Whatever happened to promoting small business capital formation?

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Thank you, David [Burton], for that introduction. I appreciate all that the Heritage Foundation in general, and David in particular, are doing to focus attention on key issues in the capital markets, and I am honored to have the opportunity to be here today.

It's almost a cliché now for political figures of all stripes to state that small business is the lifeblood of our economy and the primary engine of economic growth and job creation in this country. But it's a truth worth repeating, and in this era of partisan polarization, it's good to have some common ground, at least on a conceptual level.[1]

But small business has a big collective action problem here in Washington, where it is regularly and systematically underrepresented in the legislative and regulatory process. Small business owners are focused on making ends meet and growing their businesses, not hiring high-priced lobbyists to influence policy. Big businesses and unions, by contrast, can afford to hire lobbyists to develop relationships with politicians and regulators—which is the way business in the U.S. increasingly gets done.[2] As an SEC Commissioner, I believe that this issue warrants the agency's highest level of priority. And, as the son of two long-time small business owners, I take this issue personally.

I'd like to think that the SEC, with its mandate to "promote efficiency, competition, and *capital formation*" would be immune from, or at least could rise above, these trends.[3] But sadly, we at the SEC are not doing nearly enough to ensure that small businesses have the access to capital that they need to grow. We layer on rule after rule until it becomes prohibitively expensive to access the public capital markets. Only rarely do we remove any of our rules, even after they have long since ceased to serve their purpose or have become obsolete or worse. And although we have made significant progress in expanding our economic analysis of new rules and rule amendments, we almost never consider how heavily the weight of the entire corpus of rules bears down on registrants.

Of course, not all of this is the SEC's fault. Much of the ever-growing rulebook is a direct result of congressional mandates. But the Commission has discretion, along with exemptive authority, to make these mandates less onerous. Unfortunately, its track record for doing so is mixed. Moreover, on the rare occasions when Congress attempts to help us streamline our rules, the SEC's response is rarely enthusiastic. When the JOBS Act undertook a much-needed liberalization of private offerings under Rule 506, the Commission infamously responded with a proposed rule that seeks not only to undo some of the benefits achieved in that bipartisan statute, but also to impose new burdens on all Regulation D transactions.[4]

Given these negative trends for capital formation in general, it's no surprise that issues specific to *small business* capital formation too often remain on the proverbial back burner. This lack of attention doesn't just harm small business; it also harms investors and the public at large. Companies are understandably hesitant to incur the ever-increasing burdens of going public. Investors that don't have the resources to buy into a venture capital fund then do not get the opportunity to profit from the potentially explosive growth of early-stage companies. Moreover, when the burdens of going public push venture capital funds to exit their investments through M&A activity rather than an IPO, the public at large loses out on the significant job growth that normally occurs after an IPO.[5]

Thankfully, the SEC has the ability to pursue meaningful reforms—both substantive and procedural—that could significantly improve small business capital formation. Hopefully, some day we actually will, unprompted by Congress.

In pursuing these reforms, the SEC must think about its capital formation regime on a big picture level. For example, we need to ask whether our system of registration requirements and exemptions therefrom, as it has evolved over the past eight decades, provides companies with an end-to-end solution for accessing the capital markets. And by end-to-end, I mean that companies at any point in their lifespan should be able to access the capital markets. The alternative is to leave growing companies entirely dependent on the vagaries of bank funding—just ask Europe how that is working.[6]

We also need to ensure that the rules that apply to small businesses are easily understandable, even without a law degree or expensive lawyers. At least for small businesses, our focus should be on aligning our exemptions with the ways in which companies raise capital, rather than shoehorning capital-raising techniques into existing, complicated exemptions.[7]

I also believe that a fully robust capital markets ecosystem for small companies should encompass both the private and the public capital markets. Our rules should facilitate access to both, equally, as this redundancy can protect against market failures.[8]

What does this mean in practice? To start, we need a robust set of private offering exemptions under Regulation D that allow a company to access our capital markets while still remaining private as long as it so desires.[9] But we also need the parallel ability for a company to access the public markets at the time, and through the means, of its choosing: for example, crowdfunding; Regulation A or A+ offerings; IPOs with emerging growth company scaling, including smaller reporting company scaling if applicable; and finally IPOs without any scaling or a registration under Section 12(g) of the Exchange Act.

