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April 14, 2017

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

Re: Request Proposals to Foster Economic Growth

Dear Sens. Crapo and Brown:

I am writing in response to your request for proposals to foster economic growth. You indicated that you wanted "three to five priority proposals that will promote economic growth and/or enable consumers, market participants and financial companies to better participate in the economy." In this letter, I have provided five proposals:

1. Broaden the accredited investor definition for purposes of Regulation D offerings;
2. Improve secondary markets for small public and Regulation A companies;
3. Clarify the rules governing finders or private placement brokers;
4. Improve the rules governing equity and debt crowdfunding; and
5. Improve the rules governing Emerging Growth Companies

These five proposals are discrete improvements to the current regulatory framework. Each would help address issues in a different part of the capital market that serves different types of firms. A great many more reforms to the existing regulatory regime should be made to improve the regulatory environment for small, entrepreneurial firms seeking to raise capital and to improve capital markets more generally. Citations to a number of papers that address these additional ideas are provided at the end of this letter.

Broaden the Accredited Investor Definition for Purposes of Regulation D Offerings

The SEC adopted Regulation D in 1982 during the Reagan Administration. Regulation D creates a safe harbor such that an issuer that complies with the requirements of Regulation D will be treated as exempt pursuant to the private-offering exemption from the registration requirements of the Securities Act. Regulation D achieves this by creating three exemptions (Rule 504, Rule

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505, and Rule 506). Rules 506 is the most important. Under Rule 506, a company may raise an unlimited amount of money. It may sell securities to an unlimited number of "accredited investors" and up to 35 non-accredited yet sophisticated investors. Under Regulation D an "accredited investor" is, generally, either a financial institution or a natural person who has an annual income of more than $200,000 ($300,000 joint) or a residence exclusive net worth of $1 million or more.

The problem is that the regulatory definition of what constitutes a sophisticated investor is highly amorphous. It hinges on whether the investor has such "knowledge and experience in financial and business matters" that the investor "is capable of evaluating the merits and risks of the prospective investment." The risk to an issuer of selling to an investor whom the issuer deemed sophisticated, but whom a court or regulator later deems unsophisticated, is the risk of having the issuer's entire offering disqualified or being subject to rescission demands by investors in subsequent litigation. Accordingly, many issuers are very reluctant to rely on the sophisticated-investor provisions of Regulation D. In fact, only 10 percent of Regulation D offerings have any non-accredited investors, and they typically account for a minor portion of the capital raised.

What this means in practice is that sophisticated investors without high incomes or net worth are unable to invest in the companies with the most profit potential. People who fall in this category are disproportionately young. It also means that young entrepreneurs seeking to raise capital from their non-wealthy peers find it more difficult to raise capital.

The solution is for Congress to broaden the definition of an accredited investor for purposes of Regulation D to include persons who have met specific statutory bright-line tests for whether an investor has the "knowledge and experience in financial and business matters" and whether the investor "is capable of evaluating the merits and risks of the prospective investment." Specifically, Congress should amend section 2(a)(15) of the Securities Act of 1933, relating to the definition of an accredited investor, to codify the current income and net worth thresholds and further provide that a person is an accredited investor 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 exam that tested for investment knowledge;
> (2) met relevant educational requirements, such as an advanced degree in finance, accounting, business, or entrepreneurship; or
> (3) acquired relevant professional certification, accreditation, or licensure, such as being a certified public accountant, chartered financial analyst, certified financial planner, or registered investment adviser.

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Improve Secondary Markets for Small Public and Regulation A Companies

Robust secondary markets are important because their existence facilitates primary securities offerings, because they enhance investor returns, and because they foster a more efficient allocation of scarce capital. The secondary market for large public companies is robust; the secondary market for smaller firms is much less so. The primary reason for this is the U.S. regulatory regime, particularly blue sky laws. U.S. law should allow the development of venture exchanges so that a robust secondary market for the securities of smaller companies can develop. These are often called SME exchanges, or alternative investment markets in the European or academic literature. SME stands for small and medium-sized enterprises.

The most important step that can improve U.S. secondary markets is to reduce the burdens imposed by blue sky laws. In some cases, it is simply impossible to achieve blue sky compliance. This means that companies not traded on a national securities exchange, and therefore not having their securities treated as covered securities exempt from blue sky compliance, have serious regulatory difficulties in secondary markets.

In order to improve small-firm secondary markets, Congress should amend section 18(b) of the Securities Act to treat all securities as covered securities that (1) are traded on established securities markets and (2) have continuing reporting obligations as (a) a registered company; (b) pursuant to Regulation A; or (c) pursuant to regulation crowdfunding. An established securities market should be defined to include those on electronic markets such as an SEC-designated alternative trading system (ATS). This would probably be sufficient to allow venture exchanges to develop in the United States without having to adopt an alternative, separate regulatory framework for venture exchanges.

