although a legitimate function of the securities laws for reasons explained above, this requires policymakers to carefully balance the costs (which are typically underestimated by regulators and policymakers) and benefits (which are typically overestimated by regulators and policymakers) of mandatory disclosure.[140] Moreover, more disclosure is not always better because it enables issuers to obfuscate by drowning investors in barely relevant and immaterial information. The third is protecting investors from investments or business risks that regulators deem imprudent or ill-advised. This is not an appropriate function of government and can be highly counter-productive. The fourth is protecting investor freedom of choice or investor liberty and, thereby, allowing investors to achieve higher returns and greater liquidity. This primarily requires regulators to exercise restraint, or eliminate existing regulatory barriers, both in the regulation of primary offerings by issuers and of secondary market sales by investors to other investors. In practice, this aspect of investor protection is almost entirely ignored by state and federal regulators.

Disclosure requirements have become so voluminous that they obfuscate rather than inform, making it more difficult for investors to find relevant information.[141] The average number of pages in annual reports devoted to footnotes and "Management's Discussion and Analysis" has

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[139] "The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." U.S. Securities and Exchange Commission, "What We Do: Introduction," http://www.sec.gov/about/whatwedo.shtml#intro. The statutory charge is "[w]henever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." See §3(f) of the Securities Exchange Act of 1934 and §2(b) of the Securities Act of 1933.

[140] "Some Limits and Drawbacks of MD," section in Luca Enriques and Sergio Gilotta, "Disclosure and Financial Market Regulation," in *The Oxford Handbook on Financial Regulation*, edited by Eilís Ferran, Niamh Moloney, and Jennifer Payne (Oxford: Oxford University Press, 2015) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2423768; Omri Ben- Shahar and Carl E. Schneider, "The Failure of Mandated Discourse," *University of Pennsylvania Law Review*, Vol. 159 (2011), pp. 647–749, http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2066&context=journal_articles.

[141] Troy A. Paredes, "Blinded by the Light: Information Overload and Its Consequences for Securities Regulation," *Washington University Law Quarterly*, Vol. 81 (2003), pp. 417–485, https://openscholarship.wustl.edu/cgi/viewcontent.cgi?article=1287&context=law_lawreview and Troy A. Paredes, "Remarks at The SEC Speaks in 2013," U.S. Securities and Exchange Commission, February 22, 2013, http://www.sec.gov/News/Speech/Detail/Speech/1365171492408#.Ut2WJbROmM8. See also Keith F. Higgins, "Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting," U.S. Securities and Exchange Commission, April 11, 2014, http://www.sec.gov/News/Speech/Detail/Speech/1370541479332#.VItSmXt4zYg.

quadrupled.[142] The number of words in corporate annual 10-Ks increased from 29,996 in 1997 to 41,911 in 2014.[143] This has undoubtedly become an even bigger problem over the past six years. And calls for even more disclosure relating to even more subjects will notably exacerbate the problem if implemented. Very few investors, whether professional or retail, are willing to wade through lengthy disclosure documents, often running hundreds of pages of dense legalese, available on the SEC's EDGAR database[144] or multitudinous state blue sky filings in the forlorn hope that they will find something material to their investment decision that is not available elsewhere in shorter, more focused, more accessible materials. Many of these more accessible materials are, of course, synopses of both the mandated disclosure documents (usually Forms 10-K, 10-Q, or 8-K3) and other voluntarily disclosed information, such as shareholder annual reports or materials provided to securities analysts by companies. But the fact that the vast majority of investors rely on these summary materials strongly implies that the legal requirements exceed what most investors find material to their investment decisions.

The law should not, even in principle, adopt a regulatory regime that is designed to protect all investors from every conceivable ill. Even in the case of fraud, there needs to be a balancing of costs and benefits. Securities law should deter and punish fraud but, given human nature, it can never entirely eliminate fraud. The only way to be certain that there would be no fraud would be to make business impossible. In other words, the socially optimal level of fraud is not zero.[145] While fraud imposes significant costs on the person who is defrauded, preventing fraud also has significant costs (both to government and, more significantly quantitatively, to law-abiding firms or investors) At some point the costs of fraud prevention exceed the benefits, however defined.[146] It is up to policymakers to assess this balance and make appropriate judgments in light of the evidence.

About three-fifths of the states conduct what is called "merit review."[147] Under merit review, state regulators decide whether a securities offering is too risky or too unfair to be offered within their

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[142] Ernst & Young, "Now is the Time to Address Disclosure Overload," *To the Point*, No. 2012-18, June 21, 2012, https://www.lexissecuritiesmosaic.com/gateway/sec/speech/%24FILE_TothePoint_BB2367_DisclosureOverload_21June2012.pdf.

[143] Vipal Monga and Emily Chasan, "The 109,894-Word Annual Report: As Regulators Require More Disclosures, 10-Ks Reach Epic Lengths: How Much Is Too Much?" *The Wall Street Journal*, June 1, 2015 https://www.wsj.com/articles/BL-CFOB-8071

[144] U.S. Securities and Exchange Commission, "[Electronic Data Gathering, Analysis, and Retrieval] EDGAR, Search Tools," https://www.sec.gov/edgar/search-and-access#.

[145] Gary S. Becker, "Crime and Punishment: An Economic Approach," in Gary S. Becker and William M. Landes, eds., *Essays in the Economics of Crime and Punishment* (New York: Columbia University Press, 1974), http://www.nber.org/chapters/c3625.pdf and Richard A. Posner, "An Economic Theory of the Criminal Law," *Columbia Law Review*, Vol. 85 (1985), pp. 1193–1231, http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2827&context=journal_articles.

[146] This discussion omits several subsidiary issues, including the relative efficacy of civil and criminal penalties, the degree of deterrence that is socially optimal, and measurement issues. For a recent review of some of these issues, see Keith N. Hylton, "The Theory of Penalties and the Economics of Criminal Law," *Review of Law and Economics*, Vol. 1, No. 2 (2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=337460.

[147] For a dated but detailed look at blue sky laws, see U.S. Securities and Exchange Commission, "Report on the Uniformity of State Regulatory Requirements for Offerings of Securities that Are Not 'Covered Securities,'" Securities and Exchange Commission October 11, 1997, http://www.sec.gov/news/studies/uniformy.htm#seci . For a critique of blue sky laws, see Rutheford B. Campbell Jr., "Federalism Gone Amuck: The Case for Reallocating Governmental Authority over the Capital Formation Activities of Businesses," *Washburn Law Journal*, Vol. 50

state, effectively substituting their investment judgment for that of investors. Merit review is wrong in principle. Moreover, it is very unlikely that regulators make better investment decisions than investors. Lastly, merit review is expensive and it delays offerings considerably.[148]

Recommendations

1. See the discussion above under Fundamental Reform.
2. It is our intention to provide within the next six months incremental reform proposals to Securities Act Schedule A, Securities Act section 7 and 10 (relating to registration statements and prospectuses), 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)[149] and by extension to Regulation S-K and Regulation S-X, among others.
3. See also "Repeal Title XV of the 2010 Dodd-Frank Act," "ESG/CSR" and "Materiality" below.

For Further Information

1. David R. Burton, "Securities Disclosure Reform."[150]

(Spring 2011), p. 573, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1934825. ("In retrospect, there can be little doubt that the failure of Congress to preempt state authority over the registration of securities was a significant blunder."); 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 Roberta S. Karmel, "Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?" *Brooklyn Law Review*, Vol. 53 (1987), pp. 105–125. The North American Securities Administrators Association, in its "Application for Coordinated Review of Regulation A Offering," delineates between merit review and disclosure jurisdictions. There are 49 participating jurisdictions, including Puerto Rico, the U.S. Virgin Islands, and the District of Columbia. Of the states, 28 are merit review states, 16 are disclosure states, and two (New Jersey and West Virginia) are "disclosure" states that "reserve the right" to make "substantive comments." Four states do not, at this time, participate, North American Securities Administrators Association, http://www.nasaa.org/wp-content/uploads/2014/05/Coordinated-Review-Application-Sec-3b.pdf.

[148] Rutheford B. Campbell Jr., "The Insidious Remnants of State Rules Respecting Capital Formation," Washington University Law Quarterly, Vol. 78 (2000), pp. 407–434, https://openscholarship.wustl.edu/law_lawreview/vol78/iss2/4/; Henry G. Manne and James S. Mofsky, "What Price Blue Sky: State Securities Laws Work Against Private and Public Interest Alike," in *The Collected Works of Henry G. Manne*, Vol. 3 (Liberty Fund, 1996); Therese H. Maynard, "The Future of California's Blue Sky Law," *Loyola of Los Angeles Law Review*, Vol. 30 (1997), pp. 1531–1556, http://digitalcommons.lmu.edu/cgi/viewcontent.cgi?article=2067&context=llr; Mark A. Sargent, "A Future for Blue Sky," *University of Cincinnati Law Review*, Vol. 62 (1993), pp. 471–512; James S. Mofsky and Robert D. Tollison, "Demerit in Merit Regulation," *Marquette Law Review*, Vol. 60 (1977), pp. 367–378; James S. Mofsky, *Blue Sky Restrictions On New Business Promotions* (Matthew Bender & Company, 1971); and John P. A. Bell and Stephen W. Arky, "Blue Sky Restrictions on New Business Promotions," *The Business Lawyer*, Vol. 27, No. 1 (November 1971), pp. 361–365. See also discussion of merit review in 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

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

[150] David R. Burton, "Securities Disclosure Reform," Chapter 5, *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, Editor (The Heritage Foundation: 2017) http://thf-

2. David R. Burton, "Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth."[151]
3. SEC Concept Release on Business and Financial Disclosure Required by Regulation S-K.[152]

c. Smaller Reporting Companies and Non-Accelerated Filers

Summary of the Problem and Policy Analysis

Regulation S-K governs non-financial statement disclosures by reporting companies. It has moderately reduced reporting requirements for "smaller reporting companies" and non-accelerated filers. The Commission recently improved its rules for small public companies by broadening these categories and moderately reducing the burden on smaller reporting companies.[153]

Generally, an issuer qualifies as a "smaller reporting company" if it has public float of less than $250 million or it has less than $100 million in annual revenues and no public float or public float of less than $700 million.[154] A non-accelerated filer is an issuer that is neither an accelerated filer nor a large accelerated filer. Generally, an accelerated filer is an issuer that has an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $75 million or more, but less than $700 million.[155]

As discussed elsewhere, the number of public companies keeps falling because of the regulatory burden on reporting companies and companies become public much later in their life-cycle. This has an adverse impact on small companies' access to capital and the ability of non-accredited investors to access the large gains that accrue to investors in successful entrepreneurial firms.

Recommendation

Congress should require the Division of Economic and Risk Analysis (DERA) and the Division of Corporation Finance at SEC to jointly send a survey to every issuer that is either a smaller reporting company or a non-accelerated filer (and their counsel and accountants). The survey should be structured so that the responses can be anonymous (in the sense that the SEC staff cannot

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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.

[151] 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.

[152] SEC Concept Release on Business and Financial Disclosure Required by Regulation S-K, April 13, 2016 https://www.sec.gov/rules/concept/2016/33-10064.pdf.

[153] "Accelerated Filer and Large Accelerated Filer Definitions," Securities and Exchange Commission, *Federal Register*, Vol. 85, No. 59, March 26, 2020 https://www.govinfo.gov/content/pkg/FR-2020-03-26/pdf/2020-05546.pdf; "Smaller Reporting Company Definition," Securities and Exchange Commission, *Federal Register*, Vol. 83, No. 132, July 10, 2018 https://www.govinfo.gov/content/pkg/FR-2018-07-10/pdf/2018-14306.pdf. See also "Modernization of Regulation S–K Items 101, 103, and 105," Securities and Exchange Commission, *Federal Register*, Vol. 85, No. 196, October 8, 2020 https://www.govinfo.gov/content/pkg/FR-2020-10-08/pdf/2020-19182.pdf.

[154] 17 CFR §229.10.

[155] 17 CFR §240.12b-2.

determine which issuer, law firm or accounting firm provided which survey response). The use of an independent third-party who would collect the surveys and redact information identifying respondents should be authorized. The survey should seek information regarding (1) which provisions in Regulation S-K, Regulation S-X, Financial Accounting Standards Board rules, Public Company accounting Oversight Board rules and other relevant regulations that are problematic and impose unwarranted costs, (2) quantitative information regarding costs and (3) suggestions for improvement to Regulation S-K, Regulation S-X, Financial Accounting Standards Board rules, Public Company accounting Oversight Board and other relevant regulations. The Congress should require that DERA and the Division of Corporation Finance consult with the Census Bureau, the Bureau of Economic Analysis and the Bureau of Labor Statistics before undertaking the survey because these agencies have extensive experience in collecting survey data. The SEC should compile this information (including cost data and a detailed compilation of recommendations made by issuers, their counsel and their accountants) and issue a report to Congress within one year.

For Further Information

1. David R. Burton, "Securities Disclosure Reform."[156]
2. David R. Burton, "Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth."[157]
3. "Report on Review of Disclosure Requirements in Regulation S-K," Securities and Exchange Commission.[158]
4. SEC Concept Release on Business and Financial Disclosure Required by Regulation S-K.[159]

Legislative Language

See recommendation paragraph above.

[156] 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.

[157] 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.

[158] "Report on Review of Disclosure Requirements in Regulation S-K," Securities and Exchange Commission, December, 2013 https://www.sec.gov/files/reg-sk-disclosure-requirements-review.pdf.

[159] SEC Concept Release on Business and Financial Disclosure Required by Regulation S-K, April 13, 2016 https://www.sec.gov/rules/concept/2016/33-10064.pdf.

d. Blue Sky Pre-emption and Covered Securities

Summary of the Problem and Policy Analysis

State securities laws are generally called blue sky laws.[160] About three-fifths of the states conduct what is called "merit review."[161] Under merit review, state regulators decide whether a securities offering is too risky or too unfair to be offered within their state, effectively substituting their investment judgment for that of investors. Famously, under this standard before NSMIA preempted state regulation of exchange-listed registered offerings,[162] Massachusetts decided that Apple Computer's IPO was too risky to allow their IPO to be offered in Massachusetts.[163] This harmed rather than protected investors in Massachusetts and if more regulators had followed the Massachusetts example, Apple would not have gotten off the ground, harming consumers around the globe. Merit review is wrong in principle. As discussed below, there are at least eight reasons to doubt that regulators make better investment decisions than investors risking their own money. Moreover, merit review impedes capital formation by introducing large and unnecessary expense and delay to the offering process.[164]

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[160] For a discussion of the history of blue sky laws, see Jonathan R. Macey and Geoffrey P. Miller, "Origin of the Blue Sky Laws," *Texas Law Review*, Vol. 70, No. 2 (1991), pp. 347–397, http://digitalcommons.law.yale.edu/fss_papers/1641/, and Paul G. Mahoney, "The Origins of the Blue Sky Laws: A Test of Competing Hypotheses," UVA *Law & Economics Research Paper* No. 01-11, December 2001, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=296344.

[161] For a dated but detailed look at blue sky laws, see U.S. Securities and Exchange Commission, "Report on the Uniformity of State Regulatory Requirements for Offerings of Securities that Are Not 'Covered Securities,'" Securities and Exchange Commission October 11, 1997, http://www.sec.gov/news/studies/uniformy.htm#seci . For a critique of blue sky laws, see Rutheford B. Campbell Jr., "Federalism Gone Amuck: The Case for Reallocating Governmental Authority over the Capital Formation Activities of Businesses," *Washburn Law Journal*, Vol. 50 (Spring 2011), p. 573, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1934825. ("In retrospect, there can be little doubt that the failure of Congress to preempt state authority over the registration of securities was a significant blunder."); 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 Roberta S. Karmel, "Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?" *Brooklyn Law Review*, Vol. 53 (1987), pp. 105–125. The North American Securities Administrators Association, in its "Application for Coordinated Review of Regulation A Offering," delineates between merit review and disclosure jurisdictions. There are 49 participating jurisdictions, including Puerto Rico, the U.S. Virgin Islands, and the District of Columbia. Of the states, 28 are merit review states, 16 are disclosure states, and two (New Jersey and West Virginia) are "disclosure" states that "reserve the right" to make "substantive comments." Four states do not, at this time, participate, North American Securities Administrators Association, http://www.nasaa.org/wp-content/uploads/2014/05/Coordinated-Review-Application-Sec-3b.pdf.

[162] National Securities Market Improvement Act of 1996, Public Law No. 104-290.

[163] Richard E. Rustin and Mitchell C. Lynch, "Apple Computer Set to Go Public Today; Massachusetts Bars Sale of Stock as Risky," *Wall Street Journal*, December 12, 1980 https://online.wsj.com/public/resources/documents/AppleIPODec12_1980_WSJ.pdf.

[164] Rutheford B. Campbell Jr., "The Role of Blue Sky Laws After NSMIA and the JOBS Act," *Duke Law Journal* , Vol. 66 , 2016, pp. 605-631 https://scholarship.law.duke.edu/dlj/vol66/iss3/6; Rutheford B. Campbell Jr., "The Insidious Remnants of State Rules Respecting Capital Formation," Washington University Law Quarterly, Vol. 78 (2000), pp. 407–434, https://openscholarship.wustl.edu/law_lawreview/vol78/iss2/4/; Henry G. Manne and James S. Mofsky, "What Price Blue Sky: State Securities Laws Work Against Private and Public Interest Alike," in *The Collected Works of Henry G. Manne*, Vol. 3 (Liberty Fund, 1996); Therese H. Maynard, "The Future of California's Blue Sky Law," *Loyola of Los Angeles Law Review*, Vol. 30 (1997), pp. 1531–1556, http://digitalcommons.lmu.edu/cgi/viewcontent.cgi?article=2067&context=llr; Mark A. Sargent, "A Future for Blue

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. Anecdotes and self-interested testimony from state regulators do not count as evidence.

In a free society, it is inappropriate paternalism for the government to prevent people from investing in companies that they judge to be good investment opportunities, or in which they may invest for reasons other than pecuniary gain (personal relationships or affinity for the mission of the enterprise).[165] It is a violation of their liberty and constrains their freedom. Citizens, not government, should be the judge of what is in their interest. This idea, however, is under sustained assault both by progressives and by "libertarian paternalists."[166] Both progressives and libertarian paternalists rely on the common sense findings of behavioral economics that people are not always rational, sometimes make poor decisions, and respond to sales pressure or disclosure documents differently.[167] Securities regulators are increasingly looking to this body of literature to inform or justify their actions.[168]

There are at least eight reasons to doubt that government regulators have better investment judgment than private investors investing their own money. First, there is the inability of a central regulatory authority to collect and act on information as quickly and accurately as dispersed private

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Sky," *University of Cincinnati Law Review*, Vol. 62 (1993), pp. 471–512; James S. Mofsky and Robert D. Tollison, "Demerit in Merit Regulation," *Marquette Law Review*, Vol. 60 (1977), pp. 367–378; James S. Mofsky, *Blue Sky Restrictions On New Business Promotions* (Matthew Bender & Company, 1971); and John P. A. Bell and Stephen W. Arky, "Blue Sky Restrictions on New Business Promotions," *The Business Lawyer*, Vol. 27, No. 1 (November 1971), pp. 361–365.

[165] It is our strong contention that if there is full disclosure, and investors understand the dual mission of the enterprise, investors should be free to invest in benefit corporations (or benefit LLCs) and social enterprises, and the founders of such enterprises should be free to sell securities to the public.

[166] Christine Jolls, Cass R. Sunstein, and Richard H. Thaler, "A Behavioral Approach to Law and Economics," Yale Law School Faculty Scholarship Series Paper No. 1765, 1998, http://digitalcommons.law.yale.edu/fss_papers/1765; Richard H. Thaler and Cass R. Sunstein, "Libertarian Paternalism," American Economic Association Papers & Proceedings, May 2003, Cass R. Sunstein and Richard H. Thaler, "Libertarian Paternalism Is Not An Oxymoron," *The University of Chicago Law Review*, Vol. 70 (2003), pp. 1166–1187, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=405940; and Ted O'Donoghue and Matthew Rabin, "Studying Optimal Paternalism, Illustrated by a Model of Sin Taxes," American Economic Association Papers & Proceedings, May 2003, pp. 186–191. See also Glen Whitman, "Against the New Paternalism: Internalities and the Economics of Self-Control," Cato Institute Policy Analysis No. 563, February 22, 2006, http://object.cato.org/sites/cato.org/files/pubs/pdf/pa563.pdf.