We need to involve the entire Commission staff in promoting small business capital formation. This is not just a matter for the Division of Corporation Finance. Our Division of Trading and Markets, for example, has a role to play. While Corp Fin is focusing on the methods by which a growing company can seek to raise capital from public or private markets, TM should be thinking about how to facilitate secondary market liquidity for that company's shares.[10] This is not a matter of putting the cart before the horse; secondary market liquidity can make or break a primary offering, as we are learning in our Regulation A+ rulemaking. And TM must constantly be evaluating the application of trading and registration rules to small entities, as they recently did with the long-awaited, and well received (certainly by yours truly) M&A Brokers no-action letter.[11]

Our Office of the Chief Accountant, in supervising the FASB and PCAOB, needs to ensure that their respective accounting and auditing standards are scaled or scalable for smaller businesses.[12]

We need to promote an infrastructure of intermediaries, such as investment banks and accounting firms, with sufficient economic incentives to specialize in smaller companies.[13]

And, our Division of Enforcement must also play its part. The SEC should be focused on personal responsibility for individual wrongdoers rather than corporate liability and shareholder penalties for amorphous misconduct. Similarly, we should ensure that we recognize that not every business failure is fraudulent. Entrepreneurs need to have the room to take risks, which means room to fail. Without risk there is no reward for investors.

The good news is that we have many of these elements in place already. The bad news is that some of these elements are missing, and some could be improved. So I'd like to discuss a number of near- and medium-term fixes to some of our regulations that could help to facilitate small business capital formation.

The private securities markets have been an incredibly important part of the small business capital formation story over the past decade, so I am hesitant to advocate any significant changes. However, looming over these markets is the threat of the Commission finalizing proposed Regulation D rules that would impose new, substantial burdens.[14]

As I noted in my dissenting statement for the proposed amendments to Regulation D,[15] certain aspects of the proposal could be acceptable. They could help the Commission gain useful data about the private markets, thereby facilitating a data-driven approach to oversight of these markets. But the majority of the proposal would do more harm than good, stifling the private markets while achieving no clear offsetting investor protection goals.[16] Thus I believe the most productive near-term step we could take in the Regulation D markets today would be simply to withdraw the proposed rule.

In the medium term, the Commission needs to do a deeper dive into Regulation D, to consider fundamental questions about who uses it and for what purposes. For example, 99% of capital raised under Regulation D is pursuant to the Rule 506 exemption, even though two-thirds of those offerings are sufficiently small that they could have been done under Rule 504 or 505.[17] The simple reason for this is that Rule 506 offerings are blue sky exempt, while Rule 504 and 505 offerings are not. I believe we should consider broadening the blue sky exemption to help make the choice between types of Regulation D offerings a meaningful one. Taking a closer look at this and a number of additional issues in our private offering rules[18] could reduce regulatory frictions and improve private offerings.

Finally, we need to look at the secondary market for private company shares, where innovation appears to have slowed.[19] We need more facilities to improve trading among accredited investors in the private secondary market. We should also examine whether our resale rules are clear and whether expanded or additional safe harbors might be appropriate to facilitate these transactions.[20]

Switching gears now to the public markets, I will start off small and work my way up.

To begin, I believe that crowdfunding can play an important role in small business capital formation. A would-be entrepreneur far from Silicon Valley with no contacts in established angel investor or venture capital communities should be given a chance, through the wisdom of the crowd, to get funding for his or her idea. But unfortunately the path forward for interstate equity crowdfunding is not clear. While the initial crowdfunding bill introduced in the House properly balanced the competing interests of investor protection and capital formation, the Senate version eventually included in the JOBS Act so skewed that balance that it threatens to rob crowdfunding of much of its potential. For example, the requirement that companies raising over $500,000 file audited financial statements is far too expensive for the amount of money being raised.[21]

If this were the only issue, perhaps we could find an easy way forward. But unfortunately there are many other issues that commenters and others have identified that need to be addressed.[22] I am committed to finalizing our rulemaking in a workable fashion and, if that is not possible, then the Commission should be loudly telling Congress that we need a legislative fix, and that we need it now. I am genuinely excited by the potential democratization of early-stage capital raising that crowdfunding promises; I am just dismayed by the potentially unworkable, nanny-state construct of Title III of the JOBS Act. One last point on crowdfunding—regardless of how we proceed, we need to make sure crowdfunding is fully integrated into our capital markets, rather than treating it as a curiosity, or consigning companies that make use of it to a dead end.[23]

In the meantime, we should finish implementing the JOBS Act's robust reforms to Regulation A, and couple these reforms with the formation of venture exchanges. I have not been shy about expressing my belief that these two reforms, taken together, are potentially revolutionary.