Congress should also establish an alternative regulatory regime for venture exchanges that would treat venture exchanges as national securities exchanges for purposes of blue sky pre-emption, but more like ATSs for regulatory purposes. The Main Street Growth Act would create venture exchanges along these lines.

Clarify the Rules Governing Finders or Private Placement Brokers

A finder is a person who is paid to assist small businesses to find capital by making introductions to investors, either as an ancillary activity to some other business (such as the practice of law, public accounting, or insurance brokerage), as a Main Street business colleague, or as an acquaintance or friend or family member of the business owner. Finders are sometimes called private placement brokers, particularly by those familiar with the work and proposals of the American Bar Association Task Force on Private Placement Broker-Dealers. They are typically paid a small percentage of the amount of capital they helped the business owner to raise. Finders are often used by the smallest firms to help raise capital. The SEC has created a regulatory cloud

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with respect to finders and failed to resolve the issues it created for nearly two decades. Neither finders nor business brokers should be treated the same for regulatory purposes as a Wall Street investment bank.

Congress should create a statutory exemption needed for small-business finders who are not "engaged in the business" of "effecting transactions in securities for the account of others" or of "buying and selling securities." As an integral component of that exemption, it is necessary to create a bright-line "small finder" safe harbor such that small finders are deemed not to be engaged in the business of being a securities broker or dealer. Such a bright-line safe harbor would eliminate much of the regulatory uncertainty associated with the use of finders. Specifically, an exemption should be created for finders from the Section 15 registration requirement providing a safe harbor such that a finder is deemed not to be engaged in the business of effecting transactions in securities for the account of others if the finder meets one or more of the following criteria:

1. The finder does not receive finder's fees exceeding $300,000 in any year,
2. The finder does not assist an issuer in raising more than $10 million in any year,
3. The finder does not assist any combination of issuers in raising more than $20 million in any year, or
4. The finder does not assist any combination of issuers with respect to more than 15 transactions in any year.

For those "larger" finders (those who do not meet the above criteria), which really are holding themselves out as in the business of being a "private placement broker," something more akin to the American Bar Association proposal to have finder registration and limited regulation of private placement brokers may make sense. Some states have pursued this approach, but so long as the SEC holds to its current position, these licensing regimes will be of limited utility (except in the case of intrastate offerings). It would be reasonable to prohibit finders from engaging in certain activities to be eligible for this exemption on the grounds that such activities would constitute crossing the line to effecting transactions in securities or providing investment advice (thus triggered investment advisory registration requirements). Among those activities that would be proscribed would be:

1. Holding investor funds or securities;
2. Recommending the purchase of specific securities (This would be analogous to personalized investment advice provisions in Advisers Act Rule 203A, 17 C.F.R. 275.203A-3 (a)(3)(ii).); and
3. Participating materially in negotiations between the issuer and investors.

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Improve the Rules Governing Equity and Debt Crowdfunding

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).

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. Initial SEC data on Title III crowdfunding implies strongly that crowdfunding is not living up to its potential. A number of steps should be taken to remedy this problem.

In order for crowdfunding to be an attractive option for all but the very smallest start-ups, the amount that can be raised using Title III should be increased to $5 million.

Congress should make it clear that funding portals are not liable for the misstatements of issuers. The SEC final rule treats funding portals as issuers, 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.

Congress should repeal the requirement that crowdfunding issuers raising $500,000 or more provide audited financial statements. Except for start-up firms with no operating history, audits are expensive. There are many other exemptions, usually used by much larger firms, which do not have this requirement.

Congress should repeal restrictions on curation by funding portals. Funding portals are prohibited from offering “investment advice or recommendations.” 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.” 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 its final rule, albeit with limited success. 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 Advisers Act 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." 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.

Congress should substantially reduce the complex initial and ongoing mandatory disclosure requirements on crowdfunding issuers. The disclosure requirements in the final rule are voluminous. Under SEC regulations, there are 25 specific disclosure requirements—(a) through (y)—most of which have multipart requirements. The statute is less demanding with 12 specific requirements. The bottom line is that these requirements are nearly as burdensome as those found in Regulation A and constitute a large fraction of the burden imposed on smaller reporting companies. Crowdfunding companies are the smallest issuers, and it is inappropriate to impose this level of burden on the smallest companies. A better-scaled disclosure regime is needed.