[167] Jolls, Sunstein, and Thaler, "A Behavioral Approach to Law and Economics," ibid., and Russell B. Korobkin and Thomas S. Ulen, "Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics," *California Law Review*, Vol. 88, No. 4 (2000), pp. 1051–1144, http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1490&context=californialawreview.

[168] See, for example, Kara M. Stein, "Remarks Before the Consumer Federation of America's 27th Annual Financial Services Conference," U.S. Securities and Exchange Commission, December 4, 2014, http://www.sec.gov/News/Speech/Detail/Speech/1370543593434#.VITlxsmwU0Q; Library of Congress and U.S. Securities and Exchange Commission, "Annotated Bibliography on the Behavioral Characteristics of U.S. Investors," August 2010, https://www.sec.gov/investor/locinvestorbehaviorbib.pdf; and Securities and Exchange Commission Investor Advisory Committee, Minutes of May 17, 2010, meeting in Washington, DC, http://www.sec.gov/spotlight/invadvcomm/iacmeeting051710-agenda.pdf.

actors.[169] There is a reason why government has a reputation for being ponderous and slow to act.[170] In the context of securities regulation, it is highly doubtful that government regulators have a better understanding of business and the markets than those participating in those markets. Second, private investors have strong incentives to be good stewards of their own money, both in the sense of not taking unwarranted risks, and in the sense of seeking high returns. Investors may also seek to invest for reasons that do not involve pecuniary gain, including support of the persons launching an enterprise or support for a social enterprise that has a dual mission. Government regulators have an entirely different set of incentives. Third, individuals, not government officials, know their own risk tolerance and their own portfolios. Investing in a riskier security[171] can reduce the overall risk of a portfolio if the security in question is negatively correlated or even not highly covariant with price movements of the overall portfolio.[172] Fourth, government officials are people too, and exhibit the same irrationality and tendency to sometimes make poor decisions as anyone else. There is absolutely no reason to believe that regulators are less subject to the concerns identified by behavioral economics and the "libertarian paternalists" than are others. Moreover, since most securities regulators are lawyers, and a legal education provides no training for making investment decisions, there is no particular reason to believe that they have *any* relevant "expertise" that will make their investment decisions objectively better than those investing their own money. Fifth, as public-choice economics has demonstrated, government officials are not angels but act in their own self-interest.[173] This, too, is in keeping with basic common sense. Government officials have an interest in enlarging their agencies, growing their budgets, increasing their power, and improving their employment prospects.[174] These interests motivate their behavior. They are no more (or less) benevolent than any other group of people, including issuers and investors, and there is no reason to believe that government regulators will act in the interest of investors when those interests conflict with their own interests. The analysis of politics, and the politicians and regulators who conduct politics, should be stripped of its "romance."[175]

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[169] Friedrich A. Hayek, "The Pretence of Knowledge," Prize Lecture to the Memory of Alfred Nobel, December 11, 1974, http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1974/hayek-lecture.html; Friedrich A. Hayek, *Individualism and Economic Order* (1948), http://mises.org/books/individualismandeconomicorder.pdf; Friedrich A. Hayek, "The Use of Knowledge in Society," *American Economic Review*, Vol. 34, No. 4 (September 1945), pp. 519–530, http://www.econlib.org/library/Essays/hykKnw1.html; and Friedrich A. Hayek, "Economics and Knowledge," *Economica* (February 1937), pp. 33–54, http://www.econlib.org/library/NPDBooks/Thirlby/bcthLS3.html.

[170] Peter H. Schuck, *Why Government Fails So Often: And How It Can Do Better* (Princeton, NJ: Princeton University Press, 2014); Clifford Winston, *Government Failure versus Market Failure: Microeconomics Policy Research and Government Performance* (Washington, DC: American Enterprise Institute and the Brookings Institution, 2006); and William S. Peirce, *Bureaucratic Failure and Public Expenditure* (Academic Press, 1981).

[171] A security with a high degree of unique risk (as opposed to market risk or systemic risk).

[172] This is often called a negative beta or low beta investment. For a discussion of these issues, see, for example, "Introduction to Risk, Return and the Opportunity Cost of Capital," in Richard A. Brealey, Stewart C. Meyers, and Franklin Allen, *Principles of Corporate Finance*, 8th Edition (New York: McGraw–Hill, 2006), and most introductory-finance textbooks.

[173] See, for example, Gordon Tullock, Authur Seldon and Gordon L. Brady, *Government Failure: A Primer in Public Choice* (Washington, DC: Cato Institute, 2002).

[174] For a specific discussion of this issue with respect to securities regulation, see Enriques and Gilotta, "Disclosure and Financial Market Regulation," op. cit.

[175] William F. Shughart, "Public Choice," in David R. Henderson, ed., Concise Encyclopedia of Economics (Liberty Fund, 2007), http://www.econlib.org/library/Enc/PublicChoice.html. James M. Buchanan, *The Collected Works of James M. Buchanan, The Logical Foundations of Constitutional Liberty*, Vol. 1, (Liberty Fund, 1999), p. 46, from a lecture originally given at the Institute for Advanced Studies in Vienna, Austria, in 1979. ("My primary title for this lecture, 'Politics without Romance,' was chosen for its descriptive accuracy. Public choice theory has been the

Sixth, government officials making investments have a notoriously bad track record.[176] Massachusetts regulators' opinion regarding the wisdom of investing in Apple Computer, discussed above, is just one of almost literally countless examples. Seventh, in their capacity as risk assessors, regulators have an increasingly obvious bad track record. In the most recent financial crisis, government regulators' judgment proved no better than that of private actors assuring the public that everything was fine until it was evident to anyone paying the slightest attention that it was not.[177] Eighth, it is a reasonable hypothesis that government regulators are unduly risk averse. There are at least two reasons for this: (1) Government tends to attract people who are risk averse. They have a lower risk tolerance than those making entrepreneurial investments.[178] (2) Government regulators' incentives tend to make them unduly risk averse. An investment that goes bad may make the headlines and their regulatory judgment may be criticized. An investment that never happened because it did not receive regulatory approval will not make the headlines, and their judgment will not be second-guessed.

Recommendations

Preempt blue sky registration, qualification and continuing reporting requirements for (1) securities traded on established securities markets (including a national securities exchange or an alternative trading system), and (2) issuers that have continuing reporting obligations as public companies, under the small issues exemption (Regulation A) or crowdfunding (Regulation CF). Preempt blue registration and qualification requirements for Regulation A primary and secondary offerings.

avenue through which a romantic and illusory set of notions about the workings of governments and the behavior of persons who govern has been replaced by a set of notions that embody more skepticism about what governments can do and what governors will do, notions that are surely more consistent with the political reality that we may all observe about us. I have often said that public choice offers a 'theory of governmental failure' that is fully comparable to the 'theory of market failure' that emerged from the theoretical welfare economics of the 1930's and 1940's.")

[176] Burton W. Folsom Jr. and Anita Folsom, *Uncle Sam Can't Count: A History of Failed Government Investments, from Beaver Pelts to Green Energy* (Broadside Books, 2014); Howard Pack and Kamal Saggi, "The Case for Industrial Policy: A Critical Survey," World Bank Policy Research Working Paper No. 3839, February 2006, http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-3839 ("Overall, there appears to be little empirical support for an activist government policy even though market failures exist that can, in principle, justify the use of industrial policy.").

[177] For example, then Federal Reserve Board Chairman Ben Bernanke said in February 2008, "Among the largest banks, the capital ratios remain good and I don't anticipate any serious problems of that sort among the large, internationally active banks that make up a very substantial part of our banking system." "Fed Chairman: Some Small US Banks May Go Under," CNBC, February 28, 2008, http://www.cnbc.com/id/23390252. Only seven months later, the Emergency Economic Stabilization Act of 2008 established the Troubled Asset Relief Program (TARP), with Bernanke's support, to bail out the big banks.

[178] Michael J. Roszkowski1 and John E. Grable, "Evidence of Lower Risk Tolerance Among Public Sector Employees in Their Personal Financial Matters," *Journal of Occupational and Organizational Psychology*, Vol. 82, No. 2 (June 2009), pp. 453–463.

For Further Information

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2. Rutheford B. Campbell Jr., "Federalism Gone Amuck: The Case for Reallocating Governmental Authority over the Capital Formation Activities of Businesses."[180]
3. Rutheford B. Campbell Jr., "The Role of Blue Sky Laws After NSMIA and the JOBS Act."[181]
4. Comment Letter of David R. Burton regarding Proposed Rule "Amendments for Small and Additional Issues Exemptions under Section 3(b) of the Securities Act."[182]
5. David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth."[183]
6. Concept Release on Harmonization of Securities Offering Exemptions, Securities and Exchange Commission.[184]
7. Comment Letter of David R. Burton regarding *Concept Release on Harmonization of Securities Offering Exemptions*.[185]

Legislative Language

1. Amend Securities Act section 18(b)(1) by adding a new subparagraph (D):

"(D) A security –
(i) traded on established securities markets (including a national securities exchange or an alternative trading system), and
(ii) the issuer of which has continuing reporting obligations pursuant to –
(1) section 13 of the Securities Exchange Act of 1934;
(2) section 15(d) of the Securities Exchange Act of 1934;
(3) section 3(b) of the Securities Act of 1933 [15 U.S. Code §77c(b)] and the regulations thereunder; or

[179] 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.
[180] Rutheford B. Campbell Jr., "Federalism Gone Amuck: The Case for Reallocating Governmental Authority over the Capital Formation Activities of Businesses," Washburn Law Journal, Vol. 50 (Spring 2011), p. 573, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1934825 ("In retrospect, there can be little doubt that the failure of Congress to preempt state authority over the registration of securities was a significant blunder.").
[181] Rutheford B. Campbell Jr., "The Role of Blue Sky Laws After NSMIA and the JOBS Act," Duke Law Journal , Vol. 66 , 2016, pp. 605-631 https://scholarship.law.duke.edu/dlj/vol66/iss3/6.
[182] Comment Letter of David R. Burton regarding Proposed Rule "Amendments for Small and Additional Issues Exemptions under Section 3(b) of the Securities Act." March 21, 2014 https://www.sec.gov/comments/s7-11-13/s71113-52.pdf.
[183] 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.
[184] 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.
[185] 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.

(4) section 4A(b) of the Securities Act of 1933 [15 U.S. Code §77d-1(b)] and the regulations thereunder.

Note: See discussion above under the section heading "Improvements to Regulation A, Protecting Investors with Primary and Secondary Offering Blue Sky Preemption" for a discussion regarding a new subparagraph (C) as follows:

2. Amend Securities Act section 18(b)(1) by adding a new subparagraph (C):

"(C) a security that was offered pursuant to –

(i) section 3(b) of the Securities Act of 1933 [15 U.S. Code §77c(b)][186] (or is the same class of security in all respects as said security), or
(ii) section 4(a)(6) of Securities Act of 1933 [15 U.S. Code §77d(a)(6)][187] (or is the same class of security in all respects as said security)

and is listed, authorized for listing, or otherwise traded on –

(i) a national securities exchange (or tier or segment thereof), or
(ii) an alternative trading system (as defined in 17 CFR §242.300).

3. Also amend Securities Act section 18(b)(4)(C) [15 U.S. Code § 77r(b)(4)(C)] by adding a new subparagraph (H):

"(H) section 15 U.S. Code §77c(b) of this title."

e. Broaden Application of Emerging Growth Company (EGC) provisions

Summary of the Problem and Policy Analysis

Title I of the JOBS act created a new concept of emerging growth companies (EGCs). EGCs are excused for five years from complying with a number of onerous disclosure requirements and from Sarbanes–Oxley act Section 404(b) internal control reporting requirements. This was sometimes referred to as the IPO on-ramp. The statute provides that they may submit a confidential draft registration statement to the SEC for review.

Recommendations

Make the Title I EGC exemptions permanent for all EGCs (redefined so that the status does not expire after five years) and direct the SEC to amend its regulations to the extent necessary for all smaller reporting companies and non-accelerated filers to enjoy the same exemptions.

[186] The Small Issues Exemption (Regulation A).
[187] Crowdfunding (Regulation CF).

f. Materiality

Summary of the Problem and Policy Analysis

The concept of materiality has been described as "the cornerstone" of the disclosure system established by the federal securities laws.[188] The Supreme Court has held that information or facts (or omitted information or facts) are material if there is a substantial likelihood that a reasonable investor would consider the information important in deciding how to vote or make an investment decision.[189] The Court has also indicated that information is material if there is a substantial likelihood that disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information available.[190]

There is no definition of material or materiality in the Securities Act or the Securities Exchange Act although the term "material" is used in both many times. The Commission has defined the term "material" in its regulations and changed its definition over years, often to conform to Supreme Court holdings. The current definition found in 17 CFR § 240.12b-2 is:

> Material. The term "material," when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.

These definitions are fine as far as they go but they are quite general and provide little practical guidance to issuers. There is a spirited debate about whether "principles-based" or more "prescriptive," bright-line rules should govern disclosure by issuers of material information. The Commission's rules presently balance these two approaches. Other issues related to materiality have also generated a robust debate. Congress may or may not want to wade into these issues.

As discussed in the next section, there is also a major effort to effectively redefine what is material to include information that is really directed at achieving various social or political objectives. The focus of the materiality standard should remain on what investors need to know to meet their financial, economic or pecuniary objectives, not a regulator's preferred political or social objectives.

Recommendation

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.

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[188] SEC Concept Release on Business and Financial Disclosure Required by Regulation S-K, April 13, 2016 at p. 33 https://www.sec.gov/rules/concept/2016/33-10064.pdf; "Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission," Committee Print 95-29, House Committee on Interstate and Foreign Commerce, 95th Congress, 1st Session, November 3, 1977 http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1970/1977_1103_AdvisoryDisclosure.pdf.

[189] *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Basic Inc. vs. Levinson*, 485 U.S. 224 (1988)

[190] *Matrixx Initiatives, Inc. v. Siracusano*, 131 U.S. 1309 (2011).

For Further Information

1. SEC Concept Release on Business and Financial Disclosure Required by Regulation S-K,[191]
2. See discussion under the heading "ESG/CSR" below.
3. See discussion under the heading "ERISA" below.

Legislative Language

Note: This language is a tentative suggestion and we may submit a revised recommendation.

In section 2 of the Securities Act define "material" as follows:

> "(20) The term "material" means, when used to qualify a requirement for the furnishing of information as to any subject, information limited to those matters regarding which there is a substantial likelihood that a reasonable investor would attach importance when –
>
> (i) evaluating the potential financial return and financial risks of an existing or prospective investment, or
>
> (ii) exercising, or declining to exercise, any rights appurtenant to securities.
>
> The term "material" does not include, when used to qualify a requirement for the furnishing of information as to any subject, information that –
>
> (i) primarily furthers non-pecuniary, non-economic or non-financial social or political goals or objectives, or
>
> (ii) primarily relates to events that –
>
> (A) involve a high degree of uncertainty regarding what may or may not occur in the distant future, and
>
> (B) are systemic, general or not issuer specific in nature.

g. ESG/CSR

Summary of the Problem and Policy Analysis

Traditionally, the purpose of a business has been to earn a return for its owners by cost-effectively combining the capital and entrepreneurial spirit of its founders and owners with the labor and talent of its employees in a competitive environment to satisfy the wants and needs of its customers. The relationship between owners, management, workers, suppliers, and customers are (subject to certain broad constraints imposed by law) privately decided and voluntary.

With increasing stridency, there is a major effort under way to redefine the purpose of businesses to achieve various social or political objectives unrelated to earning a return, satisfying customers, or treating workers or suppliers fairly. This is being done under the banner of social justice; corporate social responsibility (CSR); stakeholder theory; environmental, social and governance (ESG) criteria; socially responsible investing (SRI); sustainability; diversity; business ethics;

[191] SEC Concept Release on Business and Financial Disclosure Required by Regulation S-K, April 13, 2016 at p. 33 https://www.sec.gov/rules/concept/2016/33-10064.pdf.

common-good capitalism; or corporate actual responsibility.[192] These new objectives would be enforced by various means, including altering corporate disclosure requirements. There is also a major push to federalize and change corporate governance standards.[193]

If successful, these attempts to redefine the purpose of business would have marked adverse social consequences. To wit:

- Management would be even less accountable to anyone since the metrics of success will become highly amorphous and constantly changing.
- Businesses would become less productive and less competitive. Jobs would be lost, and wages would grow more slowly.
- The social welfare cost of going down this road would be considerable.[194]
- It is also one more major step toward the federalization of corporate governance.
- Last, if the SEC chooses to countenance diversity statistical reporting, it should require reporting of types of diversity that are more relevant to business success than the immutable racial, ethnic, or sexual characteristics of its directors.

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[192]Each of these terms (with the possible exception of the latter two, which are of comparatively recent vintage), has evolved in meaning over time and has substantially—even dramatically—different meanings depending on the author or speaker. There is a voluminous literature discussing—but seldom *defining*—these concepts. In the case of "social justice," the term has changed meaning with the political and social situation for two centuries. In contemporary political parlance, it is associated with ideologies that are, at the very least, deeply suspicious of market outcomes and that countenance a high degree of government intervention in the economy. Often, it is a proxy term for Social Democratic or socialist views on economics and critical race theory on social issues. Its economic dimension rests on the premise that a pre-determined distribution of goods should be enforced by the state. This is a substantially different conception of justice than most, which rely on evaluating individual actions, merit, and desert. Similarly, critical race theory evaluates people in terms of their membership in racial, ethnic or sexual groups rather than as individuals. Advocates rarely actually discuss what social justice is or define "stakeholder" — most are utterly unable to do so. Even fewer offer suggestions on how boards or management would weigh the claims of competing "stakeholders" or the implications of these concepts for shareholders and society at large. Social justice and stakeholders are buzzwords or fuzzwords that count as virtue-signaling for the writer or speaker. For a selection of recent discussions of these concepts from both critical and supportive perspectives, see Mike Gonzalez, *The Plot to Change America: How Identity Politics is Dividing the Land of the Free* (New York: Encounter Books, 2020); Peter W. Wood, *Diversity Rules* (New York: Encounter Books, 2019); Brian Barry, *Why Social Justice Matters* (Cambridge: Polity Press, 2005); Michael Novak, Paul Adams, and Elizabeth Shaw, *Social Justice Isn't What You Think It Is* (New York: Encounter Books, 2015); David Miller, *Principles of Social Justice*, revised ed. (Cambridge: Harvard University Press, 2001); Thomas Patrick Burke, *The Concept of Justice: Is Social Justice Just?* (New York: Bloomsbury Academic, 2011); and Friedrich A. von Hayek, "The Atavism of Social Justice," in Friedrich A. von Hayek, *New Studies in Philosophy, Politics, Economics and the History of Ideas*, chapter 5 (Abingdon-on-Thames: Routledge, 1978). For historical context, see Leonard Trelawny, *The Elements of Social Justice* (London: George Allen & Unwin, 1922), and John Bates Clark, *Social Justice Without Socialism* (Boston: Houghton Mifflin, 1914).

[193] See, for example, S.3215, 116th Congress, The Accountable Capitalism Act (Sen. Warren) https://www.congress.gov/bill/116th-congress/senate-bill/3215/text. Specifically, the bill would, among other things, require large corporations to obtain a federal charter, impose a duty to create a general public benefit as articulated in its charter and require directors to balance the pecuniary interests of shareholders with the interests of other persons (i.e. stakeholders) materially affected by the corporation.

[194]See the section below, headed "The Social Welfare Cost of ESG Requirements."

The Social Welfare Cost of ESG Requirements

The broader social costs associated with ESG requirements can, in principle, be quantified. This section provides an analytical framework that may be useful in analyzing the social welfare costs of ESG requirements.

To the extent ESG objectives are not pursued by businesses for the purpose of making a profit, $R > R_{ESG/CSR}$, where R is the rate of return on investment in the absence of ESG, CSR, sustainability requirements, diversity requirements, or stakeholder theory implementation, and $R_{ESG/CSR}$ is the rate of return after implementation of those requirements. The difference, $R - R_{ESG/CSR}$, is economically analogous to a tax. It is a reduction in return due to the pursuit of ESG objectives. Thus, $R - R_{ESG/CSR} = Tax_{ESG/CSR}$. This means that various techniques used in public finance to analyze the social welfare impact of taxes may be used to quantitatively analyze the social welfare cost of these provisions (i.e., $Tax_{ESG/CSR}$).