The JOBS Act breathed new life back into Regulation A, a scaled registration and reporting regime for small issuances. Previously robust, Regulation A fell out of favor after improvements to Rule 506 offerings (particularly the blue-sky preemption) made them significantly more attractive.[24] The Commission has proposed a robust set of rules to implement the JOBS Act provisions, including blue sky preemption for all offerees and for all purchasers in certain larger Regulation A offerings.[25]

The resulting outpouring of anger from state regulators in general, and NASAA in particular, wasn't unexpected. After all, state regulators have been "protecting" investors from investment opportunities that are "too risky" for decades—I'm sure the Massachusetts residents who missed out on the offering of Apple Computer in 1980 because of their regulator's concerns about the risk know this all too well.[26] But nonetheless, the state regulators' response to the Regulation A+ proposal was disappointing. I simply do not understand why a federal registration and review regime—tailored for smaller companies but nonetheless comprehensive—that does not divest states of their antifraud enforcement authority,[27] should be viewed as representing a threat to investors. So I believe we should finalize Regulation A+ expeditiously, as proposed, with only two clarifications: we should raise the cap on the maximum size of offerings from $50 million to $75 or $100 million,[28] and we should exempt shares issued pursuant to Regulation A+ from Section 12(g) of the Exchange Act.[29]

While I believe these steps would invigorate the primary issuance of small business securities under Regulation A, attention also needs to be paid to the secondary trading of Regulation A shares. Here, I've called for the creation of "Venture Exchanges": national exchanges, with trading and listing rules tailored for smaller companies, including those engaging in issuances under Regulation A. Shares traded on these exchanges would be exempt from state blue sky registration.[30] The exchanges themselves would be exempted from the Commission's national market structure and unlisted trading privileges rules, so as to concentrate liquidity in these venues. This should in turn bring market makers and analysts to these exchanges and their issuers, thereby recreating some of the ecosystem supportive of small companies that has been lost over the years.

Other variables, such as continuous trading versus periodic call auctions, tick sizes, and minimum capitalization, would be left to each exchange to determine, with the aim of creating different, idiosyncratic venues that could compete with one another.[31] I believe that these exchanges could have a transformative impact on small business capital-raising. But given everything else on the SEC's plate, I would like to engage in a little bit of crowdsourcing here. Specifically, I encourage all of you—as practitioners, academics, and interested parties—to refine this proposal through evaluating the legal and practical issues, and then to advocate for its inclusion on our agenda.

Now, we come at last to the traditional public markets. Companies of many different sizes and at many different stages of development may go through an initial public offering. Our post-IPO disclosure regime needs to effectively address these differences. Here, I believe we should make better use of the smaller reporting and emerging growth company distinctions. Whether to tailor disclosure requirements for these categories, or to exempt them entirely, should be a primary decision point for each new disclosure rule, to be addressed with data and analysis. The JOBS Act was a floor—a directive from Congress to do more in this area—not a ceiling.

In particular, I hope that as part of the Division of Corporation Finance's examination of disclosure effectiveness—or, as it used to be called, "disclosure overload"—Commission staff is examining which of our current disclosure rules could be scaled more effectively for smaller reporting and emerging growth companies. But even putting scaling aside, a reduction in the volume and cost of disclosure that benefits all companies will benefit smaller and emerging companies proportionally more, given the higher marginal cost to them of each dollar spent on compliance.[32] I hope Corp Fin staff is giving serious attention to simplifying disclosure through this project, rather than treating it as largely confirmatory of our existing disclosure regime. There's already a plethora of good ideas out there[33]; we should move forward with them.

In the medium term, I believe that we should reconsider the current thresholds for scaled disclosure and the amount of scaling that comes at each level. Currently, a "smaller reporting company" is defined as a company with up to $75 million in public float, but this definition does not align with commonly-accepted market definitions. Having two tiers of scaling—e.g., significant scaling for "nanocap" companies of up to $50 million in capitalization, and then moderate scaling for "microcap" companies with a capitalization of between $50 and $300 million—may be more appropriate.[34]

Finally, liquidity for secondary trading in small businesses should be reexamined. Secondary trading in small cap stocks is a perennial problem, and the Commission should be paying more attention to this area. In particular, we could encourage microcap companies that are not reporting companies to commit voluntarily, or as a condition of participation in a Venture Exchange or some other type of junior exchange tier, to a periodic reporting regime. It could be the Regulation A regime, or some other tailored form of reporting. This could result in better information reaching the market, which could encourage investment. I'm certainly open to other ideas, and I encourage you to weigh in on these issues.