Congress should also clarify that funding portals are not subject to the anti-money laundering, "Know Your Customer" and associated Bank Secrecy Act requirements. Funding portals do not handle customer funds; the JOBS Act prohibits them from doing so. The banks and broker-dealers that do handle customer funds must comply with these rules. Requiring funding portals to also do so is duplicative and unnecessary. The Treasury's Financial Crimes Enforcement Network (FinCEN) has proposed rules that would require funding portals to comply with these rules. The Financial Industry Regulatory Authority (FINRA) and the SEC both originally proposed requiring funding portals to comply with the anti-money-laundering rules but did not include the requirement in their final rules.

Peer-to-peer (P2P) lending represents a way of making financial intermediation for consumer and small-business loans much more efficient to the benefit of consumers, small-business owners, and small lenders. There is a very strong need to cut down the regulatory weeds and allow the potential efficiencies of Internet lending and borrowing to take place. The key substantive, non-legal point here is that a loan is a loan, not a security. 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, loans to small businesses by banks, credit unions, finance companies, or individuals 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 and protects the two incumbent consumer P2P lending platforms from competition from new entrants.

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." A debt security would be defined "as any contract that (1) provides for the repayment of the principal amount over a definite period together with interest and (2) provides no payments to the holder other than principal payments, interest payments and penalties for late payments." Crowdfunding debt security issuers would be exempt from much of the continuing disclosure requirements. "Peer-to-peer debt security" issuers should be exempt from Securities Act:

Section 4A(b)(1)(D)(ii)-(iii);
Section 4A(b)(1)(G);
Section 4A(b)(1)(H);
Section 4A(b)(4); and
Section 4A(b)(5).

Valuing equity securities requires making a judgment about expected future returns. Ergo, significant disclosure is appropriate. Moreover, some form of equity security will exist so long as the company exists. In the case of a loan, however, disclosure related to future earnings prospects is much less appropriate. The question is simply whether the loan is being repaid and, of course, once it is repaid, there is no need for continued disclosure. The exemption should include single-purpose entities whose sole purpose is to allow investors to invest in an entity that holds the debt securities of a single issuer. The statutory peer-to-peer debt security exemption should be self-effectuating and not rely on the SEC to issue rules to become effective.

Improve the Rules Governing Emerging Growth Companies

The reduced regulatory requirements for Emerging Growth Companies (EGCs), which currently lapse after five years, should be made permanent for EGCs. Among those would be:

1. Exemption from the requirement in Securities Exchange Act section 14A(a) to conduct shareholder advisory votes on executive compensation (for exemption, see Securities Exchange Act section 14A(e)(2));
2. Exemption from the requirement in Securities Exchange Act section 14A(b) to provide disclosure about and conduct shareholder advisory votes on golden parachute compensation (for exemption, see Securities Exchange Act section 14A(e)(2));
3. Exemption from the requirement in section 953(b) of the Dodd–Frank Wall Street Reform and Consumer Protection Act, as implemented by the Commission in Item 402 of Regulation S-K (17 C.F.R. §229.402), to provide disclosure of the ratio of the median annual total compensation of all employees (except the CEO) of the registrant to the

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annual total compensation of the chief executive officer (for exemption, see JOBS Act section 102(a)(3));
4. Exemption from the requirement in Securities Exchange Act section 14(i) to provide disclosure of the relationship between executive compensation and issuer financial performance (for exemption, see Securities Exchange Act section 14A(i));
5. Exemption from compliance with new or revised financial accounting standards until those standards apply to private companies (for exemption, see Securities Exchange Act section 13(a)); and
6. Exemption from the Sarbanes–Oxley section 404(b) internal control reporting requirements (for exemption, see JOBS Act section 103).

Additional Proposals

With respect to pro-growth reforms beyond these five proposals, I would direct you to ideas discussed in these papers:

Improving Entrepreneurs' Access to Capital

Abstract

Capital formation improves economic growth, boosts productivity, and increases real wages. So does entrepreneurship — which also fosters discovery and innovation. Entrepreneurs engage in the creative destruction of existing technologies, economic institutions, and business production or management techniques by replacing them with new and better ones. Entrepreneurs bear a high degree of uncertainty and are the source of much of the dynamism in the U.S. economy. New, start-up businesses account for most of the net job creation. Entrepreneurs innovate, providing consumers with new or better products. By providing other businesses with innovative, lower-cost production methods, entrepreneurship is one of the key factors in productivity improvement and real income growth. To promote prosperity, Congress and the Securities and Exchange Commission need to systematically reduce or eliminate state and federal regulatory barriers hindering entrepreneurs' access to capital. Due to the many regulatory provisions blocking entrepreneurs' access to capital, a large number of policy changes are warranted.