A tax has an excess burden or deadweight loss that can be calculated.[195] By introducing a wedge ($Tax_{ESG/CSR}$) between, in this case, the gross return and the net return, ESG/CSR reduces the size of the capital market and therefore output and employment. In a well-functioning market, the price of a capital asset should be equal to the present value of the expected future income stream generated by the asset net of taxes and depreciation.[196] Introducing a new tax (in this case $Tax_{ESG/CSR}$) would reduce the expected future income stream, and therefore, the price of the asset. It would also cause investment to flow out of the affected sector or jurisdiction.

Who bears the actual economic burden of the corporate income tax is an open question.[197] The analysis of who bears the burden of $Tax_{ESG/CSR}$ would be the same. One thing is certain: It cannot be corporations. A corporation is a legal fiction, and legal fictions do not pay taxes—people pay taxes. The corporate tax could be borne by corporate shareholders in the form of lower returns;[198]

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[195]Arnold C. Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy* (June 1962), pp. 215–240; Alan J. Auerbach and James R. Hines, "Taxation and Economic Efficiency," in Martin Feldstein and A. J. Auerbach, eds., *Handbook of Public Economics* (Amsterdam: North Holland, 2002); and John Creedy, "The Excess Burden of Taxation and Why It (Approximately) Quadruples When the Tax Rate Doubles," New Zealand Treasury *Working Paper* No. 03/29, December 2003, https://treasury.govt.nz/sites/default/files/2007-10/twp03-29.pdf. See also, for example, N. Gregory Mankiw, *Principles of Economics*, 4th ed. (Boston: Cengage Learning, 2006), chapter 8 (or many other textbooks on price theory, microeconomics, or principles of economics).

[196]See Robert E. Hall and Dale Jorgenson, "Tax Policy and Investment Behavior," *American Economic Review*, Vol. 57, No. 3 (June 1967), pp. 391–414. This section covers the basic user cost of capital analysis with taxes. See also Dale W. Jorgenson, *Investment: Capital Theory and Investment Behavior* (Cambridge, MA: MIT Press, 1996), and John Creedy and Norman Gemmell, "Taxation and the User Cost of Capital: An Introduction," New Zealand Treasury *Working Paper* No. 04/2015, March 2015, https://www.wgtn.ac.nz/cpf/publications/pdfs/2015-pubs/WP04_2015_Taxation-and-User-Cost.pdf.

[197]In the economics literature, this question is usually phrased as, "What is the incidence of the corporate income tax?"

[198]Government estimators are among the few who cling to the view that shareholders bear most of the burden. Joint Committee on Taxation, "Modeling the Distribution of Taxes on Business Income," JCX–14–13, October 16, 2013, https://www.jct.gov/publications.html?func=download&id=4528&chk=4528&no_html=1 (25 percent labor), and Julie Anne Cronin et al., "Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology," *National Tax Journal*, March 2013, https://www.ntanet.org/NTJ/66/1/ntj-v66n01p239-62-distributing-corporate-income-tax.pdf (18 percent labor).

owners of all capital (again in the form of lower returns);[199] corporate customers in the form of higher prices;[200] or employees (in the form of lower wages).[201] It is, almost certainly, some combination of these.[202] The economics profession has changed its thinking on this issue several times over the past four decades, but the latest —and highly plausible —consensus is that workers probably bear *more than half* of the burden of the corporate income tax because capital is highly mobile.[203] Labor's share of the corporate tax burden is potentially as high as three-quarters.[204] Shareholders (investors) probably bear most of the remainder.[205] Initially (i.e., in the short run), the impact on shareholder returns would be greater. Adjustments take time. In the long run, ESG requirements ($Tax_{ESG/CSR}$) would have a disproportionately negative impact on labor due to capital factor mobility.

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[199]The non-corporate sector can be affected because competition will eventually cause wages, prices, and after-tax returns in the corporate *and* non-corporate sectors to be the same. For a more detailed explanation, see Arnold C. Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy*, Vol. 70, No. 3 (June 1962), pp. 215–240.

[200]The focus of the economics profession to date has been almost exclusively the impact on capital and labor rather than customers.

[201]Arnold C. Harberger, "The ABCs of Corporation Tax Incidence: Insights into the Open-Economy Case," in *Tax Policy and Economic Growth* (Washington, DC: American Council for Capital Formation, 1995); Arnold C. Harberger, "The Incidence of the Corporation Income Tax Revisited," *National Tax Journal*, Vol. 61, No. 2 (June 2008), pp. 303–312, http://www.ntanet.org/NTJ/61/2/ntj-v61n02p303-12-incidence-corporation-income-tax.pdf; Matthew H. Jensen and Aparna Mathur, "Corporate Tax Burden on Labor: Theory and Empirical Evidence," *Tax Notes*, June 6, 2011, https://www.aei.org/wp-content/uploads/2011/06/Tax-Notes-Mathur-Jensen-June-2011.pdf; Kevin A. Hassett and Aparna Mathur, "A Spatial Model of Corporate Tax Incidence," American Enterprise Institute, December 1, 2010, https://www.aei.org/wp-content/uploads/2011/10/-a-spatial-model-of-corporate-tax-incidence_105326418078.pdf; Robert Carroll, "The Corporate Income Tax and Workers' Wages: New Evidence from the 50 States," Tax Foundation *Special Report* No. 169, August 3, 2009, https://taxfoundation.org/corporate-income-tax-and-workers-wages-new-evidence-50-states/; Desai Mihir, Fritz Foley, and James Hines, "Labor and Capital Shares of the Corporate Tax Burden: International Evidence," December 2007, http://piketty.pse.ens.fr/files/Desaietal2007.pdf; and "Why Do Workers Bear a Significant Share of the Corporate Income Tax?" in Jason J. Fichtner and Jacob M. Feldman, "The Hidden Cost of Federal Tax Policy," 2015, https://www.mercatus.org/system/files/Fichtner-Hidden-Cost-ch4-web.pdf. For a contrary view, see Kimberly A. Clausing, "In Search of Corporate Tax Incidence," *Tax Law Review*, Vol. 65, No. 3 (2012), pp. 433–472, http://ssrn.com/abstract=1974217.

[202]It requires extreme, implausible assumptions about elasticities of demand for, or supply of, factors for this not to be the case. Alan J. Auerbach, "Who Bears the Corporate Tax? A Review of What We Know," National Bureau of Economic Research *Working Paper* No. 11686, October 2005, http://www.nber.org/papers/w11686.pdf; William M. Gentry, "A Review of the Evidence on the Incidence of the Corporate Income Tax," Department of the Treasury, Office of Tax Analysis, *OTA Paper* No. 101, December 2007, https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-101.pdf; and Stephen J. Entin, "Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays The Tax?" Heritage Foundation *Center for Data Analysis Report* No. 04–12, November 5, 2004, http://s3.amazonaws.com/thf_media/2004/pdf/cda04-12.pdf.

[203]In a competitive market, capital will flow from jurisdictions with a relatively low expected after-tax return to jurisdictions with a relatively high expected after-tax return until the expected after-tax returns are equal. Social and legal barriers reduce labor mobility relative to capital mobility. Gentry, "A Review of the Evidence on the Incidence of the Corporate Income Tax"; William C. Randolph, "International Burdens of the Corporate Income Tax," Congressional Budget Office *Working Paper* 2006–09, August 2006, https://cbo.gov/sites/default/files/cbofiles/ftpdocs/75xx/doc7503/2006-09.pdf; and R. Alison Felix, "Passing the Burden: Corporate Tax Incidence in Open Economies," Federal Reserve Bank of Kansas City, October 2007, https://www.kansascityfed.org/Publicat/RegionalRWP/RRWP07-01.pdf.

[204]Ibid.

[205]As opposed to non-corporate capital and customers.

Recommendations

1. Oppose efforts to redefine the purpose of business in the name of social justice, corporate social responsibility (CSR), stakeholder theory, environmental, social and governance (ESG) criteria, socially responsible investing (SRI), sustainability, diversity, business ethics, or common-good capitalism.
2. See recommendations under the heading "Materiality" above.
3. See recommendations under the heading "ERISA" below.
4. See recommendations under the heading "Prohibition on Racial, Sex, and Ethnic Discrimination" below.

For Further Information

1. See discussion under the heading "Materiality" above.
2. See discussion under the heading "ERISA" below.
3. See discussion under the heading "Prohibition on Racial, Sex, and Ethnic Discrimination" below.
4. See forthcoming Heritage Foundation Special Report tentatively entitled "The Purpose of Business: A Guide to Corporate Social Responsibility and ESG Requirements."

Legislative Language

1. See legislative language under the heading "Materiality" above.
2. See legislative language under the heading "ERISA" below.
3. See legislative language under the heading "Prohibition on Racial, Sex, and Ethnic Discrimination" below.

h. Prohibition on Racial, Sex, and Ethnic Discrimination

Summary of the Problem and Policy Analysis

Many, perhaps most, of the proponents of diversity, inclusion, social justice, critical race theory, multiculturism, and identity politics reject (in their words) "the very foundations of the liberal order, including equality theory, legal reasoning, Enlightenment rationalism, and neutral principles of constitutional law."[206] They are engaged in a systematic and sustained effort to effectively change our national ethos from *E Pluribus Unum* to *De Uno, Multis*.[207]

[206] See "What is Critical Race Theory?," in Richard Delgado and Jean Stefancic, *Critical Race Theory: An Introduction*, 3rd ed. (New York: New York University Press, 2017), p. 3, and Kevin R. Johnson, "Richard Delgado's Quest for Justice for All," *Law & Inequality: A Journal of Theory and Practice*, Vol. 33, No. 2 (2015) https://scholarship.law.umn.edu/cgi/viewcontent.cgi?article=1213&context=lawineq ("A brief, simple commentary cannot do justice to Delgado's pioneering legal scholarship —he is nothing less than a legend, a sort of LeBron James or Michael Jordan among legal academics."). See also Jonathan Butcher and Mike Gonzalez, "Critical Race Theory, the New Intolerance, and Its Grip on America," Heritage Foundation Backgrounder No. 3567, December 7, 2020, https://www.heritage.org/sites/default/files/2020-12/BG3567.pdf.

[207] For this formulation of the problem, see Mike Gonzalez, The Plot to Change America: How Identity Politics Is Dividing the Land of the Free (New York: Encounter Books, 2020).

They seek to alter the "narrative" and to make sex, race, ethnicity, and sexual orientation central to law, public policy, and our self-understanding instead of individual achievement, merit, talent, and the content of our character. They actively seek to discriminate on the basis of sex, race, ethnicity, or sexual orientation rather than achieve a society in which such discrimination is unlawful and rare. They seek a *faux* diversity measured by group identity, determined largely by immutable characteristics—rather than true diversity that accounts for the rich tapestry of human experience. They seek to subordinate individual merit to group identity. Securities regulators should not go down this path.

Proposals such as NASDAQ's proposed board diversity rule, which rely on self-identification for board-diversity disclosures, raise liability concerns with respect to misrepresentations under the anti-fraud and reporting provisions of the federal securities laws. A person who is a Caucasian male is objectively not a female Native American, whether he "self-identifies" as a female Native American or not.

The Principles of the Civil Rights Act

The Civil Rights Act of 1964 makes it an unlawful employment practice for an employer to "limit, segregate, or classify his employees or applicants for employment…because of such individual's race, color, religion, sex, or national origin." Specifically, it reads as follows:

> Unlawful Employment Practices (a) Employer practices. It shall be an unlawful employment practice for an employer—
>
> (1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin; or
>
> (2) to limit, segregate, or classify his employees or applicants for employment in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's race, color, religion, sex, or national origin.[208]

The Civil Rights Act also makes preferential treatment based on numbers or percentages unlawful:

> Preferential Treatment Not to be Granted on Account of Existing Number or Percentage Imbalance
>
> (j) Nothing contained in this subchapter shall be interpreted to require any employer, employment agency, labor organization, or joint labor–management committee subject to this subchapter to grant preferential treatment to any individual or to any group because of the race, color, religion, sex, or national origin of such individual or group on account of an imbalance which may exist with respect to the total number or percentage of persons of any race, color, religion, sex, or national origin employed by any employer, referred or classified

[208] Section 703 of the Civil Rights Act of 1964, 42 U.S. Code § 2000e-2.

> for employment by any employment agency or labor organization, admitted to membership or classified by any labor organization, or admitted to, or employed in, any apprenticeship or other training program, in comparison with the total number or percentage of persons of such race, color, religion, sex, or national origin in any community, state, section, or other area, or in the available work force in any community, state, section, or other area.[209]

The securities laws should incorporate Civil Rights Act principles to prevent regulators, including SROS, from adopting rules or practices that discriminate on the basis of race, color, religion, sex, or national origin. Racism and sexism should not be legally mandated by securities regulators.

Racism and Sexism Are Moral Steps Backwards

I have a dream that my four little children will one day live in a nation where they will not be judged by the color of their skin but by the content of their character.[210]
—Martin Luther King, Jr.

Sex, like race, is a visible, immutable characteristic bearing no necessary relationship to ability.[211]
—Ruth Bader Ginsburg (in oral argument as an attorney in *Frontiero v. Richardson*)

The Constitution abhors classifications based on race, not only because those classifications can harm favored races or are based on illegitimate motives, but also because every time the government places citizens on racial registers and makes race relevant to the provision of burdens or benefits, it demeans us all. Purchased at the price of immeasurable human suffering, the equal protection principle reflects our Nation's understanding that such classifications ultimately have a destructive impact on the individual and our society.[212]
—Justice Clarence Thomas (*Grutter v. Bollinger)*

Racism: A belief that race is a fundamental determinant of human traits and capacities.[213]

Sexism: Prejudice or discrimination based on sex; behavior, conditions, or attitudes that foster stereotypes of social roles based on sex.[214]

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[209] 42 U.S. Code § 2000e–2(j).
[210] Martin Luther King, Jr., "I Have a Dream," address delivered August 28, 1963, https://kinginstitute.stanford.edu/king-papers/documents/i-have-dream-address-delivered-march-washington-jobs-and-freedom.
[211] Katherine Franke, "Symposium: The Liberal, Yet Powerful, Feminism of Ruth Bader Ginsburg," October 9, 2020, https://www.scotusblog.com/2020/10/symposium-the-liberal-yet-powerful-feminism-of-ruth-bader-ginsburg/ and Robert Cohen and Laura J. Dull, "Supplemental Online Material for 'Teaching About the Feminist Rights Revolution': Ruth Bader Ginsburg as 'The Thurgood Marshall of Women's Rights,'" November 2017, https://tah.oah.org/november-2017/supplemental-online-material-for-teaching-about-the-feminist-rights-revolution-ruth-bader-ginsburg-as-the-thurgood-marshall-of/.
[212] Grutter v. Bollinger, 539 U. S. 306, 353 (2003), Thomas opinion (concurring in part and dissenting in part) https://www.supremecourt.gov/opinions/boundvolumes/539bv.pdf.
[213] Merriam-Webster Online, "Racism," https://www.merriam-webster.com/dictionary/racism.
[214] Ibid.

Nasdaq' proposed board diversity rule is racist and sexist in that it mandates that firms establish quotas and discriminate based on sex, skin color, ethnicity, or sexual orientation rather than making determinations based on individual achievement, talent, experience, or competence. It defines diversity entirely in terms of these immutable characteristics — instead of the myriad of other kinds of diversity such as a director's achievement, expertise, experience, approach to business or business philosophy, educational background, socio-economic background, ethical views, political views, integrity, geographic location, and so on.

Morally, rules like the proposed Nasdaq board diversity rule represent a marked step backwards. It is rejection of the principle that people should be judged on the content of their character and their individual achievement rather than their sex, race, national origin, ethnicity, or sexual orientation. It is rejection of the principle that people should be judged as individuals rather than as members of a racial or sexual group. It is a rejection of the principle of equal protection under the law (or, in this case, regulations promulgated under law). It is a rejection of the principle that we are all created equal. Legal discrimination or quotas on the basis of race, ethnicity or sex should be a relic of the past.

The type of diversity created by the Nasdaq proposed rule, for example, would be faux diversity—skin deep, if you will. It is a rejection of the kind of diversity that is most likely to enable a business to understand the true diversity of the American people and actually be relevant to business profitability, such as a director's achievement, expertise, experience, approach to business or business philosophy, educational background, socio-economic background, ethical views, political views,[215] integrity, or geographic location. There is also strong reason to believe that those chosen under such a rule but who "self-identify" as women, a designated minority, or LGBTQ+ will have been educated in the same handful of schools and come from the same coastal urban centers as most existing directors.

Recommendations

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, ethnicity or sex should be a relic of the past.

For Further Information

1. David R. Burton, "Nasdaq's Proposed Board-Diversity Rule Is Immoral and Has No Basis in Economics."[216]

[215] It is probably not advisable to require reporting on the political ideology or the party affiliation of board members and management. The country is politicized enough. But the one study that we found on the subject appears to show a strong, statistically robust positive impact of political heterogeneity of boards on firm performance. Incheol Kim, Christos Pantzalis, and Jung Chul Park, "Corporate Boards' Political Ideology Diversity and Firm Performance," Journal of Empirical Finance, Vol. 21 (2013) https://ssrn.com/abstract=2055800.

[216] David R. Burton, "Nasdaq's Proposed Board-Diversity Rule Is Immoral and Has No Basis in Economics," Heritage Foundation Backgrounder No. 3591, March 9, 2021 https://www.heritage.org/sites/default/files/2021-

2. Comment Letter of Twelve Banking Committee Senators regarding Nasdaq Board Diversity Rule.[217]
3. Comment Letter of Thomas J. Fitton regarding Nasdaq Board Diversity Rule.[218]

Legislative Language

Sec. xxx. (a) Discrimination by Financial Regulators Unlawful. -- It shall be an unlawful for a financial regulator to –

(1) promulgate any rule,
(2) provide guidance,
(3) issue a no action letter, private letter ruling or take similar action,
(4) initiate or pursue any enforcement action; or
(5) take any other action

that would

(1) discriminate against any individual or entity on the basis of any individual's race, color, religion, sex, or national origin; or
(2) limit, segregate, or classify employees, applicants, officers, board members, management, customers, clients, regulated individuals or regulated entities in any way which would deprive or tend to deprive any individual of opportunities or otherwise adversely affect such individual because of any individual's race, color, religion, sex, or national origin.

(b) Financial Regulator Definition. -- Financial Regulator means –
(1) the Department of the Treasury (including, but not limited to, (i) the Office of the Comptroller of the Currency, (ii) the Financial Crimes Enforcement Network, and (iii) the Internal Revenue Service),
(2) the Federal Reserve Board,
(3) the Consumer Financial Protection Bureau,
(4) the Securities and Exchange Commission,
(5) the Federal Deposit Insurance Corporation,
(6) the Commodity Futures Trading Commission,
(7) the Federal Housing Finance Agency,
(8) the National Credit Union Administration,
(9) any state banking commissioner,
(10) any state insurance commissioner,
(11) any state securities commissioner,
(12) any national securities association, and

03/BG3591_0.pdf. See also Comment Letter of David R. Burton regarding Nasdaq Board Diversity Rule, January 4, 2021 https://www.sec.gov/comments/sr-nasdaq-2020-081/srnasdaq2020081-8204282-227462.pdf.
[217] Comment Letter of Twelve Banking Committee Senators regarding Nasdaq Board Diversity Rule, February 12, 2021 https://www.sec.gov/comments/sr-nasdaq-2020-081/srnasdaq2020081-8369379-229219.pdf.
[218] Comment Letter of Thomas J. Fitton regarding Nasdaq Board Diversity Rule, December 29, 2020 https://www.sec.gov/comments/sr-nasdaq-2020-081/srnasdaq2020081-8191441-227278.pdf.

(13) any other self-regulatory organization (as defined in xxx).

Congress may also want to consider liability comparable to that under 42 U.S. Code §1983 for regulators that violate the forgoing.

i. PCAOB-Registered Audit Firms for Non-custodial Broker-Dealers

Summary of the Problem and Policy Analysis

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.

The bill 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. They would still be subject to the full panoply of both SEC and FINRA rules governing broker-dealers.

Recommendation

Exempt privately-held, non-custodial broker-dealers from the requirements to use a PCAOB registered firm for their audits.