While all of these substantive changes are, I believe, important to pursue, I'm sure that there are other good ideas out there, and that the list of ideas will change over time. So I believe that we at the SEC also need changes to our mindset and our procedures, with the objective of institutionalizing an enhanced small business focus at the SEC.

It is important for Commissioners, as well as senior staff based in Washington, to get outside the Beltway.[35] While I'm on the road, I like to speak directly with businesses—and particularly small businesses. That takes some extra effort to arrange, but getting outside the Washington bubble is eye-opening. I do this as often as I can, and I never come back to DC without new information and real-life stories from those who are actually working in the real economy. But, there is the ages-old problem of getting the Commission to focus on these issues when there are so many statutory mandates and other initiatives competing for limited bandwidth.

And so, I believe the SEC needs to create an Office of the Small Business Advocate, reporting to the Commission.[36] This office would be modeled on the Office of the Investor Advocate created by the Dodd-Frank Act. There's a natural parallel here, in that our staff perennially faces difficulty in receiving views from certain segments of the market that find it difficult and expensive to participate in the normal notice and comment rulemaking process: retail investors and small businesses. Having a single point of contact for outreach to these underrepresented groups, who can then turn around and advocate their views to the staff, is critical. Finally, just as the Investor Advocate now runs the Investor Advisory Committee, the Small Business Advocate could take charge of the SEC's Advisory Committee on Small and Emerging Companies and the Government-Business Forum, an incredibly important group that does not have the profile it deserves at the Commission.[37]

We should also invigorate the process of considering small business issues in rulemaking. The SEC has grown in leaps and bounds in its focus on economic analysis following several key losses at the D.C. Circuit for failure to give adequate consideration to the economic impacts of our rules. While the D.C. Circuit losses gave us an external impetus for reform, the reform the SEC undertook was in fact completely internal: we centralized the economic analysis function in DERA, crafted and adopted the economic guidance, and enforced compliance with it internally in our rule-writing process. The results so far are encouraging, and we need to continue to improve our economics function at the Commission by ensuring that DERA has all the resources and Commission attention it needs to be successful.

But while compliance with our economic analysis mandate has thrived, compliance with our small business mandates has languished. The Paperwork Reduction Act, Small Business Regulatory Enforcement Fairness Act, and the Regulatory Flexibility Act all require some form of analysis to be undertaken by the Commission in promulgating new rules. Yet they are all generally treated as afterthoughts on the "back end" of the rulemaking process. I believe we should devote the kind of resources to these analyses that we do to economic analysis, not because we are being forced to, but because we should. We already have the tools and statutory mandate to consider the impacts of our regulations on small businesses; we should use them.

To assist us in that endeavor, we used to rely on a robust Office of Advocacy at the Small Business Administration providing input on our rulemakings.[38] I was thrilled to see that the SEC recently announced a new partnership with the SBA to engage with small businesses and educate them about capital formation opportunities, thereby fulfilling our mandate under Section 701 of the JOBS Act. Unfortunately, the vitality of our partnership with SBA on rulemaking is lacking. I understand that there may be some hesitancy by the SBA to review the rulemakings of an independent agency. But that review process is beneficial, and if it is not legally mandated, we should voluntarily commit to it. Our rules should be sufficiently robust to stand up to that analysis; if they are not, then we have to work to make them so.

Similarly, our engagement with the Office of Management and Budget shouldn't be limited to routine Paperwork Reduction Act compliance. Executive Order 13563, administered by OMB's Office of Information and Regulatory Affairs (OIRA), contains many sound principles for reducing regulatory burdens, such as assessing the cumulative cost of regulations, and conducting a retrospective analysis of existing rules.[39] Executive Order 13579 in turn states that independent agencies "should comply" with these principles, and specifically directs independent agencies to develop and release to the public a plan for periodic review of existing significant regulations.[40] As you know, I do not shy away from fighting for the SEC's independence. But here, where the principles are bipartisan best practices, the SEC should commit to working with OIRA to achieve compliance.[41]

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This is an ambitious agenda, but one worth pursuing. Small business capital formation is too important an issue for us to ignore. While the Commission has a busy rulemaking calendar, this is another of the "day job" items—the core competencies of the Commission—that we cannot afford to neglect.

Thank you again for coming today.