[available at: http://www.heritage.org/sites/default/files/2017-02/BG3182.pdf]
February 14, 2017

Securities Disclosure Reform

Abstract

The adverse impact of the current securities disclosure regime on small entrepreneurial and start-up firms, as well as on innovation, job creation, and economic growth is substantial. Moreover, disclosure requirements have become so voluminous that they obfuscate rather

than inform. This Heritage Foundation backgrounder outlines a program of interim reforms to improve the existing disclosure regime. It recommends specific changes to Regulation A, crowdfunding, Regulation D, and the regulation of small public companies and of secondary markets to improve the current regulatory environment. This Backgrounder also outlines a program of fundamental reform that would dramatically simplify the existing disclosure regime to the benefit of both investors and issuers. This proposal would replace the current 14 disclosure categories with three disclosure regimes — public, quasi-public, and private—and disclosure under the first two categories would be scaled based on either public float or the number of beneficial shareholders.

[available at: http://www.heritage.org/sites/default/files/2017-02/BG3178.pdf]
February 13, 2017

Reforming FINRA

Abstract

FINRA is a regulator of central importance to the functioning of U.S. capital markets. 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. FINRA itself, the SEC, and Congress should reform FINRA to improve its rule-making and arbitration process. This Heritage Foundation backgrounder outlines alternative approaches that Congress and the regulators can take to improve FINRA , and provides specific recommended reforms

[available at: http://www.heritage.org/sites/default/files/2017-02/BG3181.pdf]
February 1, 2017

Financial Privacy in a Free Society

Abstract

Financial and personal privacy is a key component of life in a free society, where individuals enjoy a private sphere free of government involvement, surveillance, and control. The U.S. financial regulatory framework is largely inconsistent with these ideas, and it is long past the time for fundamentally reforming the information exchange and reporting system that has grown over the past three decades. The current regulatory regime is overly complex and burdensome, and its ad hoc nature has likely impeded efforts to combat terrorism, enforce laws, and collect taxes. To better meet the needs of the citizens these laws are meant to serve, regulators must develop better information about the costs and benefits of the current regime, especially given that the current framework appears grossly cost ineffective. This Heritage Foundation

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Backgrounder *recommends seven reforms to move the U.S. toward an improved financial privacy regime that protects individuals' privacy rights while improving law enforcement's ability to apprehend and prosecute criminals and terrorists.*

[available at: http://thf-reports.s3.amazonaws.com/2016/BG3157.pdf]
September 23, 2016

Broadening Regulation D: Congress Should Let More People Invest in Private, High-Growth Companies

Abstract

The Securities and Exchange Commission's Regulation D accounts for more than $1.3 trillion in new capital annually. Under current Regulation D rules, sophisticated investors without high incomes or net worth are often unable to invest in the companies that offer the greatest opportunities (often with greater risk). People who fall in this category are disproportionately young. Current rules are amorphous and have demonstrably limited the pool of people from whom businesses can raise capital. Congress should provide bright-line rules for determining who is financially sophisticated, and therefore eligible to invest in Regulation D private placements. This would increase the number of people allowed to invest in private firms, broadening the options available to investors and helping entrepreneurs to raise capital. The House-passed Fair Investment Opportunities for Professional Experts Act would have a positive impact on both investors and entrepreneurs. It should, however, be improved by (1) broadening the definition of who would qualify as a sophisticated investor, and (2) minimizing the role of the Financial Industry Regulatory Authority.

[available at: http://thf-reports.s3.amazonaws.com/2016/BG3137.pdf]
August 15, 2016

How Dodd–Frank Mandated Disclosures Harm, Rather than Protect, Investors

Introduction

Title XV of the Dodd–Frank Wall Street Reform and Consumer Protection Act[1] 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).

[available at: http://thf-reports.s3.amazonaws.com/2016/IB4526.pdf]

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March 10, 2016

Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth

Abstract

Securities and Exchange Commission (SEC) regulations impose high costs on companies seeking to access the public securities markets. These costs are prohibitively high for small and medium-sized companies and impede their ability to access the capital needed to grow, innovate, and create jobs. Reasonable mandatory disclosure by public companies promotes capital formation and the efficient allocation of capital. However, both Regulation S-K and Regulation S-X, which govern public company disclosure, should be revised to reduce compliance costs by better scaling disclosure requirements and eliminating requirements that do little or nothing to protect investors.

[available at: http://thf_media.s3.amazonaws.com/2014/pdf/BG2924.pdf]
June 20, 2014

Thank you for the opportunity to provide these recommendations.

Sincerely,

David R. Burton
Senior Fellow in Economic Policy