For Further Information

David Burton, "The Benefits of the Small Business Audit Correction Act."[219]

Legislative Language

S.2724, H.R.8983, 116th, Congress Small Business Audit Correction Act of 2019 (Sen. Cotton, Rep. Hill)

j. Consolidated Audit Trail

Summary of the Problem and Policy Analysis

The Securities and Exchange Commission is implementing a Consolidated Audit Trail (CAT) program that requires broker-dealers to report securities transactions to CAT NMS LLC, a Delaware-based limited-liability company jointly owned by broker-dealers on an equal basis. CAT

[219] David Burton, "The Benefits of the Small Business Audit Correction Act," *The Daily Signal*, June 29, 2018 https://www.dailysignal.com/2018/06/29/the-benefits-of-the-small-business-audit-correction-act/.

requirement invades investor privacy, creates a severe risk of data breaches, and imposes high costs that will likely lead to more small firms leaving the financial services industry. It has been plagued by delay and technical problems. There is little reason to have any confidence in the SEC or CAT NMS LLC. Their assurances should not be taken at face value. The risks of identity theft and huge financial losses for ordinary Americans are quite high.

The consolidated audit trail database will become an incredibly attractive target for hackers. The SEC, the Financial Industry Regulatory Authority, and 23 self-regulatory organizations will be able to access the consolidated audit trail database at will. It is anticipated that there will be as many as 3,000 regulatory users. It will include personally identifiable information with respect to millions of people, including Social Security numbers, date of birth, and brokerage account information. When one of the many users are hacked and ordinary investors lose their life savings, it is far from clear by whom they will be compensated. We can be sure, however, that the SEC – the progenitor of this problem – will do nothing to help the investors other than issue regretful press releases.

Recommendation

Congress should terminate the Consolidated Audit Trail program.

For Further Information

1. David Burton, "Why the SEC's Consolidated Audit Trail Is a Bad Idea."[220]
2. Jay Clayton, "Consolidated Audit Trail: Focus on Effective Implementation Puts CAT on Track."[221]
3. Hester Peirce, "This CAT is a Dangerous Dog."[222]
4. "Statement of Hester M. Peirce."[223]
5. Hester Peirce, "Liberty's Loss."[224]
6. Christopher A. Iacovella, "Why We're Suing the SEC."[225]

[220] David Burton, "Why the SEC's Consolidated Audit Trail Is a Bad Idea," *The Daily Signal*, December 04, 2019 https://www.dailysignal.com/2019/12/04/why-the-secs-consolidated-audit-trail-is-a-bad-idea/.
[221] Jay Clayton, "Consolidated Audit Trail: Focus on Effective Implementation Puts CAT on Track," December 16, 2020 https://www.sec.gov/news/public-statement/clayton-consolidated-audit-trail-2020-12-16
[222] Hester Peirce, "This CAT is a Dangerous Dog," RealClearPolicy, October 9, 2019 https://www.realclearpolicy.com/articles/2019/10/09/this_cat_is_a_dangerous_dog_111285.html.
[223] "Statement of Hester M. Peirce," May 15, 2020 https://www.sec.gov/news/public-statement/peirce-statement-response-release-34-88890-051520.
[224] Hester Peirce, "Liberty's Loss," December 10, 2020 https://www.sec.gov/news/speech/peirce-libertys-loss-2020-12-10.
[225] Christopher A. Iacovella, "Why We're Suing the SEC," *Wall Street Journal*, May 17, 2020 https://www.wsj.com/articles/why-were-suing-the-sec-11589740995.

k. Repeal Title XV of the 2010 Dodd-Frank Act

Summary of the Problem and Policy Analysis

Title XV of the Dodd–Frank Wall Street Reform and Consumer Protection Act contains three provisions requiring public companies to report in their disclosure documents with respect to conflict minerals, mine safety, and resource extraction. In addition, Dodd-Frank Title IX Section 953(b) requires disclosure of the ratio between a company's CEO pay and the median pay of all other employees. The primary purpose of these requirements is to further political objectives. They are unrelated to the purpose of the securities laws and the mission of the Securities and Exchange Commission (SEC).

Recommendations

Repeal Title XV (especially sections 1501-1504) and Title IX Section 953(b) of the 2010 Dodd-Frank Act.

For Further Information

David R. Burton, "How Dodd–Frank Mandated Disclosures Harm, Rather than Protect, Investors."[226]

Legislative Language

Repeal Title XV (especially sections 1501-1504) and Title IX Section 953(b) of the 2010 Dodd-Frank Act.

l. FINRA Reforms

i. Introduction

FINRA is a regulator of central importance to the functioning of U.S. capital markets. It is the primary regulator of broker-dealers and those that work for them. It has a budget that is well over half of the SEC's budget. It is neither a true self-regulatory organization nor a government agency. It is largely unaccountable to the industry or to the public. Due process, transparency, and regulatory-review protections normally associated with regulators are not present, and its arbitration process is flawed. Reforms are necessary. Neither FINRA itself nor the SEC have made meaningful reforms. The problems with FINRA are serious and wide ranging. This section of this submission is a very short summary. Congress must act.

ii. Reforms

Summary of the Problem and Policy Analysis

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

FINRA has been delegated immense regulatory authority by Congress and the SEC, but as a Delaware not-for-profit organization, it is not, for example, subject to the notice-and-comment provisions of the Administrative Procedure Act, the Freedom of Information Act, the Regulatory Flexibility Act, the Sunshine Act, the Paperwork Reduction Act, or cost-benefit-analysis requirements. In contrast to a court, FINRA's arbitration and disciplinary hearings are not generally open to the public. Its rule making is generally done in private. However, once a rule is finalized by FINRA and submitted to the SEC for approval, the SEC does make the rule available for public comment. It is very, very rare for the SEC to require FINRA to amend a proposed rule. Its Board of Governors meetings are closed.

When dealing with FINRA, the many protections afforded to the public when dealing with government are unavailable, and the recourse that one would normally have when dealing with a private party—both access to the courts and the ability to decline to do business—is also generally unavailable.

The combination of arbitrators not needing to provide reasons for their decision and the near-total lack of review for customer or intra-industry arbitrations is fundamentally unfair and affords no recourse to either customers or firms that are the victims of poorly reasoned, unjust, or arbitrary decisions. Some of these disputes, of course, involve modest amounts of money. But others involve substantial sums and can, in the case of customers, involve their life savings. Similarly, a firm that is forced to unjustly pay an award has no recourse.

FINRA fees are not voluntary. Before raising these fees, FINRA should be required to obtain an affirmative vote by Congress or, at least, by the SEC. FINRA should not have a financial incentive to impose fines. Fines should go to either a newly established investor reimbursement fund or to the Treasury (which is usually the case when a government agency imposes fines). Such a fund would reimburse consumers when sufficient funds cannot be recovered from the firm or individual committing the misconduct.

Some of the largest firms have committed multibillion dollar frauds but FINRA has imposed few consequences on the individuals who committed this fraud. There is bipartisan, bi-ideological concern about FINRA enforcement. A distressing high percentage of FINRA regulator individuals have misconduct record. It is, of course, possible that the high level of advisers with misconduct records is due to aggressive FINRA enforcement, and that the high level of re-employment in the financial industry of advisers with misconduct records is because the misconduct involved was minor. Given the information currently available to the public and policymakers, it is simply impossible to know. And that needs to change.

<u>Recommendations</u>

Transparency

1. Congress should require that FINRA's Board of Governors meetings be open to the public, unless the board votes to meet in executive session. The criteria for whether they can close the meeting should be established in advance and carefully circumscribed.

2. Congress should require that FINRA's Board of Governors agenda be made available to the public in advance, and that board minutes describing actions taken be published with alacrity. Such requirements are analogous to, but less stringent than, the requirements imposed on government agencies by the Sunshine Act.
3. Congress should require that FINRA make available to the public in advance rule-makings that the FINRA board is expected to consider.
4. Given that under current law FINRA proceedings supplant a civil trial and there is no means of accessing the courts, Congress should require FINRA arbitration and disciplinary hearings should be open to the public and reported. This is analogous to the public-trial requirement in the Sixth Amendment and the long-standing presumption that all court proceedings in the United States are open to the public.

Arbitration

1. Administrative-law courts are required to make "findings and conclusions, and the reasons or basis therefore, on all the material issues of fact, law, or discretion presented on the record." Congress should require that FINRA arbitrators be required to make findings of fact based on the evidentiary record and to demonstrate how those facts led to the award given. These written FINRA arbitration decisions should be subject to SEC review and limited judicial review.
2. This may be difficult for many existing FINRA arbitrators who do not have training in finance or in the law. If raising FINRA arbitrator honoraria is necessary in order to attract those with the requisite skills, FINRA should do so.
3. Congress should require that all SRO fines, including those imposed by FINRA, go to either a newly established investor reimbursement fund or to the Treasury. FINRA should not have a financial interest in imposing fines.

Rule-Making

1. Congress should require all SROs, including FINRA, to conduct meaningful cost-benefit analysis as part of the rule-making process.
2. Congress should require all SROS, including FINRA, to publish its rules in proposed format and seek public comment before they are submitted to the SEC (which very rarely changes SRO rules).

Oversight

Congressional oversight of FINRA has been light. To improve oversight, Congress should:

1. Require that FINRA submit an annual report to Congress with detailed, specified information about its budget and fees; its enforcement activities (including sanctions and fines imposed by type of violation and type of firm or individual); its dispute resolution activities; and its rule-making activities;
2. Conduct annual oversight hearings on FINRA, its budget, its enforcement activities, its dispute resolution activities, and its rule-making activities;

3. Require an annual GAO review of FINRA with respect to its budget, its enforcement activities, its dispute resolution activities, and its rule-making activities and a separate review of the SEC's oversight of FINRA; and
4. Make FINRA, the Municipal Securities Rulemaking Board (MSRB) and the National Futures Association (NFA) each a "designated federal entity" and establish an inspector general with respect to financial SROs, including FINRA, the MSRB, and the NFA or, alternatively, placing FINRA, the MSRB, and the NFA within the ambit of an existing inspector general.
5. Require FINRA to obtain an affirmative vote by Congress or, at least, by the SEC to raise its fees imposed on broker-dealers.

For Further Information

1. David R. Burton, "Reforming FINRA."[227]
2. Hester Peirce, "The Financial Industry Regulatory Authority: Not Self-Regulation after All."[228]

Legislative Language

Legislative language will be supplied later.

m. SEC Reforms

i. Introduction

The Securities and Exchange Commission is the most important regulator of U.S. capital markets. Although its budget has increased by about 80 percent over a decade, its effectiveness remains in question. Resources have flowed into unnecessary management, "support," and ancillary functions, while core functions have been neglected. Its organizational structure is unwieldy. It takes action at a genuinely glacial pace. The Commission needs to be better managed — it does not need (as has been proposed) more managers. The number of direct reports to the Chairman needs to be reduced. Its information technology programs appear to be poorly managed and is among the most costly in government. The SEC bases its decisions on inadequate data and does much less than most agencies to provide data to Commissioners, other policymakers, and the public. Its enforcement efforts directed at fraud and other malfeasance by managers of large financial institutions are inadequate. The Commission does little to remove unnecessary regulatory impediments to entrepreneurial capital formation. Reforms are necessary so that the SEC can better support well-functioning capital markets.

[227] David R. Burton, "Reforming FINRA," Heritage Foundation Backgrounder No. 3181, February 1, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3181.pdf.
[228] Hester Peirce, "The Financial Industry Regulatory Authority: Not Self-Regulation after All," Mercatus Center Working Paper, January 2015, https://www.mercatus.org/system/files/Peirce-FINRA_0.pdf.

ii. Reforms

Summary of the Problem and Policy Analysis

Under reorganization Plan No. 10 of 1950,24[229] the Chairman has executive authority over the SEC staff and, absent a statutory requirement, the structure of the SEC. The organization and structure of the SEC has not really been rethought for 70 years. It shows. It is a mess. Details regarding reforms and documentation of problems can be found in "Reforming the Securities and Exchange Commission."[230]

Commissioners and Congress operate in an almost data free environment because the SEC is so bad at collecting and publishing relevant data. Data available to the Commission and Congressional policymakers with respect to securities markets, securities offerings, securities market participants and securities law enforcement is seriously deficient. This becomes evident when what is available to the Commission and Congress in the securities regulation field is compared to, for example, the Internal Revenue Service Statistics of Income and IRS Databook relevant to tax policy,[231] the data provided with respect to health care by the National Center for Health Statistics, the Centers for Medicare & Medicaid Services and others,[232] the data provided regarding labor and employment by the Bureau of Labor Statistics and others,[233] education data,[234] transportation data[235] and the general economic data provided by the Bureau of Economic Analysis[236] or the Census[237] and so on.

The Division of Economic and Risk Analysis (DERA) should substantially improve the collection and regular publication of data on securities offerings, securities markets and securities law enforcement and publish an annual data book of time series data on these matters. With a budget of about $72 million and about 175 employees, it has adequate resources to do so.[238] It should conduct surveys and collect information internally available (both data from filings and from enforcement actions). It should publish on a regular basis time series data in compliance with OMB's Standards and Guidelines for Statistical Surveys and the Paperwork Reduction Act. DERA should consult with the Office of Management and Budget (OMB) Office

[229] Title 5, United States Code, Appendix, Reorganization Plans, http://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title5a-node84-leaf114&num=0&edition=prelim and 15 U.S. Code § 78d-2.
[230] David R. Burton, "Reforming the Securities and Exchange Commission," Heritage Foundation Backgrounder No. 3378, January 30, 2019 https://www.heritage.org/sites/default/files/2019-01/BG3378.pdf.
[231] Tax Statistics https://www.irs.gov/statistics.
[232] The National Center for Health Statistics https://www.cdc.gov/nchs/index.htm; The Centers for Medicare & Medicaid Services (CMS), Research, Statistics, Data & Systems https://www.cms.gov/Research-Statistics-Data-and-Systems/Research-Statistics-Data-and-Systems.html.
[233] Bureau of Labor Statistics https://www.bls.gov/; National Labor Relations Board. Graphs & Data https://www.nlrb.gov/news-outreach/graphs-data; U.S. Equal Employment Opportunity Commission, Statistics https://www.eeoc.gov/eeoc/statistics/.
[234] National Center for Education Statistics https://nces.ed.gov/.
[235] Bureau of Transportation Statistics https://www.bts.gov/.
[236] Bureau of Economic Analysis http://www.bea.gov/.
[237] Census Bureau, Data Tools and Apps https://www.census.gov/data/data-tools.html.
[238] Fiscal Year 2019 Congressional Budget Justification, United States Securities and Exchange Commission, pp 15-17, 39 https://www.sec.gov/files/secfy19congbudgjust.pdf.

of Information and Regulatory Affairs (OIRA) and the Interagency Council on Statistical Policy and secure advice from key statistic agencies such as the Census Bureau and the Bureau of Economic Analysis regarding the most effective means of collecting information and protecting the privacy of those providing the information.

Specifically, DERA should publish annual data on:

> (1) the number of offerings and offering amounts by type (including type of issuer[239], type of security[240] and exemption used[241]);
> (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,[242] 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.

Recommendations

1. Congress should enact legislation reducing the number of direct reports to the Chairman from 23 to 12.
2. Offices performing similar functions should be merged. First, the Office of Equal Employment Opportunity and the Office of Minority and Women Inclusion should be

[239] By industry; by measures of size such as gross revenues, assets or employees; by age (i.e. years in existence); reporting status; and so on.
[240] Common stock, preferred stock, bond, (and whether the bond or preferred stock is convertible into common stock), other classes of security, whether options or warrants were attached; and so on.
[241] Regulation D (Rule 504 and 506 (including 506(b) and 506(c)); Regulation A (Tier 1 and Tier 2); Crowdfunding (Tiers 1, 2 & 3); non-Regulation D section 4(a)(2) offerings, Rule 144A and other exemptions.
[242] Civil or Criminal (referrals, convictions, settlements); with respect to broker-dealers (Breach of Fiduciary Duty, Suitability violations, Negligence, Failure to Supervise, Misrepresentation, Fraud, Breach of Contract, Omission of Facts, Violation of Blue Sky Laws, Unauthorized Trading, Manipulation, Churning); issuer violations by type of violation (e.g. fraud, non-compliance with Regulation S-K, Regulation S-X, failure to file an 8-K, Regulation A, Regulation CF, etc.) and type of issuer ((private issuer, Regulation A issuer, crowdfunding issuer, reporting company, investment company, registered investor advisor, broker-dealer, registered representative, etc.).

merged.[243] Second, the Office of Investor Education and advocacy should be merged into the Office of the Investor advocate Office.[244]

3. The number of managers per employee should be reduced.
4. Resources should flow toward core functions and away from ancillary and support functions.
5. Congress should require an Inspector General's report or a GAO report regarding Information Technology spending and contracting by the SEC. Spending appears to be much too high and IT contracting poorly managed.
6. Congress should seriously examine the staffing level and the level of spending in the IG's office. It appears to be much too high.
7. Any three members should be empowered to place an item on the agenda and to receive adequate staff support to do so even without the Chairman's support.
8. Congress should create a large case unit within the Division of Enforcement.
9. 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 above).
10. Respondents should be allowed to elect whether an adjudication occurs in the SEC's administrative law court or an ordinary article III federal court.
11. Congress should require both the SEC and the GAO to study whether Commission delegation of authority to staff should be narrowed and whether sunsetting of delegation of authority should be required.
12. Congress should require the Commission to publish a detailed annual report on SRO supervision.

For Further Information

David R. Burton, "Reforming the Securities and Exchange Commission."[245]

Legislative Language

Legislative language will be supplied later.

[243] This would require amending 12 U.S. Code § 5452 (§342 of the Dodd–Frank Act).
[244] The Office of the Investor Advocate Office was created by § 915 of the Dodd–Frank Act and has a statutory basis at 15 U.S.C. § 78d(g). The Office of Investor Education and Advocacy appears to have no statutory basis. Ergo, the Office of the Investor Advocate should be the surviving entity.
[245] David R. Burton, "Reforming the Securities and Exchange Commission," Heritage Foundation Backgrounder No. 3378, January 30, 2019 https://www.heritage.org/sites/default/files/2019-01/BG3378.pdf.

IV. Anti-Money Laundering/Combating the Financing of Terrorism/Know Your Customer (AML/CFT/KYC)

a. Introduction

Privacy, both financial and personal, is a key component of life in a free society. Unlike in totalitarian or authoritarian regimes, individuals in free societies have a private sphere free of government involvement, surveillance, and control. The United States Constitution's Bill of Rights, particularly the Fourth, Fifth, and Ninth Amendments, together with structural federalism and separation of powers protections, is designed to further that end by protecting individual rights. The current financial regulatory framework is inconsistent with these principles.

In general, individuals should have control over who has access to information about their personal and financial lives. Individuals should be free to lead their lives unmolested and unsurveilled by government unless there is a reasonable suspicion[246] that they have committed a crime or conspired to commit a crime. Any information-sharing regime must include serious safeguards to protect the privacy of individuals and businesses. Financial privacy is especially vital because it can be the difference between survival and systematic suppression of an opposition group in a country with an authoritarian government. Many businesses, dissidents, and human rights groups maintain accounts outside the countries where they are active for precisely this reason.

Financial privacy can allow people to protect their life savings when a government tries to confiscate its citizens' wealth, whether for political, ethnic, religious, or "merely" economic reasons. Businesses need to protect their private financial information, intellectual property, and trade secrets from competitors in order to remain profitable. Financial privacy is of deep and abiding importance to freedom, and many governments have shown themselves willing to routinely abuse private financial information.

Many government agencies, in both the U.S. and other countries, are currently involved in collecting and disseminating private individuals' information for the purpose of conducting their national security, law enforcement, and tax administration functions. The unique requirements for fulfilling each of these purposes dictate certain policy choices for designing an optimal financial-privacy regime. The current U.S. framework is overly complex and burdensome, and its ad hoc nature has likely impeded efforts to combat terrorism, enforce laws, and collect taxes. Efforts to improve the existing framework must focus on protecting individuals' privacy rights while improving law enforcement's ability to apprehend and prosecute criminals and terrorists.

Reform efforts also need to focus on costs versus benefits. The current framework, particularly the anti-money laundering (AML) rules, is clearly not cost-effective. The AML regime costs an estimated $4.8 billion to $8 billion annually. Yet, this AML system results in fewer than 700 convictions annually, a substantial proportion of which are simply additional counts against persons charged with other predicate crimes. Thus, each conviction costs at least $7 million and

[246] See, for example, *Terry v. Ohio*, 392 U.S. 1, 21 (1968). ("And, in justifying the particular intrusion, the police officer must be able to point to specific and articulable facts which, taken together with rational inferences from those facts, reasonably warrant that intrusion.")

probably much, much more if add-on AML counts where the AML laws were not the initial cause of the investigation are excluded.