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1 See, e.g., President Barack Obama, Proclamation, National Small Business Week, 2014 (May 9, 2014) ("Small businesses represent an ideal at the heart of our Nation's promise—that with ingenuity and hard work, anyone can build a better life. They are also the lifeblood of our economy, employing half of our country's workforce and creating nearly two out of every three new American jobs.").

2 In fact, it's gotten so bad that a portfolio invested in companies with the largest lobbying expenditures would have doubled the performance of the S&P 500 over the past year. See Motif Investing, "Kings of K Street" at https://www.motifinvesting.com/motifs/kings-of-k-street. According to this site, from September 2013 to August 2014, this portfolio returned approximately 35%, while the S&P 500 returned approximately 17%.

In addition, a recent Harvard Business School survey on U.S. competitiveness found that "small business as a whole is a shrinking portion of the U.S. economy." Michael E. Porter & Jan W. Rivkin, *An Economy Doing Half its Job: Findings of Harvard Business School's 2013-14 Survey on U.S. Competitiveness* (Sept. 2014). Small businesses tended to be more negative on "virtually every element of America's business environment" when compared to larger businesses, including with regard to the U.S. "education system, regulations, infrastructure, and tax code." Id. at 11 (emphasis added). While the report favorably cites progress at state and local governmental levels to help improve U.S. competitiveness, it notes that the "federal government seems at times to be the biggest impediment to U.S. competitiveness." Id. at 33.

3 E.g., Securities Act 3(b).

4 Rel. No. 33-9416, *Amendments to Regulation D, Form D and Rule 156* (July 10, 2013) (proposing to require, among other things: the filing of Form D 15 calendar days before the first use of general solicitation in a 506(c) offering, rather than 15 calendar days after the first sale; the filing of a closing amendment to Form D; the expansion of disclosures required on Form D; automatic disqualification for failures to comply with Rule 506; legends in general solicitations; and the filing of written general solicitation materials with the Commission for 2 years).

5 See, e.g., Martin Kenney, Donald Patton & Jay R. Ritter, *Post-IPO Employment and Revenue Growth for U.S. IPOs, June 1996-2010* (May 2012) (finding that EGCs' post-IPO employment increased 156%).

6 Europe is the extreme example, but we in the U.S. can't indulge in too much schadenfreude. See, e.g., Ruth Simon & Angus Loten, *Small Business Lending Is Slow to Recover: Lending Remains Far Below Pre-Recession Levels; Things 'Aren't What They Used to Be'*, Wall St. J. (Aug. 17, 2014) ("Across the U.S., small-business lending has been stuck in a slow, grinding recovery behind most other types of

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business and consumer loans. At the end of the first quarter, banks held $585 billion in loans to small businesses, up 1% from last September but still 18% less than the peak of $711 billion in 2008, according to the Federal Deposit Insurance Corp.").

7 For example, the legality of "demo days"—commonplace events where start-ups make presentations to potential investors—appears to involve an analysis of whether the event falls within the guidance provided by staff in the Division of Corporation Finance back in 1995. See Michigan Growth Capital Symposium (May 4, 1995). This no-action letter discusses factors to consider in determining whether such an event would constitute general solicitation or general advertising for purposes of Rule 502(c) of Regulation D, which itself is only one step in complying with an offering under Rule 505 or 506(b) of Regulation D.

While a revision of the rules themselves could be a beneficial long-term goal, in the interim greater attention paid to compliance guidelines, interpretations, or manuals for small businesses could help.

8 Indeed, as we have seen recently, robust private markets helped pick up the slack for an IPO process that had grown too onerous. See Vladimir Ivanov & Scott Bauguess, *Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009–2012* (July 2013) at 9 [hereinafter "DERA Paper"]. Among other things, the DERA Paper compares issuances under different methods of capital-raising; the size of the Reg D markets compared to public equity markets is significant. Id. at 9 (Figure 4 (size) and Table 2 (number of offerings)). In addition, Reg D offerings overwhelmingly raise new equity capital, as compared to public debt markets which have as a substantial component the refinancing of existing debt (e.g., rolling over debt with an expiring term). Id. at 9-10. Cf. IPO Task Force, *Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth* (Oct. 20, 2011), at 6 (showing average of 192 IPOs/year post-1999, versus 547 IPOs/year pre-1999). Following the JOBS Act, which eliminated some of the regulatory frictions to going public, some of the balance in this area has recently been restored. See, e.g., Proskauer, *2014 IPO Study* (2014) (noting that 136 C Corporations went public in 2013, for a value of $41 billion, which is the largest deal number since the financial crisis, and largest deal value since the dot-com boom; and 77 of 100 companies reviewed in depth qualified as EGCs, with 88% of them taking advantage of the JOBS Act's provisions for confidential S-1 submission). We must now resist calls for new restrictions that would upend this order—and particularly calls for restrictions on private markets as a way of driving companies and investors to public markets.