FinCEN is among the most opaque of regulators and provides little information beyond anecdotes to Congress. From a regulator that demands massive information reporting and transparency from the private sector, it is not too much to expect a modest degree of transparency and data provision and to move past the "trust us, we know best and we need not explain ourselves" paradigm that has existed for decades. The hypocrisy and opaqueness that FinCEN routinely exhibit towards the public and Congress is astounding. Moreover, FinCEN does not engage in meaningful cost-benefit analysis and to the extent it does estimate costs, its estimates are absurdly low.

For Further Information

David R. Burton and Norbert J. Michel, "Financial Privacy in a Free Society."[247]

b. Raise CTR threshold

Summary of the Problem and Policy Analysis

The original cash transaction report threshold has not been adjusted from $10,000 for half a century. Had it been, then the threshold would exceed $50,000.[248] Congress should adjust the CTR threshold for inflation from $10,000 to $60,000. It makes little sense to continue collecting millions of reports on lawful transactions. The massive reporting obfuscates rather than aids the search for illicit finance. 16 million cash transaction reports were filed in 2019.[249] The reporting threshold for non-bank "financial institutions" (usually money service businesses or MSBs)[250] is often as low as $3,000.[251] These thresholds are effectively lower still because of the structuring rules governing smaller transaction that aggregate to more than these thresholds.[252]

Recommendations

1. Congress should adjust the CTR threshold for inflation from $10,000 to $60,000.
2. Congress should adjust the non-bank reporting threshold for inflation from $3,000 to $10,000.

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[247] David R. Burton and Norbert J. Michel, "Financial Privacy in a Free Society," Heritage Foundation Backgrounder No. 3157, September 23, 2016 http://thf-reports.s3.amazonaws.com/2016/BG3157.pdf.
[248] Economic Report of the President, January 2021, Table B–5. Chain-type price indexes for gross domestic product, 1969–2020 https://www.govinfo.gov/content/pkg/ERP-2021/pdf/ERP-2021.pdf.
[249] 16,087,182 to be precise. "Agency Information Collection Activities; Proposed Renewal; Comment Request; Renewal Without Change of the Bank Secrecy Act Reports of Transactions in Currency Regulations at 31 CFR 1010.310 Through 1010.314, 31 CFR 1021.311, and 31 CFR 1021.313, and FinCEN Report 112—Currency Transaction Report," Table 1—2019 Filers, by Range of the Number of Reports Filed (Tranches), and Type of Financial Institution, Federal Register, Vol. 85, No. 94, May 14, 2020 https://www.govinfo.gov/content/pkg/FR-2020-05-14/pdf/2020-10310.pdf.

[250] 31 CFR § 1010.100(ff).
[251] See 12 U.S. Code §1953 and 31 CFR §1010.410(e).
[252] 31 CFR § 1010.314.

3. Alternatively, Congress should eliminate currency transaction reports (CTRs) altogether and streamline the reporting process so that suspicious activity reports (SARs) are the only reporting mechanism.

For Further Information

David R. Burton and Norbert J. Michel, "Financial Privacy in a Free Society."[253]

Legislative Language

1. Amend 31 U.S. Code §5313, 31 U.S. Code §5331 and 26 U.S. Code §6050I(a) such that cash transaction reports are only required with respect to a cash payment, receipt, or transfer of $60,000 or more and index the amount for inflation.
2. Amend 12 U.S. Code §1953 such that 31 CFR §1010.410(e) is increased to $10,000.

c. Repeal Beneficial Ownership Reporting

Summary of the Problem and Policy Analysis

The Corporate Transparency Act (CTA) was incorporated into the National Defense Authorization Act as Title LXIV of the 1480-page bill.[254] It would create a large compliance burden – over $1 billion annually -- on approximately 11 million businesses with 20 or fewer employees (the only non-exempt category). It would create as many as a million inadvertent felons. Those most able to abuse the financial system would be exempt.[255]

The primary burden created by the beneficial ownership reporting regime is on firms with 20 or fewer employees or less than $5 million in gross receipts. These are the firms least able to absorb yet another increase in the regulatory burden imposed by the federal government. Determining who is and is not a "beneficial owner" under either bill would be complex, highly ambiguous, and would often require hiring legal counsel or a compliance expert. In fact, it would probably take a decade or more of prosecutions and litigation before the meaning of "beneficial owner," "substantial control," "substantial economic benefit," and "directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise" are reasonably well established. Defending these cases would be expensive—and often economically destroy the small businesses and business owners who must defend themselves against the federal government.

The beneficial ownership reporting rules in the CTA are easily and lawfully avoided by the sophisticated, so they would do virtually nothing to achieve their stated aim of protecting society

[253] David R. Burton and Norbert J. Michel, "Financial Privacy in a Free Society," Heritage Foundation Backgrounder No. 3157, September 23, 2016 http://thf-reports.s3.amazonaws.com/2016/BG3157.pdf.
[254] Public Law No: 116-283, Title LXIV (§§6401-6403), The William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021 https://www.congress.gov/bill/116th-congress/house-bill/6395/text.
[255] David R. Burton, "The Corporate Transparency Act and the ILLICIT CASH Act," Heritage Foundation Backgrounder No. 3449, November 7, 2019 https://www.heritage.org/sites/default/files/2019-11/BG3449_0.pdf; David R. Burton, "Beneficial Ownership Reporting Regime Targets Small Businesses and Religious Congregations," Heritage Foundation Backgrounder No. 3289, March 5, 2018 https://www.heritage.org/sites/default/files/2018-05/BG3289.pdf.

from terrorism or other forms of illicit finance. Furthermore, better beneficial ownership information than the proposed reporting regime would obtain is already provided to the IRS. Allowing the IRS to share this information with the Treasury Department's Financial Crimes Enforcement Network would impose no additional costs on the private sector and better meet the needs of law enforcement by providing more comprehensive information and better enforcement than would the proposed reporting regime.[256]

If Congress wants FinCEN to be able to acquire *better* beneficial ownership information at *radically lower cost to the public*, an alternative approach would require the Internal Revenue Service to compile a beneficial ownership database based on information already provided to the agency in the ordinary course of tax administration and to share the information in this database with FinCEN. The database would be compiled from information provided on six Internal Revenue Service forms:

1. SS-4 [Application for Employer Identification Number];
2. 1065 (Schedule K-1) [Partner's Share of Income, Deductions, Credits, etc.];
3. 1120S (Schedule K-1) [Shareholder's Share of Income, Deductions, Credits, etc.];
4. 1041 (Schedule K-1) [Beneficiary's Share of Income, Deductions, Credits, etc.];
5. 1099 DIV [Dividends and Distributions]; and
6. (6) 8822-B [Change of Address or Responsible Party — Business]

If policymakers felt that reporting by non-dividend-paying C corporations was required, such a provision could be adopted.

This approach was not adopted. This was primarily because the strong proponents of beneficial ownership reporting were on the House Financial Services, Senate Banking and Judiciary committees and not on the House Ways and Means and Senate Finance committees. Thus, jurisdictional issues in Congress led to a legislative result that will harm millions of small businesses. Congress should rectify its error.

<u>Recommendations</u>

1. Congress should repeal the beneficial ownership reporting regime on small businesses imposed by the Corporate Transparency Act and instruct FinCEN to withdraw any regulations proposed or promulgated pursuant to the Act.
2. If Congress wants FinCEN to be able to acquire better beneficial ownership information at radically lower cost to the public, then an alternative approach would require the Internal Revenue Service to compile a beneficial ownership database based on information already provided to the agency in the ordinary course of tax administration and to share the information in this database with FinCEN. Internal Revenue Code section 6103 contains literally dozens of exceptions to the general rule of tax return confidentiality. Internal Revenue Code section 6103(i) permits disclosure for federal law enforcement purposes but that provision generally requires an *ex parte* order by a Federal district court judge or magistrate judge. Congress could choose to amend section 6103 to loosen those

[256] Ibid.

requirements and allow access by FinCEN to a narrow database of beneficial ownership information that would be maintained by the IRS.

For Further Information

1. David R. Burton, "The Corporate Transparency Act and the ILLICIT CASH Act."[257]
2. Michael J. Chow, "Economic Costs to Small Businesses Due to the Corporate Transparency Act." [258]

Legislative Language

1. Repeal section 5336 of Title 31. Potentially amend Internal Revenue Code section 6103(i).

2. Amend Internal Revenue Code section 6103(i) by adding at the end thereof a new subclause 6103(i)(3)(A)(iii) as follows:

"(iii) (I)The Secretary shall maintain a database consisting of the ownership and responsible person information on the following tax forms (and any successor forms) –

(A) Form SS-4,
(B) Form1065 (Schedule K-1),
(C) Form 1120S (Schedule K-1),
(D) Form 1041 (Schedule K-1),
(E) Form 1099-DIV, and
(F) Form 8822-B.

(II) The information in the database shall include the name of the owner or responsible person of a business entity, the tax identification number of said owner or responsible person, the percentage interest (relating to both income and capital, if different) owned by said owner or responsible person, the name and address of said owner or responsible person, the name of the business entity, and the tax identification number of the business entity.

(III) The Director of the Financial Crimes Enforcement Network and his delegates may inspect the database created pursuant to this subclause solely for the purposes of discharging the duties and powers of the Director in accordance with 31 U.S. Code § 310(b)(2)."

d. Financial Action Task Force (FATF)

Summary of the Problem and Policy Analysis

The Financial Action Task Force (FATF) styles itself as "the global money laundering and terrorist financing watchdog." It is an intergovernmental body that makes "recommendations" and then black lists governments that do not comply. It has pushed for ever-increasing regulation of the

[257] David R. Burton, "The Corporate Transparency Act and the ILLICIT CASH Act," Heritage Foundation Backgrounder No. 3449, November 7, 2019 https://www.heritage.org/sites/default/files/2019-11/BG3449_0.pdf .
[258] Michael J. Chow, "Economic Costs to Small Businesses Due to the Corporate Transparency Act," NFIB Research Center, September 18, 2019 https://www.nfib.com/assets/NFIB_Corporate_Transparency_Act.pdf

financial sector and money transmission since its creation in 1989 with virtually no consideration of the costs it has imposed on the private sector and developing countries and with virtually no retrospective review as to which "recommendations" are effective and which are not.[259] Because it uses the OECD funding formula, the United States pays for about one-fifth of its budget.[260]

Recommendations

Congress should require the U.S. delegation[261] to the Financial Action Task Force (FATF) to vote to require that FATF establish procedures to conduct a rigorous cost-benefit analysis of a proposed recommendation before making such a recommendation and conduct a rigorous retrospective analysis and review of its past recommendations regarding (1) their effectiveness or lack thereof and (2) their cost. These analyses should (1) provide citations to peer reviewed literature that supports or opposes the recommendation or explicitly acknowledge that there is no such supporting literature or (2) rely on data published by a reliable third-party or explicitly acknowledge that there is no such data.

For Further Information

1. James M. Roberts, David R. Burton, Nicolas D. Loris, and Adam N. Michel, "Organization for Economic Co-operation and Development (OECD): What America Should Do."[262]
2. Financial Action Task Force: 30 Years [263]

Legislative Language

Congress should enact a resolution or statute implementing the recommendation above.

e. The Organization for Economic Cooperation and Development (OECD)

Summary of the Problem and Policy Analysis

The OECD was once politically centrist and did valuable work to develop greater trade and access to capital markets among market-oriented democratic member states. Today's OECD has largely devolved into a taxpayer-funded advocacy group for higher taxes, more intrusive government, burdensome regulation, and climate activism. The U.S. Mission to the OECD[264] should work to

[259] *Financial Action Task Force: 30 Years* (2019) https://www.fatf-gafi.org/media/fatf/documents/brochuresannualreports/FATF30-(1989-2019).pdf.
[260] Member Countries' Budget Contributions for 2019 https://www.oecd.org/about/budget/member-countries-budget-contributions.htm .
[261] For information about the U.S. delegation to FATF, see Financial Action Task Force https://home.treasury.gov/policy-issues/terrorism-and-illicit-finance/financial-action-task-force.
[262] James M. Roberts, David R. Burton, Nicolas D. Loris, and Adam N. Michel, "Organization for Economic Co-operation and Development (OECD): What America Should Do," Heritage Foundation Backgrounder No. 3593, March 16, 202 https://www.heritage.org/sites/default/files/2021-03/BG3593.pdf.
[263] *Financial Action Task Force: 30 Years* (2019) https://www.fatf-gafi.org/media/fatf/documents/brochuresannualreports/FATF30-(1989-2019).pdf.
[264] U.S. Mission to the Organization for Economic Cooperation & Development https://usoecd.usmission.gov/

steer the OECD back toward promotion of free markets, prosperity, and economic growth. If it cannot, U.S. membership should be reevaluated.

Recommendations

Congress should require the U.S. Mission to the OECD to support tax competition, oppose tax increases and to support reasonable levels of regulation. Regulations, particularly those governing finance, AML and environmental matters, should not be recommended or endorsed by the OECD unless it conducts a rigorous cost-benefit analysis of a proposed recommendation before making such a recommendation. These analyses should (1) provide citations to peer reviewed literature that supports or opposes the recommendation or explicitly acknowledge that there is no such supporting literature or (2) rely on data published by a reliable third-party or explicitly acknowledge that there is no such data.

For Further Information

3. James M. Roberts, David R. Burton, Nicolas D. Loris, and Adam N. Michel, "Organization for Economic Co-operation and Development (OECD): What America Should Do."[265]
4. Chris Edwards and Daniel J. Mitchell, *Global Tax Revolution: The Rise of Tax Competition and the Battle to Defend It*.[266]

Legislative Language

Congress should enact a resolution or statute implementing the recommendation above.

f. Cost-Benefit Analysis

Summary of the Problem and Policy Analysis

Neither FinCEN nor the Internal Revenue Service has ever produced an estimate of the aggregate costs imposed by the Bank Secrecy Act regulatory and reporting regime and the associated tax reporting. We have produced one of the few extant such estimates and found that the system imposes costs of $4.8-$8 billion annually. It is important to note that this estimate is undoubtedly a significant underestimate of the actual burden because we took OMB burden hour estimates at face value. For example, the OMB estimates that FinCEN's "Future Commission Merchants and Introducing Brokers Customer Identification" requirements can be met in two minutes per customer, an assumption which is, at the least, questionable. The OMB makes a similar estimate regarding the Broker-Dealers Customer Identification Program. We do not believe that people can generally fill out any government form in two minutes. We also only looked at BSA requirements and not IRS requirements.

[265] James M. Roberts, David R. Burton, Nicolas D. Loris, and Adam N. Michel, "Organization for Economic Co-operation and Development (OECD): What America Should Do," Heritage Foundation Backgrounder No. 3593, March 16, 202 https://www.heritage.org/sites/default/files/2021-03/BG3593.pdf.
[266] Chris Edwards and Daniel J. Mitchell, *Global Tax Revolution: The Rise of Tax Competition and the Battle to Defend It* (Washington: Cato Institute, 2008).

In examining any FinCEN burden estimate in a rulemaking, it is evident that they routinely underestimate compliance costs and rarely, if ever, take into account the initial and continuing cost of financial institutions familiarizing themselves with the rules, training, creating compliance programs and hiring consultants.

Recommendations

1. Congress should require FinCEN and the GAO to conduct a detailed, comprehensive estimate of the aggregate costs incurred because of U.S. AML, CFT, KYC and BSA requirements both before and after the survey that would be required below.
2. Congress should require FinCEN to send a survey to all regulated businesses. The survey should be structured so that the responses can be anonymous (in the sense that the FinCEN staff cannot determine which business provided which survey response). The use of an independent third-party who would collect the surveys and redact information identifying respondents should be authorized. The survey should seek information regarding the costs imposed by various requirements and total costs incurred. It should also seek recommendations for improvement to the system. The Congress should require that FinCEN consult with the Census Bureau, the Bureau of Economic Analysis and the Bureau of Labor Statistics before undertaking the survey because these agencies have extensive experience in collecting survey data. FinCEN should compile this information (including cost data and a detailed compilation of recommendations made by regulated businesses) and issue a report to Congress within one year.

For Further Information

David R. Burton and Norbert J. Michel, "Financial Privacy in a Free Society."[267]

Legislative Language

To be supplied.

g. Transparency and Data Provision by Regulators

Summary of the Problem and Policy Analysis

From regulators that demand massive information reporting and transparency from the private sector, it is not too much to expect a modest degree of transparency and data provision and to move past the "trust us, we know best and we need not explain ourselves" paradigm that has existed for decades. The hypocrisy and opaqueness that regulators routinely exhibit towards the public and Congress is astounding.

[267] David R. Burton and Norbert J. Michel, "Financial Privacy in a Free Society," Heritage Foundation Backgrounder No. 3157, September 23, 2016 http://thf-reports.s3.amazonaws.com/2016/BG3157.pdf.

Recommendation

Congress should direct the Department of Justice (in consultation with the IRS and FinCEN) to annually report the number of AML referrals, prosecutions, and convictions (including those that were made without a simultaneous prosecution for a predicate crime), and the number of occasions where BSA/AML customer requirements lead to a criminal prosecution or conviction for a non-money-laundering crime. To the extent possible, the data should report retroactively for the previous 10 years.

For Further Information

David R. Burton and Norbert J. Michel, "Financial Privacy in a Free Society."[268]

Legislative Language

To be supplied.

h. AML and Virtual or Alternative Currencies

Summary of the Problem and Policy Analysis

Combatting the financing of terrorism and other illicit finance is an important function. Rules and reporting that *actually* help to accomplish this objective in a cost-effective manner constitute sound policy. These are smart regulations. Conversely, rules and reporting that do not *actually* further the objective of countering terrorism or other illicit finance and merely add substantial costs to the operations of law-abiding businesses are dumb regulations. Then there are rules that may actually impede law enforcement objectives. FinCEN has proposed a rule "Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets,"[269] that, in its current form, falls in the one of the two latter categories. It would do almost nothing to combat terrorism and illicit finance. In fact, there is strong reason to believe that it will make countering terrorism and illicit finance substantially more difficult. It is likely to have a devastating economic impact on the responsible actors in the virtual currency, alternative currency or digital asset field and drive virtual currency users to engage in peer-to-peer transactions via unhosted wallets that cannot be effectively supervised by regulators. Finally, it will serve to protect legacy financial institutions from competition from disruptive FinTech newcomers to the detriment of the broader public. Ergo, the rule is quite literally counterproductive if one assumes the actual objective of the rule is to combat terrorism and illicit finance.

[268] David R. Burton and Norbert J. Michel, "Financial Privacy in a Free Society," Heritage Foundation Backgrounder No. 3157, September 23, 2016 http://thf-reports.s3.amazonaws.com/2016/BG3157.pdf.
[269] "Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets," Financial Crimes Enforcement Network (''FinCEN''), Treasury, Proposed Rules, *Federal Register*, Vol. 85, No. 247, December 23, 2020 (RIN 1506–AB47) https://www.govinfo.gov/content/pkg/FR-2020-12-23/pdf/2020-28437.pdf; "Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets," Financial Crimes Enforcement Network (''FinCEN''), Treasury, Notice of Proposed Rulemaking; Extension of Comment Period, *Federal Register*, Vol. 86, No. 17, January 28, 2021 https://www.govinfo.gov/content/pkg/FR-2021-01-28/pdf/2021-01918.pdf.

Stated a little differently, you can interpret this rushed rulemaking[270] in one of two ways. Perhaps FinCEN actually wants to combat terrorism financing and other illicit finance in the virtual currency space and the agency just made a mistake in how to go about it. Or perhaps what FinCEN really cares about is either creating the *appearance* of action by generating some press or protecting legacy financial institutions from disruptive competition. After all, few, if any, journalists will take the time a few years hence to see if the rule actually worked. If it is the former, then, as explained below, FinCEN should withdraw this rule and start over. If it proceeds with this ill-advised rule, then it will be clear that it is either appearances, a desire to protect existing financial institutions from competition or a simple lack of understanding and sophistication that govern FinCEN's actions.

Recommendations

Either place a moratorium on the FinCEN proposed a rule "Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets" or amend the Bank Secrecy Act to provide parity between the requirements imposed on traditional financial payment mechanisms and virtual, alternative or digital currency.

For Further Information

1. Comment Letter of David R. Burton regarding "Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets."[271]
2. Norbert Michel, "Treasury's Christmas Gift Is Another Flawed AML Rule."[272]
3. Comment Letter of Jerry BritoPeter and Van Valkenburgh regarding "Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets."[273]

Legislative Language

To be supplied.

i. Protocol Amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters

Summary of the Problem and Policy Analysis

The Protocol amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters will lead to substantially more transnational identity theft, crime, industrial espionage, financial fraud, and the suppression of political opponents and religious or ethnic minorities by authoritarian and corrupt governments. It puts Americans' private financial information at risk.