9 Private capital markets should be available from the moment that an entrepreneur with maxed-out credit cards, a borrowed-down 401(k), and tapped-out friends and family decides to take the next step towards his or her dream, all the way through investments from angels, venture capital firms, and investment banks.

10 Obviously, the robustness of the primary market will be impaired if purchasers of shares in a primary issuance have no way to exit their investment.

11 See Faith Colish et al., *M&A Brokers* (Jan. 31, 2014, rev'd Feb. 4, 2014) (providing assurance that TM would not recommend enforcement action against persons not registered as broker-dealers who engage in securities transactions solely in connection with the transfer of ownership and control of a privately-held company).

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[12] The FASB's Private Company Council and recent simplification projects are positive steps in this direction. See FASB, Private Company Council, at http://www.fasb.org/pcc. The PCAOB also has a number of programs focused on small business needs. See PCAOB, Featured Issue: Small Business, at http://pcaobus.org/Featured/Pages/SmallBusiness.aspx. However, a standard-setting agenda more focused on updating substantive auditing and quality control standards, rather than pie-in-the-sky endeavors such as firm rotation, would be of greater use to smaller auditors and the smaller companies they audit.

[13] See, e.g., IPO Task Force, *Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth* (Oct. 20, 2011) at 31 [hereinafter IPO Task Force] (discussing how regulations have triggered a fundamental change in the structure of the U.S. capital markets, shifting large investment banks toward short-term trading of large-cap stocks rather than fostering small cap company growth).

[14] See supra n.4.

[15] Daniel M. Gallagher, *Statement at Open Meeting regarding Proposed Amendments to Regulation D, Form D and Rule 156 under the Securities Act* (July 10, 2013), available at http://www.sec.gov/News/Speech/Detail/Speech/1370539665007.

[16] As the rulemaking notes, the purpose of Form D has, since its inception, been to "collect empirical data which will provide a basis for further action by the Commission either in terms of amending existing rules and regulations or proposing new ones . . . [and] to elicit information necessary in assessing the effectiveness of Regulation D as a capital raising device for small businesses." See Rel. No. 33-9416 at 108. There could be investor protection benefits in the future, but those would be derivative of the Commission taking better-informed actions in the future as a result of the improved information environment. See, e.g., id. at 147. Given the limited nature of the investor benefits to be achieved directly through the rulemaking, a limited amount of additional data-gathering could be cost-justified, but repetitive and burdensome Form D filing requirements, backed by the threat of automatic disqualification for failure to comply, are unjustifiable.

[17] See DERA Paper at 3 ("Rule 506 accounts for 99% of amounts sold through Regulation D. More than two-thirds of non-fund issuers could have claimed a Rule 504 or 505 exemption based on offering size, indicating that issuers value the Blue Sky law preemption allowed under Rule 506.").

[18] For example, we should look to respond to questions such as: Should there be a more significant distinction made under Regulation D between limited private placements by small growing companies and large capital raises by private funds? Should the harsh restrictions on general solicitation and general advertising for offerings other than Rule 506(c) be liberalized? Should we scale the financial information provided to purchasers in certain Regulation D offerings in different ways or at different thresholds in offering size?

[19] There was a spurt of innovation in this area in the early 2010s, as holders of shares in private tech companies were looking to take advantage of overwhelming public interest in those companies by transferring their shares in a private sale, but after those companies went public, less attention has been paid to this area. Given that the JOBS Act's increase in the Section 12(g) registration threshold may result in fewer companies being "forced" to go public by bumping up against the 12(g) limit—

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particularly if we were to raise Rule 701's disclosure threshold for offers or sales pursuant to certain compensatory benefit plans to match the raised 12(g) limit, as I believe we should—mechanisms for facilitating private resales (e.g., from employees needing liquidity or desiring to diversify to accredited investors) could be useful.

20 For example, the SEC's Government-Business Forum on Small Business Capital Formation has recommended that the SEC adopt a rule to facilitate certain private resales that currently fall outside Rule 144's requirements, pursuant to so-called "Section 4(a)(1½)." See SEC Government-Business Forum on Small Business Capital Formation, Final Report (June 2014) at 12 (reporting on the 32d Annual meeting of the Forum in November 2013). Adopting a new safe harbor that would clarify when private resales of restricted securities are permitted—particularly given that the statutory exemption is an implied one—could help facilitate transactions in this area.