[270] The proposed rule was pushed out in the closing days of the Trump administration with, initially, a highly truncated comment period.
[271] Not yet posted on the FinCEN website.
[272] Norbert Michel Treasury's Christmas Gift Is Another Flawed AML Rule Forbes https://www.forbes.com/sites/norbertmichel/2021/01/15/treasurys-christmas-gift-is-another-flawed-aml-rule/?sh=2f5cc688472d.
[273] Comment Letter of Jerry BritoPeter and Van Valkenburgh, Coin Center, December 22, 2020 https://www.coincenter.org/app/uploads/2020/12/2020-12-22-comments-to-fincen.pdf.

The risk is highest for American businesses involved in international commerce. The Protocol is part of a contemplated new and extraordinarily complex international tax information sharing regime involving two international agreements and two Organization for Economic Co-operation and Development (OECD) intergovernmental initiatives. It will result in the automatic sharing of bulk taxpayer information among governments worldwide, including many that are hostile to the United States, corrupt, or have inadequate data safeguards. It will add another layer to the already voluminous compliance requirements imposed on financial institutions and have a disproportionately adverse impact on small banks and broker-dealers.

Recommendations

1. Do Not Ratify the Protocol Amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters

2. Replace the current patchwork of international agreements with a well-considered, integrated international convention that ensures robust information sharing for the purposes of preventing terrorism, crime, and fraud, but also provides enforceable legal protections for the financial and other privacy interests of member states' citizens and the legitimate commercial interests of their businesses. Membership in this convention should be restricted to governments that (1) are democratic (representative democracies with legitimate elections and protections for political minorities); (2) respect free markets, private property, and the rule of law; (3) can be expected to always use the information in a manner consistent with the security interests of the member states; and (4) have—in law and in practice—adequate safeguards to prevent the information from being obtained by hostile parties or used for inappropriate commercial, political, or other purposes.

For Further Information

1. David R. Burton, "Two Little Known Tax Treaties Will Lead to Substantially More Identity Theft, Crime, Industrial Espionage, and Suppression of Political Dissidents."[274]
2. David R. Burton and Norbert J. Michel, "Financial Privacy in a Free Society."[275]
3. David R. Burton, "Thinking Anew about Information Exchange and Reporting."[276]

Legislative Language

Not applicable. However, we do intend to eventually produce a draft multilateral convention on information sharing.

[274] David R. Burton, "Two Little Known Tax Treaties Will Lead to Substantially More Identity Theft, Crime, Industrial Espionage, and Suppression of Political Dissidents," Heritage Foundation Backgrounder No. 3087, December 21, 2015 http://thf-reports.s3.amazonaws.com/2015/BG3087.pdf.
[275] David R. Burton and Norbert J. Michel, "Financial Privacy in a Free Society," Heritage Foundation Backgrounder No. 3157, September 23, 2016 http://thf-reports.s3.amazonaws.com/2016/BG3157.pdf.
[276] David R. Burton, "Thinking Anew about Information Exchange and Reporting," January 15, 2014 https://www.heritage.org/technology/commentary/thinking-anew-about-information-exchange-and-reporting.

j. Preempt State Regulation of Money Transmitting Businesses

Summary of the Problem and Policy Analysis

18 U.S. Code §1960 prohibits the operation of an unlicensed money-transmitting business and also prohibits the knowing transfer of funds derived from (or intended for) criminal activity. Title 18 considers a business unlicensed if it fails to comply with federal "money transmitting business registration requirements," or if it operates without a state license if one is required. Additionally, 31 U.S. Code §5330 requires money-transmitting businesses to register with the U.S. Secretary of the Treasury.[277]

Regarding the state–federal relationship, 31 U.S. Code §5330 (a)(3) explicitly states that it does not supersede "any requirement of State law relating to money transmitting businesses operating in such State." Congress should preempt state registration requirements for money transmission businesses because the technological changes of the past few decades ensure that any money transmitter, regardless of the state in which it is domiciled, can easily transfer funds around the entire globe. Money transmission is not only an interstate business it is an international business and it is appropriate that the federal government be the sole regulator of money transmission business. The primary function of state regulation is to raise costs and protect banks from non-bank competitors.

Recommendation

Congress should preempt state registration requirements for money transmission businesses.

For Further Information

David R. Burton and Norbert J. Michel, "Financial Privacy in a Free Society."[278]

Legislative Language

1. Repeal 31 U.S. Code §5330(a)(3).

2. Add a new subsection (f) to section 5330 as follows:

"(f) Other Laws. This section shall supersede any provision of a law, rule, regulation, or other requirement of any State or political subdivision of a State to the extent that such provision relates to the registration and regulation of a money transmitting business."

Or something similar.

[277] See also 31 CFR Subpart C, 31 CFR §1022.300 *et seq*.
[278] David R. Burton and Norbert J. Michel, "Financial Privacy in a Free Society," Heritage Foundation Backgrounder No. 3157, September 23, 2016 http://thf-reports.s3.amazonaws.com/2016/BG3157.pdf.

V. Banking

a. Introduction

Banks—as well as other financial firms—have long dealt with capital rules, liquidity rules, leverage rules, and the constant threat that regulators would make up new rules or enforce old rules differently. For decades, this framework has increasingly made it more difficult to create and maintain jobs and businesses that benefit Americans. One of the main reasons the regulatory regime has been counterproductive for so long is because it seeks to micromanage people's financial risk, a process that substitutes regulators' judgments for those of private investors. This approach creates less diverse investments than would otherwise exist and provides a false sense of security because the government confers an aura of safety on all banks that play by the rules. It is bound to fail for at least three reasons:

(1) people take on more risk than they would in the absence of such rules;
(2) people have lower incentives to monitor financial risks than they would otherwise; and
(3) compared to other actors in the market, regulators do not have superior knowledge of future risks.

In addition to these shortcomings, the U.S. regulatory framework has consistently protected incumbent firms from new competition—the very market forces that drive innovation, lower prices, and prevent excessive risk-taking. The result is that entrepreneurs have had fewer opportunities, and consumers have had fewer choices, higher prices, and less knowledge regarding financial risks. When the system crashes, as it has done on several occasions, people naturally tend to blame the excesses in the private sector while giving the government more power to stabilize the economy. In the end, this process is a perverse self-reinforcing cycle that fails to make the economy any safer as it chips away at economic freedom and prosperity.

A well-functioning financial sector results in a society with more goods and services, more employment opportunities, and higher incomes. Vibrant financial firms make it easier and less costly to raise the capital necessary for launching or operating a business, to borrow money for buying or building a home, and to invest in ideas that improve productivity and increase wealth. Financial enterprises are the arteries through which money from one sector of the economy flows into others, creating jobs and wealth in the process. Just as with nonfinancial businesses, excessive government regulation disrupts that smooth functioning, preventing financial firms from serving the needs of their customers and society. Nonetheless, federal policymakers have used this approach for decades. It has demonstrably failed.

Depending on the banking activity, at least eight federal regulators could supervise, examine, or otherwise regulate a bank. They are:

(1) the Federal Reserve;
(2) the Federal Deposit Insurance Corporation (FDIC);

(3) the Securities and Exchange Commission (SEC);[279]
(4) the Commodity Futures Trading Commission (CFTC);
(5) the Consumer Financial Protection Bureau (CFPB);
(6) the Federal Housing Finance Agency (FHFA);
(7) U.S. Treasury Department, Office of the Comptroller of the Currency (OCC) and
(8) U.S. Treasury Department, Financial Crimes Enforcement Network (FinCEN).[280]

These are, of course, in addition to state regulators. Although a dual state–federal system has existed for more than a century, the U.S. bank regulatory framework is now more federalized than ever because the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) requires that any FDIC-insured state bank not engage in any activity impermissible for national banks—and nearly all state banks are FDIC insured.[281]

The currently regulatory framework has imposed enormous costs on banks and undoubtedly contributed to the decline in the overall number of banks and the increased concentration in the banking industry.[282] Regulatory costs do not increase linearly with size and high regulatory costs accord a competitive advantage to large institutions. Out of the 5,001 FDIC insured depository institutions,[283] the largest 10 account for nearly half of the deposits.[284]

U.S. banks have dealt with some form of risk management from regulatory agencies since the early republic. Securities market regulation was originally focused on fraud prevention and disclosure. Particularly at the state level, but increasingly at the federal level, regulations in both areas have become more concerned with active risk management. Essentially every sort of panic, crisis, or downturn has been met with added regulation in the name of preventing the next calamity, a goal that can never be reached. Worse, the new regulations often fail to address the underlying cause of the problem and typically exacerbate the situation. The 2010 Dodd–Frank Act is the latest example of this flawed approach. Even if Congress repealed Dodd–Frank in its entirety, a highly flawed regulatory structure that weakened financial markets and contributed mightily to the 2008 financial crisis would remain.

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[279] If the bank sells securities to customers, it will also be subject to regulation by the Financial Industry Regulatory Authority (FINRA).
[280] The Internal Revenue Service (IRS), a part of the Treasury Department, also impose a wide variety of information-reporting and due-diligence requirements on financial institutions.
[281] 12 U.S. Code §1831a.
[282] See Hester Peirce and Stephen Matteo Miller, "Small Banks by the Numbers, 2000–2014," Mercatus Center, March 17, 2015, http://mercatus.org/publication/small-banks-numbers-2000-2014. The FDIC's resolution process has also contributed to industry concentration because the FDIC promotes the acquisition of failing banks by healthy, larger banks, thus concentrating assets in a smaller number of larger banks.
[283] "Number of FDIC-Insured Institutions," FDIC, https://www7.fdic.gov/qbp/grtable.asp?rptdate=%2FQBP%2Fcontent%2F2020dec&selgr=DSTRUA1; "Statistics at a Glance," FDIC https://www.fdic.gov/bank/statistical/stats/2020dec/industry.pdf.
[284] "FDIC - Statistics on Depository Institutions Report," FDIC https://www7.fdic.gov/sdi/main.asp?formname=standard; "The Biggest US Banks by Total Deposits (2020)," MX Technologies https://www.mx.com/moneysummit/biggest-us-banks-by-deposits/.

b. Create a New Financial Firm Charter

Summary of the Problem and Policy Analysis

U.S. banking law remains stuck in the 1930s regarding which functions financial companies should perform. It was never a good idea either to restrict banks to taking deposits and making loans or to prevent investment banks from taking deposits. Doing so makes markets less stable. All financial intermediaries function by pooling the financial resources of those who want to save and funneling them to others that are willing and able to pay for additional funds. This underlying principle should guide U.S. financial laws.

Recommendation

Policymakers should create new charters for financial firms that eliminate activity restrictions and reduce regulations in return for straightforward higher equity or risk-retention standards. Ultimately, these charters would replace government regulation with competition and market discipline, thereby lowering the risk of future financial crises and improving the ability of individuals to create wealth.

For Further Information

Gerald P. Dwyer and Norbert J. Michel, "A New Federal Charter for Financial Institutions."[285]

c. Reduce the Role of the FDIC

Summary of the Problem and Policy Analysis

Congress should shrink the role of the Federal Deposit Insurance Corporation (FDIC). There are many market-based options used around the world that could replace the FDIC bank-resolution process (for failed banks) and bring much-needed market discipline to the banking sector. New Zealand, for instance, uses an open-bank-resolution policy that freezes a portion of a failed bank's assets but allows the bank to remain open to conduct limited business in a way that minimizes economic disruptions.[286] Policymakers should also reduce the FDIC insurance coverage limit to at least the pre-Dodd–Frank limit of $100,000 per account. Even lowering the value to the pre-1980 limit of $40,000 per account would ensure a level (based on 2014 data) nearly 10 times the average

[285] Gerald P. Dwyer and Norbert J. Michel, "A New Federal Charter for Financial Institutions," Chapter 23 in *Prosperity Unleashed: Smarter Financial Regulation*, Norbert J. Michel, ed. (Washington: The Heritage Foundation, 2017), pp. 349–361, https://www.heritage.org/sites/default/files/2017-02/23_ProsperityUnleashed_Chapter23.pdf.

[286] Reserve Bank of New Zealand, "Open Bank Resolution Policy FAQs," http://rbnz.govt.nz/faqs/open-bank-resolution-policy-faqs. The FDIC used an open-bank assistance (OBA) policy 137 times between 1950 and 1992. With reforms, OBA could be converted into a sound open-bank resolution policy. See "Open Bank Assistance," Chapter 5 in *Federal Deposit Insurance Corporation, Managing the Crisis: The FDIC and RTC Experience 1980–1984*, Vol. 1, August 1998, p. 152, https://www.fdic.gov/bank/historical/managing/documents/history-consolidated.pdf. A streamlined bankruptcy or resolution procedure for large banks, such as the one developed by the Hoover Institution's Working Group on Economic Policy, also deserves serious consideration. See Kenneth E. Scott and John B. Taylor, eds., *Bankruptcy Not Bailout: A Special Chapter 14* (Stanford, CA: Hoover Institution Press, 2012).

transaction account balance.[287] Research shows that countries with more government involvement in a deposit insurance system and with higher levels of deposit insurance coverage tend to have more bank failures and financial crises.[288]

Recommendation

1. Reduce the FDIC insurance coverage limit to at least the pre-Dodd–Frank limit of $100,000 per account.
2. Improve the bank resolution process.

For Further Information

1. Norbert Michel and David Burton, "Financial Institutions: Necessary for Prosperity."[289]
2. Thomas L. Hogan and Kristine Johnson, "Alternatives to FDIC Deposit Insurance."[290]

Legislative Language

1. Amend the "standard maximum deposit insurance amount" as defined in 12 U.S. Code §1821(a)(1)(E) such that it is $100,000 and repeal §1821(a)(1)(F).
2. Amend the "standard maximum share insurance amount" as defined in 12 U.S. Code §1787(k)(6) and conform §1787(k)(3).

d. Repeal Titles I, II and VIII of the 2010 Dodd-Frank Act

Summary of the Problem and Policy Analysis

To make it more difficult for the federal government to bail out large financial firms, Congress should repeal Title I, Title II, and Title VIII of the Dodd-Frank Act.[291] Title I of Dodd–Frank created the Financial Stability Oversight Council (FSOC), a sort of super-regulator tasked with identifying so-called systemically important financial institutions (SIFIs) and singling them out for especially stringent regulation. The problem, of course, is that this process effectively identifies

[287] See Jesse Bricker, Lisa J. Dettling, Alice Henriques, Joanne W. Hsu, Kevin B. Moore, John Sabelhaus, Jeffrey Thompson, and Richard A. Windle, "Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, Vol. 100, No. 4 (September 2014), p. 16, http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf. See also Christine M. Bradley, "A Historical Perspective on Deposit Insurance Coverage," *FDIC Banking Review*, Vol. 13, No. 2 (2000), pp. 1–25, https://www.fdic.gov/bank/analytical/banking/br2000v13n2.pdf.
[288] For an overview, see Thomas L. Hogan and Kristine Johnson, "Alternatives to FDIC Deposit Insurance," *Independent Review*, Vol. 20, No. 3 (Winter 2016), pp. 433-454, http://www.independent.org/pdf/tir/tir_20_03_17_hogan-johnson.pdf.
[289] Norbert Michel and David Burton, "Financial Institutions: Necessary for Prosperity," Heritage Foundation Backgrounder No. 3108, April 14, 2016, https://www.heritage.org/markets-and-finance/report/financial-institutions-necessary-prosperity.
[290] Thomas L. Hogan and Kristine Johnson, "Alternatives to FDIC Deposit Insurance," *Independent Review*, Vol. 20, No. 3 (Winter 2016), pp. 433-454, http://www.independent.org/pdf/tir/tir_20_03_17_hogan-johnson.pdf.
[291] Public Law 111-203.

those firms regulators believe are too big to fail.[292] Title VIII of Dodd–Frank gives the FSOC similar (overly broad) special-designation authority for specialized financial companies known as financial market utilities.[293] Title II of Dodd-Frank established the controversial provision known as orderly liquidation authority (OLA), the law's alternative to bankruptcy for large financial firms. The OLA was based on the faulty premise that large financial institutions cannot fail in a judicial bankruptcy proceeding without causing a financial crisis. It gives these companies access to subsidized funding and creates incentives for management to overleverage and expand their high-risk investments.[294] Congress should repeal each of these provisions to guard against bailouts and too-big-to-fail problems.[295]

Recommendations

1. Repeal Title I of the Dodd-Frank Act (The Financial Stability Act of 2010 relating to the Financial Stability Oversight Council).
2. Repeal Title II of the Dodd-Frank Act (relating to orderly liquidation authority).
3. Repeal Title VIII of the Dodd-Frank Act (The Payment, Clearing, and Settlement Supervision Act of 2010 relating to financial market utilities and other matters).

For Further Information

1. Peter J. Wallison, "Title I and the Financial Stability Oversight Council."[296]
2. Paul Kupiec, "Title II: Is Orderly Liquidation Authority Necessary to Fix 'Too Big to Fail'?"[297]

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[292] Peter J. Wallison, "Title I and the Financial Stability Oversight Council," in Norbert Michel, ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans*, https://www.heritage.org/government-regulation/report/the-case-against-dodd-frank-how-the-consumer-protection-law-endangers.

[293] Norbert J. Michel, "Fixing the Dodd–Frank Derivatives Mess: Repealing Titles VII and VIII," in Norbert Michel, ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans*, https://www.heritage.org/government-regulation/report/the-case-against-dodd-frank-how-the-consumer-protection-law-endangers.

[294] Paul Kupiec, "Title II: Is Orderly Liquidation Authority Necessary to Fix 'Too Big to Fail'?" in Norbert Michel, ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans*, https://www.heritage.org/government-regulation/report/the-case-against-dodd-frank-how-the-consumer-protection-law-endangers.

[295] Norbert J. Michel, "Money and Banking Provisions in the Financial CHOICE Act: A Major Step in the Right Direction," in Norbert Michel, ed., *Prosperity Unleashed: Smarter Financial Regulation*, https://www.heritage.org/prosperity-unleashed#:~:text=Smarter%20financial%20regulations%3A%20solutions%20to,and%20accountable%20than%20ever%20before.

[296] Peter J. Wallison, "Title I and the Financial Stability Oversight Council," in Norbert Michel, ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans*, https://www.heritage.org/government-regulation/report/the-case-against-dodd-frank-how-the-consumer-protection-law-endangers.

[297] Paul Kupiec, "Title II: Is Orderly Liquidation Authority Necessary to Fix 'Too Big to Fail'?" in Norbert Michel, ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans*, https://www.heritage.org/government-regulation/report/the-case-against-dodd-frank-how-the-consumer-protection-law-endangers.

3. Norbert J. Michel, "Fixing the Dodd–Frank Derivatives Mess: Repealing Titles VII and VIII."[298]
4. Reserve Bank of New Zealand, "Open Bank Resolution Policy FAQs."[299]
5. Kenneth E. Scott and John B. Taylor, eds., *Bankruptcy Not Bailout: A Special Chapter 14* (Stanford, CA: Hoover Institution Press, 2012).
6. Thomas L. Hogan and Kristine Johnson, "Alternatives to FDIC Deposit Insurance."[300]

Legislative Language

1. Repeal Title 12, Chapter 53, Subchapter I (12 USC §§5311-5374).
2. Repeal Title 12, Chapter 53, Subchapter IV (12 USC §§5381-5394).
3. Repeal Title 12, Chapter 53, Subchapter IV (12 USC §§5461-5472).

e. Limit the Federal Reserve's Emergency Lending Powers

Summary of the Problem and Policy Analysis

The Fed has a long history of using its emergency lending and discount-window loan policies to support failing firms.[301] Because this type of lending perpetuates the too-big-to-fail problem, the Fed's ability to provide such lending should be eliminated. Instead, the Fed should be allowed only to provide system-wide liquidity, preferably with a market-wide auction program that replaces its limited primary dealer system.[302] This reform would help to protect taxpayers from funding insolvent financial institutions and make future crises less likely because risky firms would no longer expect a guaranteed lifeline from the Fed.

Recommendation

The Federal Reserve's emergency lending powers should be limited. The Fed should be allowed only to provide system-wide liquidity, preferably with a market-wide auction program that replaces its limited primary dealer system.

For Further Information

1. Norbert J. Michel, "The Fed's Failure as a Lender of Last Resort: What to Do About It."[303]

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[298] Norbert J. Michel, "Fixing the Dodd–Frank Derivatives Mess: Repealing Titles VII and VIII," in Norbert Michel, ed., *The Case Against Dodd–Frank: How the "Consumer Protection" Law Endangers Americans*, https://www.heritage.org/government-regulation/report/the-case-against-dodd-frank-how-the-consumer-protection-law-endangers.

[299] Reserve Bank of New Zealand, "Open Bank Resolution Policy FAQs," http://rbnz.govt.nz/faqs/open-bank-resolution-policy-faqs.

[300] Thomas L. Hogan and Kristine Johnson, "Alternatives to FDIC Deposit Insurance," *Independent Review*, Vol. 20, No. 3 (Winter 2016), pp. 433-454, http://www.independent.org/pdf/tir/tir_20_03_17_hogan-johnson.pdf.

[301] Norbert J. Michel, "The Fed's Failure as a Lender of Last Resort: What to Do About It," Heritage Foundation Backgrounder No. 2943, August 20, 2014, http://thf_media.s3.amazonaws.com/2014/pdf/BG2943.pdf.

[302] Norbert J. Michel, "Dodd–Frank's Title XI Does Not End Federal Reserve Bailouts," Heritage Foundation Backgrounder No. 3060, September 29, 2015, http://thf_media.s3.amazonaws.com/2015/pdf/BG3060.pdf.

[303] Norbert J. Michel, "The Fed's Failure as a Lender of Last Resort: What to Do About It," Heritage Foundation Backgrounder No. 2943, August 20, 2014, http://thf_media.s3.amazonaws.com/2014/pdf/BG2943.pdf.

2. Norbert J. Michel, "Dodd–Frank's Title XI Does Not End Federal Reserve Bailouts."[304]

Legislative Language

To be supplied at a later date.

[304] Norbert J. Michel, "Dodd–Frank's Title XI Does Not End Federal Reserve Bailouts," Heritage Foundation Backgrounder No. 3060, September 29, 2015, http://thf_media.s3.amazonaws.com/2015/pdf/BG3060.pdf.

VI. Alternative Currencies

a. Introduction

Competitive market forces can improve the means of payment in the same way that market forces improve virtually all goods and services. Furthermore, the overall historical record highlights the importance of preserving citizens' ability to use whichever form of money they choose. The current tax treatment of alternative currencies creates a major barrier to the common use of alternative currencies. Congress should eliminate tax and other legal impediments to the development of alternative currencies. Alternative currencies can better meet the needs of some consumers and businesses, and also place a significant constraint on the ability of the federal government to devalue the national currency, distort economic decision-making, and harm economic growth.

b. Common Enterprise definition

Summary of the Problem and Policy Analysis

The definition of "security" in Securities Act section 2(a)(1) does not really define the term "security" but instead provides a list of things that are a security.[305] One of the things listed is an "investment contract." The Supreme Court addressed what is an investment contract in *Securities and Exchange Commission v. W. J. Howey Co*.[306] In analyzing what is and is not an investment contract, the court held that "[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." This definition has come to be known as the *Howey* test. It has four parts:

(1) the investment of money;
(2) in a common enterprise;
(3) with an expectation of profits;
(4) derived solely from the efforts of others.

The question arises as to whether various digital assets, tokens, coins, or alternative, virtual or crypto-currencies meet this test and are therefore investment contracts and therefor a security that must either be registered or qualify for an exemption. Notwithstanding the SEC's studied ambiguity and increasingly aggressive enforcement posture, the answer to that question with respect to many digital assets and most alternative currencies is no. The purchase of an alternative

[305] It reads: "The term ''security'' means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ''security'', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."
[306] 328 U.S. 293 (1946) https://www.law.cornell.edu/supremecourt/text/328/293.

currency does not constitute an investment in "a common enterprise." The holder of an alternative currency (the "holder") is the holder of intangible property that is more akin to commodity or a coin collection than anything else.

The holder does not own the rights to a defined flow of payments from the enterprise as would be a lender or holder of a debt security.[307] Nor is the holder entitled to a portion of the accounting residual flow that constitute the earnings or profits of the enterprise (gross receipts less expenses). The holders' profits or losses have nothing to do with either the earnings or losses of the "common" enterprise or the ability of the "common enterprise" to service a non-existent debt to the holder. Ergo, the holder does not hold a claim of any sort against the revenue generated by the "common enterprise." He does not own an "investment contract."[308] Ergo, he does not own a security of the "common enterprise" (the purported issuer). The holders' profits or losses are simply a function of the alternative currency's market price just like in any other commodity or property market. The only thing the holder has in common with other holders is the hope that his commodity will increase in value.

Obviously, just because an issuer labels something a digital asset, token, coin, or an alternative, virtual or crypto currency does not make it so. If the asset entitles the holder to a defined flow of payments from the enterprise in exchange for an investment (i.e. it is debt) or if the asset entitles the holder to a share, even a contingent share, in the profits of the enterprise (i.e.it is equity), then it is a security (or at least a loan).[309] But otherwise, it is not a security.

From an accounting standpoint it may be described in this way. If the proceeds from the sale of the digital asset do not appear either as a liability or equity on the enterprise's statement of financial condition (balance sheet) and if there are no payments, and no possibility of payments, from the enterprise to the holder that would be classified as an interest expense by the enterprise (to a debt holder) or as distributions[310] or dividends[311] (to an equity holder), then the asset is not a security because the holder has no interest in the common enterprise.[312]

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[307] Or for that matter, a lessor of real property or tangible personal property, a licensor of a trademark, copyright or patent, a holder of rights to royalty payments or similar party.

[308] It should go without saying that the mere existence of a contract does not make the contract an "investment contract." A contract to pay money for an automobile or a painting or a coin collection, for example is not an investment contract even though the property purchased may fluctuate in price and even though the motivation of the buyer may be to make money.

[309] We need not go down the rabbit hole of how to draw the line between loans and debt securities here. For a discussion of some of the legal issues involved in drawing lines between loans (or notes or investment contracts) and securities (bonds or debentures), see Elisabeth de Fontenay, "Do the Securities Laws Matter? The Rise of the Leveraged Loan Market," *Journal of Corporation Law*, Vol. 39 (2014), pp. 725–768 http://scholarship.law.duke.edu/faculty_scholarship/3258/ and Andrew Verstein, "The Misregulation of Person-to-Person Lending, *University of California–Davis Law Review*, Vol. 45, No. 2 (2011) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1823763. See Securities Act, Section 3 for a veritable laundry list of exemptions for securities involving banks. See *Reves v. Ernst & Young*, 494 U.S. 56 (1990) for the Supreme Court's adoption and application of the highly amorphous four-part "family resemblance" test, drawing the distinction between notes that are and are not securities.

[310] For partnerships and limited liability companies.

[311] For incorporated enterprises.

[312] Interest here means a financial interest. Security interest sounds too much like a UCC security interest. The holder may have an "interest" in the survival of the enterprise in the same sense that an owner of new product (e.g. an automobile) has an interest in the survival of the manufacturer for warranty, support and spare part purposes. But

From an economics or finance standpoint, the holder is not receiving either a return on equity capital invested or interest paid on debt capital invested. The holder is not being compensated for providing a factor of production.

The Commission sometimes acts as if anything purchased with the objective of making money is a security unless a specific statutory exemption applies. The Commission's analysis of the issues arising out of digital assets has been analytically weak and its guidance to marketplace participants of dubious utility and made at a glacial in pace. In a lengthy 2019 document guidance document entitled "Framework for "Investment Contract" Analysis of Digital Assets"[313] that basically summarizes the case law and discusses the ambiguity inherent in applying the *Howey* case, which involved orange groves, to digital assets, this is the entirety of their "analysis" of the "common enterprise" prong of *Howey*:

> Courts generally have analyzed a "common enterprise" as a distinct element of an investment contract. In evaluating digital assets, we have found that a "common enterprise" typically exists.

That non-argument is not compelling or convincing. Moreover, the staff conclusion is simply wrong for the reasons outlined above. Congress should not accept this shallow and analytically baseless conclusion from the SEC staff.

Recommendations

Congress should enact legislation providing such that holders of digital assets may not be deemed (1) parties to an investment contract or (2) an investor in a common enterprise unless, while the enterprise is a going concern, the holder is entitled to (1) a share of the earnings or profits of the common enterprise, or (2) a defined flow of payments from the common enterprise in consideration of the investment or, the holder has rights against the assets of the common enterprise upon liquidation.

For Further Information

1. Norbert J. Michel, "Improving Money Through Competition."[314]
2. "Framework for "Investment Contract" Analysis of Digital Assets," SEC Staff

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the owner of an automobile does not own securities of the automobile manufacturer simply by virtue of owning the automobile. The owner of software program has an "interest" in the software company surviving for technical support reasons and so that other users exist that use the software. This does not mean they own a security of the software company. Betamax videocassette owners did not own securities in Sony but they had an interest in the survival and success of the Betamax format. Wordstar users had a strong interest in the survival of the once successful word processing program but they did not own MicroPro securities.

[313] "Framework for "Investment Contract" Analysis of Digital Assets," SEC Staff https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

[314] Norbert J. Michel, "Improving Money Through Competition," Heritage Foundation Issue Brief No. 4730, July 7, 2017 http://www.heritage.org/monetary-policy/report/improving-money-through-competition.

3. Joseph A. Hall, "Howey, Ralston Purina and The SEC's Digital Asset Framework," [315]
4. Justin Henning, "The Howey Test: Are Crypto-Assets Investment Contracts?" [316]
5. F. A. Hayek, *Denationalisation of Money—The Argument Refined: An Analysis of the Theory and Practice of Concurrent Currencies* (London: The Institute of Economic Affairs, 1990).[317]
6. David R. Burton and Norbert J. Michel, "Removing Tax Barriers to Competitive Currencies."[318]

Legislative Language

An initial suggestion for legislative language:

Amend Securities Act section 2(a)(1) to read:

> (i) In General. – The term ''security'' means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ''security'', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.
> (ii) Digital Assets. – Holders of digital assets shall not be deemed parties to an investment contract or an investor in a common enterprise unless –
>
> (1) while the enterprise is a going concern, the holder is entitled to –
>
> (A) a share of the earnings or profits of the common enterprise, or
>
> (B) a defined flow of payments from the common enterprise in consideration of the purchase of the digital asset, or
>
> (2) upon liquidation, the holder has rights against the assets of the common enterprise.

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[315] Joseph A. Hall, "Howey, Ralston Purina and The SEC's Digital Asset Framework," *The Review of Securities & Commodities Regulation*, Vol. 52, No. 12, June 19, 2019 https://www.davispolk.com/sites/default/files/howey_ralston_purina_sec_digital_asset_framework.pdf.
[316] Justin Henning, "The Howey Test: Are Crypto-Assets Investment Contracts?," University of Miami Business Law Review, Vol. 27 https://repository.law.miami.edu/umblr/vol27/iss1/6.
[317] See, for example, F. A. Hayek, *Denationalisation of Money—The Argument Refined: An Analysis of the Theory and Practice of Concurrent Currencies* (London: The Institute of Economic Affairs, 1990), p. 102, https://mises.org/system/tdf/Denationalisation%20of%20Money%20The%20Argument%20Refined_5.pdf?file=1&type=document.
[318] David R. Burton and Norbert J. Michel, "Removing Tax Barriers to Competitive Currencies" Heritage Foundation Issue Brief No. 4761, September 13, 2017 https://www.heritage.org/sites/default/files/2017-09/IB4761.pdf.

Congress may want to consider defining the term "digital asset" in the statute. Digital asset is a broader concept that digital, virtual or alternative currency. It is narrower in one sense. An "alternative currency" can and should include precious and probably other metals.

[Note: subparagraph (i) is the current language]

c. Remove Tax Barriers to Alternative Currencies

Summary of the Problem and Policy Analysis

Policymakers rarely consider improving money with the same competitive market forces that improve other goods and services. Nonetheless, such policies should not be summarily dismissed. Money is the means of payment for virtually all goods and services. Suppressing competition among competing currencies, if history is any guide, only deprives citizens of beneficial innovations in the means of payment. The current tax treatment of alternative currencies creates a major barrier to the widespread use of alternative currencies. Congress should remove these specific barriers to entry in the market for alternative monies and ensure that no single type of money enjoys a regulatory advantage.

Competitive forces improve people's well-being because prices convey vitally important information.[319] The price of money is no different. When government has a monopoly on money, important information about the demand for money and whether there is an oversupply or undersupply of money is lost.[320] In addition, information about the expectations of market participants and the relative demand for various features of competing currencies is lost.

Ultimately, the competitive process is the optimal approach to discovering what people view as the best means of payment. Policymakers and those operating in the marketplace are likely to be able to make more informed decisions in a competitive currency environment. In a competitive currency environment, the relative price of the competing currencies will rapidly incorporate information about current market conditions and about the supply of, and demand for, the various currencies available for exchange.[321] The overall historical record, including recent monetary policy failures, highlights the importance of preserving citizens' ability to use whichever form of money they choose.[322]

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[319] F. A. Hayek, "The Use of Knowledge in Society," *American Economic Review*, Vol. 35, No. 4 (1945), pp. 519–530, http://home.uchicago.edu/~vlima/courses/econ200/spring01/hayek.pdf.

[320] See, for example, F. A. Hayek, *Denationalisation of Money—The Argument Refined: An Analysis of the Theory and Practice of Concurrent Currencies* (London: The Institute of Economic Affairs, 1990), p. 102, https://mises.org/system/tdf/Denationalisation%20of%20Money%20The%20Argument%20Refined_5.pdf?file=1&type=document.

[321] Demand for a currency would be based on characteristics that make it more or less useful, expectations about future supply and its value, or other factors.

[322] See Norbert J. Michel, "Improving Money Through Competition," Heritage Foundation Issue Brief No. 4730, July 7, 2017 http://www.heritage.org/monetary-policy/report/improving-money-through-competition, and Norbert J. Michel, "Monetary Policy Reforms for Main Street," Heritage Foundation Backgrounder No. 3237, July 27, 2017, http://www.heritage.org/monetary-policy/report/monetary-policy-reforms-main-street.

Recommendations

Amend the tax law such that changes in the relative value of an alternative currency and the dollar is not a taxable event and need not be reported.

For Further Information

1. Norbert J. Michel, "Improving Money Through Competition."[323]
2. David R. Burton and Norbert J. Michel, "Removing Tax Barriers to Competitive Currencies."[324]
3. F. A. Hayek, *Denationalisation of Money—The Argument Refined: An Analysis of the Theory and Practice of Concurrent Currencies* (London: The Institute of Economic Affairs, 1990).[325]

Legislative Language

1. Define "alternative currency" as:

(1) gold, silver, platinum, palladium, aluminum or other metal bullion or coins;
(2) a transferable certificate, electronic or otherwise, redeemable in or convertible to –
(A) physical gold, silver, platinum, palladium, aluminum or other metal,
(B) gold, silver, platinum, palladium, aluminum or other metal bullion, or
(C) gold, silver, platinum, palladium, aluminum or other metal coins; or
(3) a medium of exchange based on blockchain, distributed ledger or similar technology.

2. Define "capital asset" in Internal Revenue Code §1221(a) to exclude "alternative currencies" from the definition of capital asset.[326]

3. Add a new Internal Revenue Code §139I to exclude gains or losses from the sale or exchange of an alternative currency from gross income.[327]

[323] Norbert J. Michel, "Improving Money Through Competition," Heritage Foundation Issue Brief No. 4730, July 7, 2017 http://www.heritage.org/monetary-policy/report/improving-money-through-competition.
[324] David R. Burton and Norbert J. Michel, "Removing Tax Barriers to Competitive Currencies" Heritage Foundation Issue Brief No. 4761, September 13, 2017 https://www.heritage.org/sites/default/files/2017-09/IB4761.pdf.
[325] See, for example, F. A. Hayek, *Denationalisation of Money—The Argument Refined: An Analysis of the Theory and Practice of Concurrent Currencies* (London: The Institute of Economic Affairs, 1990), p. 102, https://mises.org/system/tdf/Denationalisation%20of%20Money%20The%20Argument%20Refined_5.pdf?file=1&type=document.
[326] Defining capital asset in this manner would also exclude the gains from tax under the §1411 investment income tax.
[327] See Internal Revenue Code §§101–140 for items explicitly excluded from gross income under current law.

4. Amend Internal Revenue Code §6045, §6721 and §6722 (relating to information reporting requirements) to make clear that capital gains (or losses) resulting from changes in the relative value of an alternative currency and the dollar need not be reported.

5. Amend Internal Revenue Code §3406 to provide that capital gains and losses arising out of alternative currency transactions should not be subject to backup withholding.

Congress also could consider adding foreign currencies, or certificates redeemable in one or more foreign currencies, to the definition of alternative currency.

H.R. 3708, 115th Congress the Cryptocurrency Tax Fairness Act. (Rep. Schweikert) would exclude from gross income any capital gains (but not losses) that stem from the "sale or exchange of virtual currency for other than cash or cash equivalents," provided those gains do not exceed $600 per transaction. Sales or exchanges which are part of the same transaction (or a series of related transactions) are treated as one sale or exchange. Virtual currency is defined as "a digital representation of value that is used as a medium of exchange" and excludes foreign currency. The Secretary of the Treasury is required to issue regulations governing the reporting of transactions. See also H. R. 5635, 116th Congress (Rep. DelBene).

Although constructive, H.R. 3708 is too narrow in focus, and its drafting raises four concerns in particular.

1. Limiting the gains exclusion to transactions under $600 will retain the discrimination against digital currencies.
2. While the legislation would presumably encompass digital alternative currencies that were based on either blockchain technology or a "digital representation" of precious metals, it would not apply to physical metals or non-digital certificates representing precious metal ownership.
3. The asymmetry of excluding gains but not losses will lead to tax-avoidance opportunities and, more importantly, raise significant problems as the Department of the Treasury drafts the reporting regulations. Because the reporting party does not necessarily know the basis of the person holding the alternative currency and therefore does not know whether a particular transaction gives rise to a gain or a loss, all transactions will need to be reported. Requiring the reporting of all transactions constitutes a major impediment to the use of alternative currencies.
4. The definition of "virtual currency" is dependent on the term "digital representation." The term "digital representation" implies that it is a representation of something else. It is not clear what that would be. The use of the term "digital technology," "blockchain, distributed ledger or similar technology," or "computer-based technology" would be less ambiguous and less subject to misinterpretation.

d. Exclude Convertible Digital Representation of Commodities from Definition of Security

Summary of the Problem and Policy Analysis

Securities regulators have provided guidance of crypto, digital, electronic or alternative currencies that is a about as clear as mud.[328] They have failed to rectify this situation. Part of the reason for this problem is their general posture that virtually anything paid for with the objective of making money is a security unless a specific statutory exemption exists. Commodities are commodities, not securities. A certificate, electronic or otherwise, that represents ownership of commodities and is convertible into a physical commodity should not be treated as a security.

Recommendations

Amend the definition of security to make it clear that a certificate (digital, electronic or otherwise) that represents ownership of commodities and is convertible into a physical commodity on demand.

Legislative Language

Amend section 2(a)(1) of the Securities Act by adding at the end thereof:

"but does not include real property, tangible personal property, a commodity or a certificate (digital, electronic or otherwise) that represents ownership of a commodity or commodities and is convertible into a physical commodity or commodities on demand (subject to reasonable conditions or fees)."

[328] Framework for "Investment Contract" Analysis of Digital Assets Strategic Hub for Innovation and Financial Technology ("FinHub," the "Staff," or "we") of the Securities and Exchange Commission https://www.sec.gov/files/dlt-framework.pdf; SEC Chairman Jay Clayton, "Statement on Cryptocurrencies and Initial Coin Offerings," December 11, 2017 https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

VII. ERISA

a. Introduction

The Employee Retirement Income Security Act of 1974 (ERISA) was enacted to protect beneficiaries of retirement and other employee benefit plans. Increasingly, there are calls to politicize retirement investing and to sacrifice plan participants retirement income in the name of social justice, socially responsible investing, ESG and so forth.

b. Investing standards

Summary of the Problem and Policy Analysis

Under ERISA, fiduciaries are obligated to act in the interest of plan beneficiaries and are not be permitted to take actions that reduce the return to beneficiaries to further a social or political objective of the fiduciary. Increasingly, there are those who argue that pursuing social justice with plan beneficiaries' money is somehow consistent with ERISA fiduciaries obligation. Fiduciaries should be in the business of providing economic value to beneficiaries and plan participants, not pursuing political or social objectives at the expense of beneficiaries and plan participants.

Recommendation

Prohibit ERISA fiduciaries from pursuing political or social objectives at the expense of the financial interest of plan participants and beneficiaries.