21 Moreover, it misses the point: investors are protected by the small amount of money they would put at risk in a crowdfunding transaction and by the wisdom of the crowds, not by the production of audited financial information. And at such an early stage in a company's development, investors' focus is properly on the quality of the start-up's idea, not that every element in its balance sheet is ticked and tied and GAAP-compliant. This was recently colorfully illustrated by the Google "Toothbrush Test": is the product something you use twice a day and does it make your life better? See, e.g., David Gelles, *In Silicon Valley, Mergers Must Meet the Toothbrush Test*, N.Y. Times Dealbook (Aug. 17, 2014).

22 The Government-Business Forum has a laundry list of 16 different recommendations with respect to crowdfunding. See supra n.20 at 19–20. While the most important issue is the $500,000 threshold for audited financial statements, other important issues include whether crowdfunding portals can curate deals and whether the portal should be liable for the misstatements of a company posting an offering on the portal. Id. at 19.

23 Specifically, we need to ensure that crowdfunding can work as a step on the way to further growth. This involves answering questions such as: How do purchasers in a crowdfunded transaction get liquidity? What protections are necessary for these holders of small amounts of stock so that they don't get squeezed out in a subsequent round of financing when a venture capital firm wants to clean up the company's cap table? While we can look to the lessons of peer-to-peer lending and donation-based crowdfunding for possible solutions to many issues, these questions are particular to equity crowdfunding and not easily solved. One way of gaining additional experience with these questions, however, could be through the states. Famously called laboratories of democracy, they can also be laboratories of equity crowdfunding done pursuant to the intrastate exemption. The SEC should be an active participant in facilitating intrastate crowdfunding, and should observe the resulting experiments carefully for best practices.

24 See GAO, *Factors That May Affect Trends in Regulation A Offerings* (July 3, 2012) at 8–9; 17–21. Specifically, Regulation A offerings are subject to burdensome state qualification proceedings while offerings under Rule 506 of Regulation D are blue-sky exempt. The fall-off in Regulation A offerings mainly takes place after 1997, see id. at 9, which is, not-coincidently, the year following the enactment of the National Securities Markets Improvements Act of 1996, which granted Rule 506 offerings their blue-sky preemption. Other causes for Regulation A's sidelining include the low cap

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on the size of Regulation A offerings and a burdensome, time-consuming SEC filing and review process for Regulation A offerings. While Regulation A offerings have other advantages relative to Rule 506 offerings (e.g., testing the waters, sales to non-accredited investors), those were outweighed by the significant ease of doing a Regulation D offering.

25 See Rel. No. 33-9497, *Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act* (Dec. 18, 2013) at 182.

26 See, e.g., Paul Atkins, *Great Moments in Financial Regulation: Apple IPO deemed too risky.*, Wall St. J. (Apr. 28, 2010).

27 See Securities Act § 18(c).

28 The SEC has discretion to raise this limit pursuant to authority already given to us in the JOBS Act. See JOBS Act § 401 (adding Securities Act § 3(b)(5)).

29 The usefulness of the expanded Regulation A+ offering limit will quickly be vitiated if those shares come to rest in the hands of too many investors, thereby triggering full, unscaled Exchange Act registration for these small businesses.

30 See Securities Act § 18(b)(1)(B) & 18(b)(4)(D)(i).

31 See Daniel M. Gallagher, *Remarks at FIA Futures and Options Expo* (Nov. 6, 2013), available at http://www.sec.gov/News/Speech/Detail/Speech/1370540289361; see generally SEC Advisory Committee on Small & Emerging Companies, *Recommendation Regarding Separate U.S. Equity Market for Securities of Small and Emerging Companies* (Feb. 1, 2013), available at http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-032113-emerg-co-ltr.pdf.

32 See, e.g., W. Mark Crain & Nicole V. Crain, *The Cost of Federal Regulation to the U.S. Economy, Manufacturing and Small Business: A Report for the National Association of Manufacturers* (Sept. 10, 2014) at 3 & Chart 1 (noting that in 2012 the total cost of federal regulations (including but not limited to financial regulations), per employee, is $34,671 for companies of less than 50 employees; $18,243 for companies of between 50 and 99 employees, and $13,750 for companies of 100 employees or more, and attributing the differential to fixed compliance costs imposing a heavier burden on smaller companies).