For Further Information

1. Comment Letter of David R. Burton regarding Financial Factors in Selecting Plan Investments.[329]
2. Financial Factors in Selecting Plan Investments, Final Rule, EBSA.[330]

Legislative Language

1. Amend section 404(a)(1) of ERISA [29 U.S. Code § 1104(a)(1)] by inserting the word "financial" before "interest."

2. Amend section 404 of ERISA [29 U.S. Code § 1104] by adding at the end a new subsection (f):

"(f) Solely in the financial interest of the participants and beneficiaries

[329] Comment Letter of David R. Burton regarding Financial Factors in Selecting Plan Investments, July 30, 2020 https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00595.pdf.

[330] "Financial Factors in Selecting Plan Investments," Final Rule, Employee Benefits Security Administration, Department of Labor, *Federal Register*, Vol. 85, No. 220, November 13, 2020 https://www.govinfo.gov/content/pkg/FR-2020-11-13/pdf/2020-24515.pdf.

(1) A fiduciary's evaluation of an investment or investment course of action must be based only on financial factors. A fiduciary may not subordinate the financial interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives and may not sacrifice investment return or take on additional investment risk to promote non-pecuniary or non-financial benefits or goals.
(2) The term 'financial factor' means a factor that a fiduciary prudently determines is expected to have a material effect on the risk or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy established pursuant to section 402(b)(1).
(3) The term 'investment course of action' includes the management of shareholder rights appurtenant to those shares, such as the right to vote proxies. A fiduciary may not adopt a practice of following the recommendations of a proxy advisory firm or other service provider unless such firm or service provider's proxy voting guidelines are consistent with the fiduciary's obligations to act based only on financial factors."

c. Proxy voting standards

Summary of the Problem and Policy Analysis

ERISA fiduciaries should be deemed to have an obligation to vote the plan shares to maximize returns rather than to achieve social justice, SRI, ESG or other political or social objectives. In addition, it should be made clear that ERISA fiduciaries that do hire proxy advisory firms have an obligation to hire proxy advisory firms[331] that make recommendations based on maximizing beneficiary returns rather than achieving political or social objectives.

Recommendation

Prohibit ERISA fiduciaries from voting plan shares to pursue political or social objectives at the expense of the financial interest of plan participants and beneficiaries and prohibit the practice of following the recommendations of a proxy advisory firm or other service provider unless such firm or service provider's proxy voting guidelines are consistent with the fiduciary's obligations to act based only in the financial interest of plan participants and beneficiaries.

For Further Information

Comment Letter of David R. Burton regarding Fiduciary Duties Regarding Proxy Voting and Shareholder Rights.[332]

[331] Two firms utterly dominant this market currently and their recommendations effectively control the votes of about one-third of all shares.
[332] Comment Letter of David R. Burton regarding Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, October 5, 2020 https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB91/00232.pdf.

Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, Final Rule, EBSA.[333]

Legislative Language

See legislative language in the "Investing Standards" section above.

[333] "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights," Final Rule, Employee Benefits Security Administration, Department of Labor, *Federal Register*, Vol. 85, No. 242, December 16, 2020 https://www.govinfo.gov/content/pkg/FR-2020-12-16/pdf/2020-27465.pdf.

VIII. LIST OF RECOMMENDATIONS

This section provides a list of the recommendations made in the previous sections.

Entrepreneurial Capital Formation

1. Establish a fundamentally reformed, simplified and rationalized securities disclosure system with three basic categories of firm (private firms, quasi-public or venture firms and public firms), reasonable, scaled disclosure requirements and specified secondary markets.
2. Enact legislation permitting finders and private placement brokers substantially along the lines of the "Unlocking Capital for Small Businesses Act."
3. 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.
4. Congress should amend the Securities Act section 4 by adding a new subsection (f) to create a safe harbor under section 4(a)(2) for micro-offerings.
5. Alternatively, Congress should create a new exemption for micro-offerings under section 4(a) of the Securities Act by enacting a new section 4(a)(8).
6. Congress should provide that a natural person is an accredited investor for purposes of Regulation D who has:
    (1) passed a test demonstrating the requisite knowledge, such as the General Securities Representative Examination (Series 7), the Securities Analysis Examination (Series 86), or the Uniform Investment Adviser Law Examination (Series 65) or a newly created accredited investor examination testing for substantive investment knowledge;
    (2) met relevant educational requirements, such as an advanced degree in finance, accounting, business, economics or entrepreneurship; or
    (3) acquired relevant professional certification, accreditation, or licensure, such as being a certified public accountant, chartered financial analyst, certified financial planner, registered representative or registered investment advisor representative.
7. 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 for Rule 506(c) offerings.
8. The statutory crowdfunding offering limit should be conformed to the new limit in Regulation CF.
9. The statutory audit requirement for crowdfunding should be conformed to the new limit in Regulation CF.
10. Clarify funding portal liability for the misstatements of issuers.
11. Clarify that the term "issuer" does not include any person who is a broker or funding portal except with respect to securities of the entity (or its parents, subsidiaries, affiliates or other related parties) operating the broker or funding portal.
12. Congress should make it clear that funding portals need not comply with AML rules because they may not hold customer funds.

13. Allow curation by funding portals by repeal restrictions on investment advice.
14. Alternatively, allow "impersonal investment advice" by funding portals.
15. Amend Section 1361(c) of the Internal Revenue Code to disregard crowdfunding and Regulation A shareholders for purposes of the 100 shareholder limit for Subchapter S corporations.
16. Preempt blue sky registration and qualification requirements for all primary and secondary Regulation A offerings.
17. 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.
18. Codify and broaden the exemption from the section 12(g) holder-of-record limitations for Regulation A securities.
19. Eliminate the income and net worth limitations imposed by Regulation A (although not by Securities Act section 3(b)).
20. Exempt P2P lending from federal and state securities laws.
21. 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.
22. Congress could adopt an alternative regulatory regime for P2P lending.
23. Exempt business brokers from the broker-dealer registration requirements.
24. Alternatively, register and reasonably regulate business brokers.

Better Public Markets

25. Congress should require the Division of Economic and Risk Analysis (DERA) and the Division of Corporation Finance at the SEC to jointly send a survey to every issuer that is either a smaller reporting company or a non-accelerated filer (and their counsel and accountants). The survey should be structured so that the responses can be anonymous (in the sense that the SEC staff cannot determine which issuer, law firm or accounting firm provided which survey response). The use of an independent third-party who would collect the surveys and redact information identifying respondents should be authorized. The survey should seek information regarding:

    (1) which provisions in Regulation S-K, Regulation S-X, Financial Accounting Standards Board rules, Public Company accounting Oversight Board rules and other relevant regulations that are problematic and impose unwarranted costs,

    (2) quantitative information regarding costs and

    (3) suggestions for improvement to Regulation S-K, Regulation S-X, Financial Accounting Standards Board rules, Public Company accounting Oversight Board and other relevant regulations.

    The Congress should require that DERA and the Division of Corporation Finance consult with the Census Bureau, the Bureau of Economic Analysis and the Bureau of Labor Statistics before undertaking the survey because these agencies have extensive experience in collecting survey data. The SEC should compile this information (including cost data and a detailed compilation of recommendations made by issuers, their counsel and their accountants) and issue a report to Congress within one year.

26. Preempt blue sky registration, qualification and continuing reporting requirements for (1) securities traded on established securities markets (including a national securities exchange or an alternative trading system), (2) issuers that have continuing reporting obligations as public companies, under the small issues exemption (Regulation A) or crowdfunding (Regulation CF). Preempt blue registration and qualification requirements for Regulation A primary and secondary offerings.
27. Make the Title I EGC exemptions permanent for all EGCs (redefined so that the status does not expire after five years) and direct the SEC to amend its regulations to the extent necessary for all smaller reporting companies and non-accelerated filers to enjoy the same exemptions.
28. 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.
29. Oppose efforts to redefine the purpose of business in the name of social justice, corporate social responsibility (CSR), stakeholder theory, environmental, social and governance (ESG) criteria, socially responsible investing (SRI), sustainability, diversity, business ethics, or common-good capitalism.
30. 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.
31. Exempt privately-held, non-custodial broker-dealers from the requirements to use a PCAOB registered firm for their audits.
32. Congress should terminate the Consolidated Audit Trail program.
33. Repeal Title XV (especially sections 1501-1504) and Title IX Section 953(b) of the 2010 Dodd-Frank Act.

FINRA Transparency

34. Congress should require that FINRA's Board of Governors meetings be open to the public, unless the board votes to meet in executive session. The criteria for whether they can close the meeting should be established in advance and carefully circumscribed.
35. Congress should require that FINRA's Board of Governors' agenda be made available to the public in advance, and that board minutes describing actions taken be published with alacrity. Such requirements are analogous to, but less stringent than, the requirements imposed on government agencies by the Sunshine Act.
36. Congress should require that FINRA make available to the public in advance rulemakings that the FINRA board is expected to consider.
37. Given that under current law FINRA proceedings supplant a civil trial and there is no means of accessing the courts, Congress should require FINRA arbitration and disciplinary hearings should be open to the public and reported. This is analogous to the public-trial requirement in the Sixth Amendment and the long-standing presumption that all court proceedings in the United States are open to the public.

FINRA Arbitration

38. Administrative law courts are required to make "findings and conclusions, and the reasons or basis therefore, on all the material issues of fact, law, or discretion presented on the record." Congress should require that FINRA arbitrators be required to make findings of fact based on the evidentiary record and to demonstrate how those facts led to the award given. These written FINRA arbitration decisions should be subject to SEC review and limited judicial review.
39. The foregoing may be difficult for many existing FINRA arbitrators who do not have training in finance or in the law. If raising FINRA arbitrator honoraria is necessary in order to attract those with the requisite skills, FINRA should do so.
40. Congress should require that all SRO fines, including those imposed by FINRA, go to either a newly established investor reimbursement fund or to the Treasury. FINRA should not have a financial interest in imposing fines.

FINRA Rulemaking

41. Congress should require all SROs, including FINRA, to conduct meaningful cost-benefit analysis as part of the rulemaking process.
42. Congress should require all SROS, including FINRA, to publish its rules in proposed format and seek public comment before they are submitted to the SEC (which very rarely changes SRO rules).

FINRA Oversight

43. Congressional oversight of FINRA has been light. To improve oversight, Congress should:
    (1) Require that FINRA submit an annual report to Congress with detailed, specified information about its budget and fees; its enforcement activities (including sanctions and fines imposed by type of violation and type of firm or individual); its dispute resolution activities; and its rule-making activities;
    (2) Conduct annual oversight hearings on FINRA, its budget, its enforcement activities, its dispute resolution activities, and its rule-making activities;
    (3) Require an annual GAO review of FINRA with respect to its budget, its enforcement activities, its dispute resolution activities, and its rule-making activities and a separate review of the SEC's oversight of FINRA;
    (4) make FINRA, the Municipal Securities Rulemaking Board (MSRB) and the National Futures Association (NFA) each a "designated federal entity" and establish an inspector general with respect to financial SROs, including FINRA, the MSRB, and the NFA or, alternatively, placing FINRA, the MSRB, and the NFA within the ambit of an existing inspector general;
    (5) Require FINRA to obtain an affirmative vote by Congress or, at least, by the SEC to raise its fees imposed on broker-dealers.

SEC Reforms

44. 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[334], type of security[335] and exemption used[336]);
    (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,[337] 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.
45. Congress should enact legislation reducing the number of direct reports to the SEC Chairman from 23 to 12.
46. SEC Offices performing similar functions should be merged. First, the Office of Equal Employment Opportunity and the Office of Minority and Women Inclusion should be merged.[338] Second, the Office of Investor Education and advocacy should be merged into the Office of the Investor Advocate Office.[339]
47. The number of managers per employee at the SEC should be reduced.
48. SEC Resources should flow toward core functions and away from ancillary and support functions.

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[334] By industry; by measures of size such as gross revenues, assets or employees; by age (i.e. years in existence); reporting status; and so on.

[335] Common stock, preferred stock, bond, (and whether the bond or preferred stock is convertible into common stock), other classes of security, whether options or warrants were attached; and so on.

[336] Regulation D (Rule 504 and 506 (including 506(b) and 506(c)); Regulation A (Tier 1 and Tier 2); Crowdfunding (Tiers 1, 2 & 3); non-Regulation D section 4(a)(2) offerings, Rule 144A and other exemptions.

[337] Civil or Criminal (referrals, convictions, settlements); with respect to broker-dealers (Breach of Fiduciary Duty, Suitability violations, Negligence, Failure to Supervise, Misrepresentation, Fraud, Breach of Contract, Omission of Facts, Violation of Blue Sky Laws, Unauthorized Trading, Manipulation, Churning); issuer violations by type of violation (e.g. fraud, non-compliance with Regulation S-K, Regulation S-X, failure to file an 8-K, Regulation A, Regulation CF, etc.) and type of issuer ((private issuer, Regulation A issuer, crowdfunding issuer, reporting company, investment company, registered investor advisor, broker-dealer, registered representative, etc.).

[338] This would require amending 12 U.S. Code § 5452 (§342 of the Dodd–Frank Act).

[339] The Office of the Investor Advocate Office was created by § 915 of the Dodd–Frank Act and has a statutory basis at 15 U.S.C. § 78d(g). The Office of Investor Education and Advocacy appears to have no statutory basis. Ergo, the Office of the Investor Advocate should be the surviving entity.

49. Congress should require an Inspector General's report or a GAO report regarding Information Technology spending and contracting by the SEC. Spending appears to be much too high and IT contracting poorly managed.
50. Congress should seriously examine the staffing level and the level of spending in the SEC IG's office. It appears to be much too high.
51. Any three members of the Commission should be empowered to place an item on the agenda and to receive adequate staff support to do so even without the Chairman's support.
52. Congress should create a large case unit within the Division of Enforcement.
53. Respondents should be allowed to elect whether an adjudication occurs in the SEC's administrative law court or an ordinary article III federal court.
54. Congress should require both the SEC and the GAO to study whether Commission delegation of authority to staff should be narrowed and whether sunsetting of delegation of authority should be required.
55. Congress should require the Commission to publish a detailed annual report on SRO supervision.

Anti-Money Laundering/Combating the Financing of Terrorism/Know Your Customer (AML/CFT/KYC)

56. Congress should adjust the CTR threshold for inflation from $10,000 to $60,000.
57. Congress should adjust the non-bank reporting threshold for inflation from $3,000 to $10,000.
58. Congress should repeal the beneficial ownership reporting regime on small businesses imposed by the Corporate Transparency Act and instruct FinCEN to withdraw any regulations proposed or promulgated pursuant to the Act.
59. If Congress wants FinCEN to be able to acquire better beneficial ownership information at radically lower cost to the public, then an alternative approach would require the Internal Revenue Service to compile a beneficial ownership database based on information already provided to the agency in the ordinary course of tax administration and to share the information in this database with FinCEN. Internal Revenue Code section 6103 contains literally dozens of exceptions to the general rule of tax return confidentiality. Internal Revenue Code section 6103(i) permits disclosure for federal law enforcement purposes but that provision generally requires an *ex parte* order by a Federal district court judge or magistrate judge. Congress could choose to amend section 6103 to loosen those requirements and allow access by FinCEN to a narrow database of beneficial ownership information that would be maintained by the IRS.
60. Congress should require the U.S. delegation to the Financial Action Task Force (FATF) vote to require that FATF establish procedures to conduct a rigorous cost-benefit analysis of a proposed recommendation before making such a recommendation and conduct a rigorous retrospective analysis and review of its past recommendations regarding (1) their effectiveness or lack thereof and (2) their cost. These analyses should (1) provide citations to peer reviewed literature that supports or opposes the recommendation or explicitly acknowledge that there is no such supporting literature or (2) rely on data published by a reliable third-party or explicitly acknowledge that there is no such data.
61. Congress should require the U.S. Mission to the OECD to support tax competition, oppose tax increases and to support reasonable levels of regulation. Regulations, particularly those

governing finance, AML and environmental matters, should not be recommended or endorsed by the OECD unless it conducts a rigorous cost-benefit analysis of a proposed recommendation before making such a recommendation. These analyses should (1) provide citations to peer reviewed literature that supports or opposes the recommendation or explicitly acknowledge that there is no such supporting literature or (2) rely on data published by a reliable third-party or explicitly acknowledge that there is no such data.

62. Congress should require FinCEN and the GAO to conduct a detailed, comprehensive estimate of the aggregate costs incurred because of U.S. AML, CFT, KYC and BSA requirements both before and after the survey that would be required below.
63. Congress should require FinCEN to send a survey to all regulated businesses. The survey should be structured so that the responses can be anonymous (in the sense that the FinCEN staff cannot determine which business provided which survey response). The use of an independent third-party who would collect the surveys and redact information identifying respondents should be authorized. The survey should seek information regarding the costs imposed by various requirements and total costs incurred. It should also seek recommendations for improvement to the system. The Congress should require that FinCEN consult with the Census Bureau, the Bureau of Economic Analysis and the Bureau of Labor Statistics before undertaking the survey because these agencies have extensive experience in collecting survey data. FinCEN should compile this information (including cost data and a detailed compilation of recommendations made by regulated businesses) and issue a report to Congress within one year.
64. Congress should direct the Department of Justice (in consultation with the IRS and FinCEN) to annually report the number of AML referrals, prosecutions, and convictions (including those that were made without a simultaneous prosecution for a predicate crime), and the number of occasions where BSA/AML customer requirements lead to a criminal prosecution or conviction for a non-money-laundering crime. To the extent possible, the data should report retroactively for the previous 10 years.
65. Either place a moratorium on the FinCEN proposed a rule "Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets" or amend the Bank Secrecy Act to provide parity between the requirements imposed on traditional financial payment mechanisms and virtual, alternative or digital currency.
66. Do Not Ratify the Protocol Amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.
67. Replace the current patchwork of international agreements with a well-considered, integrated international convention that ensures robust information sharing for the purposes of preventing terrorism, crime, and fraud, but also provides enforceable legal protections for the financial and other privacy interests of member states' citizens and the legitimate commercial interests of their businesses. Membership in this convention should be restricted to governments that (1) are democratic (representative democracies with legitimate elections and protections for political minorities); (2) respect free markets, private property, and the rule of law; (3) can be expected to always use the information in a manner consistent with the security interests of the member states; and (4) have—in law and in practice—adequate safeguards to prevent the information from being obtained by hostile parties or used for inappropriate commercial, political, or other purposes.

68. Congress should preempt state registration requirements for money transmission businesses.

Banking

69. Policymakers should create new charters for financial firms that eliminate activity restrictions and reduce regulations in return for straightforward higher equity or risk-retention standards. Ultimately, these charters would replace government regulation with competition and market discipline, thereby lowering the risk of future financial crises and improving the ability of individuals to create wealth.
70. Reduce the FDIC insurance coverage limit to at least the pre-Dodd–Frank limit of $100,000 per account.
71. Improve the bank resolution process.
72. Repeal Title I of the Dodd-Frank Act (The Financial Stability Act of 2010 relating to the Financial Stability Oversight Council).
73. Repeal Title II of the Dodd-Frank Act (relating to orderly liquidation authority).
74. Repeal Title VIII of the Dodd-Frank Act (The Payment, Clearing, and Settlement Supervision Act of 2010 relating to financial market utilities and other matters).
75. The Federal Reserve's emergency lending powers should be limited. The Fed should be allowed only to provide system-wide liquidity, preferably with a market-wide auction program that replaces its limited primary dealer system.

Alternative Currencies

76. Congress should enact legislation providing such that holders of digital assets may not be deemed (1) parties to an investment contract or (2) an investor in a common enterprise unless, while the enterprise is a going concern, the holder is entitled to (1) a share of the earnings or profits of the common enterprise, or (2) a defined flow of payments from the common enterprise in consideration of the investment or, upon liquidation, the holder has rights against the assets of the common enterprise.
77. Amend the tax law such that changes in the relative value of an alternative currency and the dollar is not a taxable event and need not be reported.
78. Amend the definition of security to make it clear that a certificate (digital, electronic or otherwise) that represents ownership of commodities and is convertible into a physical commodity on demand.

ERISA

79. Prohibit ERISA fiduciaries from pursuing political or social objectives at the expense of the financial interest of plan participants and beneficiaries.
80. Prohibit ERISA fiduciaries from voting plan shares to pursue political or social objectives at the expense of the financial interest of plan participants and beneficiaries and prohibit the practice of following the recommendations of a proxy advisory firm or other service provider unless such firm or service provider's proxy voting guidelines are consistent with the fiduciary's obligations to act based only in the financial interest of plan participants and beneficiaries.