33 See, e.g., U.S. Chamber of Commerce, *Corporate Disclosure Effectiveness: Ensuring a Balanced System that Informs and Protects Investors and Facilitates Capital Formation* (July 2014); KPMG/FERF, *Disclosure overload and complexity: hidden in plain sight* (2011).

34 See IPO Task Force at 10 ("First, [current rules] create[] a false dichotomy within the equities space wherein a company is either a micro-cap or a large cap. This is akin to classifying all motor vehicles as either sub-compact cars or semi-trucks—with nothing in between."). I acknowledge that there could be substantial controversy around this issue given the JOBS Act's exemption for smaller reporting companies from the independent public accountant report on internal controls over financial reporting otherwise required by Sarbanes-Oxley § 404(b). See Dodd-Frank Act § 989G(a). While $50m may be the appropriate cut-off for nanocap companies, I would not support expanding 404(b) compliance to companies in the $50m–$75m range. Expanding the 404(b) exemption to

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companies under $300m would run contrary to the recommendations of a SEC staff study also mandated by Section 989G of Dodd-Frank. See Office of the Chief Accountant, *Studies and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between $75 and $250 Million* (Apr. 2011). The latter study, however, called for continued improvements to the effectiveness and efficiency of Section 404(b), id. at 112–113. But the persistence of auditing errors relating to ICFR being discovered through PCAOB inspections may indicate a need for greater attention to—and expenditure of time and money on—ICFR audits. Achieving cost savings through producing deficient work product is a false economy; if greater resources are needed for high-quality internal control audits, then they should be expended—but we should reconsider whether the benefits of the ICFR audit for smaller companies, including those at my $300m threshold and below, are justified by the total cost.

[35] The SEC's Canons of Ethics are instructive on this point. See 17 CFR 200.59 ("In the performance of his rule-making and administrative functions, a member [of the SEC] has a duty to solicit the views of interested persons . . . . Insofar as it is consistent with the dignity of his official position, he should maintain contact with the persons outside the agency who may be affected by his rule-making functions . . . .").

[36] The need for such an individual or office has been debated over the years, trading off the benefits to be achieved by centralizing small business advocacy in one location, versus the costs of adding layers of bureaucracy to an already overly-bureaucratic organization. However, given the successes of the Investor Advocate to date, I've been hearing from small business advocates (e.g., Samuel Guzik) that the idea is one whose time has come, and I agree.

[37] Right now, these two small business fora, taken together, receive less focus and resources than the Investor Advisory Committee. Centralizing these functions in the Office of the Small Business Advocate and staffing that office appropriately could help restore balance and give small businesses a robust voice in our rulemaking processes.

[38] Specifically, through SBA's review of the Initial Regulatory Flexibility Analysis (IRFA) and the Final Regulatory Flexibility Analysis (FRFA) required by RegFlex.

[39] E.O. 13563, *Improving Regulation and Regulatory Review* (Jan. 18, 2011) at § 1(b)(2) & 6. E.O. 13563 on its face does not apply to the SEC or other independent regulatory agencies.

[40] E.O. 13579, *Regulation and Independent Regulatory Agencies* (July 11, 2011).

[41] To be clear, I am not advocating that the Commission voluntarily commit to mechanisms that would give the Executive Branch veto power over our regulations. But mechanisms of cooperation with the Executive Branch that result in the Commission incorporating current best practices into its rulemaking process, or receiving better information to inform the Commission's independent judgment, should be vigorously pursued. Indeed, it appeared that the Commission would be pursuing compliance, as it issued Rel. No. 33-9257, *Retrospective Review of Existing Regulations* (Sept. 6, 2011), requesting comments for how the Commission could take action consistent with the Executive Order. But the comment period closed in October 2011, and no serious effort has been made to finalize a robust plan. We should put this project back on the agenda, and do it right.

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In a hearing before the Senate Banking Committee on September 9, 2014, in response to a question from Senator Crapo, Chair White noted that the SEC is not subject to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), which requires agencies on the Federal Financial Institutions Examination Council (FFIEC) to, at least every 10 years, "conduct a review of all regulations prescribed by the Council or by any such appropriate Federal banking agency, respectively, in order to identify outdated or otherwise unnecessary regulatory requirements imposed on insured depository institutions." But the Chair noted that she is "very much committed to reviewing [the SEC's] rules in that fashion." See Hearing Video at 1:07:00. I hope that we can undertake such a process soon, and that such review would encompass all registrants, not just Federal banking agencies.