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CONGRESSIONAL TESTIMONY

Proposals to Enhance Capital Formation for Small and Emerging Growth Companies

Testimony
before the
Capital Markets and Government Sponsored Enterprises Subcommittee
of the
Committee on Financial Services
United States House of Representatives

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David R. Burton
Senior Fellow in Economic Policy
The Heritage Foundation

My name is David R. Burton. I am Senior Fellow in Economic Policy at The Heritage Foundation. I would like to express my thanks to Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee for the opportunity to be here this morning. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The 2012 JOBS Act[1] was a bipartisan achievement of consequence. Republican and Democratic members of this committee and your counterparts in the Senate put aside partisan differences, overcame substantial difficulties and legislated in the public interest by enacting substantial, positive reforms to the securities laws. These reforms will help small business entrepreneurial capital formation, innovation, and job creation. I had the good fortune to attend the Rose Garden signing ceremony when President Obama signed the JOBS Act into law. It was a reminder that important, constructive change can still be accomplished when policymakers resolve to craft genuine solutions to the problems that face the American people.

There remains, however, much to be done. Securities and Exchange Commission (SEC) implementation of the JOBS Act is much too slow, in some cases nearly a year and a half behind the pace required by Congress. And the rules being proposed by the Commission are often so voluminous and complex that they will undermine the laudable purposes of the JOBS Act. I would encourage Members of this Committee to actively monitor the rule-making process in your oversight capacity and communicate your concerns to the Commission. There are also significant statutory reforms which are still required if we are to give genuine rebirth to the spirit of enterprise, innovation, and dynamism necessary for a lasting and widespread prosperity that provides opportunity and better incomes for all Americans.

I have been asked to provide my perspective on a number of legislative proposals to enhance capital formation for small and emerging growth companies. In addition, I will comment on the Commission's implementation of the JOBS Act and suggest about a dozen specific policy changes that would promote small business capital formation and entrepreneurship.

Regulation S-K

Regulation S-K[2] is the key regulation governing non-financial statement disclosures of registered (i.e., public) companies. Regulation S-X[3] generally governs public company financial statements in registration statements or periodic reports. These two rules, including the various rules and accounting policies that they incorporate by reference, impose the vast majority of the costs incurred by public companies.

[1]The Jumpstart Our Business Startups Act, Public Law 112–106, April 5, 2012.
[2]17 CFR Part 229.
[3]17 CFR Part 210.

The Commission has estimated that "the average cost of achieving initial regulatory compliance for an initial public offering is $2.5 million, followed by an ongoing compliance cost, once public, of $1.5 million per year."[4]

For small and medium-sized firms seeking to raise capital, these costs make access to the public capital markets prohibitively expensive. Obviously, $2.5 million imposes a hefty 10 percent deadweight cost even on a $25 million offering. If the hurdle rate for investors is X percent, then a 10 percent regulatory toll charge is going to increase the required rate of return by 11.1 percent for a company to make the hurdle rate.[5] If the costs were 20 percent of the amount raised, then the required rate of return on the net amount raised will increase by 25 percent.[6]

But the continuing costs — $1.5 million annually on average according to the SEC — are actually more problematic. A company with shareholders' equity of $10 million with a healthy return on equity of 20 percent is going to earn $2 million. Net of public company regulatory costs, however, that company will earn only $500,000 and have a return on equity that is an anemic 5 percent. In effect, there is a $1.5 million toll charge for being a public company. This makes going public out of the question until companies reach a substantial size. Reducing this toll charge would make the public market available for more companies and enable them to grow more rapidly.

The table below illustrates this point. It shows the impact that $1.5 million in annual compliance costs would have on a company if it were public instead of private. It shows companies with shareholders' equity of $10 million, $20 million, and $30 million, and returns on equity as a private company of 15 percent, 20 percent, and 25 percent. By way of comparison, the return on equity for the Standard and Poor's 500 is generally in the 13 percent to 17 percent range.[7]

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[4]Proposed Rules, "Crowdfunding," *Federal Register*, Vol. 78, No. 214, November 5, 2013, p. 66509 (col. 2).

[5]If the hurdle rate (the minimum rate of return required by investors) is X, where X is the expected profit (P) divided by the investment (I) then, with costs of 10 percent, the effective amount raised will be 0.9I (i.e., 90 percent of the amount invested by investors) and the profit on the amount invested will have to 11.1 percent higher to achieve the hurdle rate. For example, if the hurdle rate were 10 percent, then the profit required on an investment of $1,000 would be $100. If the amount raised net of costs were only $900, then a profit of $100 on that $900 would be necessary to achieve the investors hurdle rate on an investment of $1,000. $100/$900 is 11.1 percent which in turn is 11 percent higher than the 10 percent hurdle rate. If the required hurdle rate were 30 percent (not atypical in highly risky investments), then the investors will require a profit (P) of $300 annually on the $1,000 investment. Thus, the net of cost $900 would have to earn a return of $300 or 33.3 percent, 11.1 percent higher than the hurdle rate of 30 percent. In short, the return will have to increase by the inverse of net of costs amount raised divided by the amount invested.

[6]Because 1/0.8 is 1.25. Following the 30 percent example above. Three hundred dollars divided by the net of cost $800 raised is 37.5 percent and 37.5 percent is 25 percent higher than 30 percent.

[7]See, e.g., Management Effectiveness Information & Trends, CSIMarket.com, http://csimarket.com/Industry/industry_ManagementEffectiveness.php (accessed April 7, 2014).

Impact of Public Company Regulatory Costs on Return on Equity

Shareholders' Equity	Private Company Return on Equity	Private Company Profit	Net of Regulatory Cost Public Company Profit	Public Company Return on Equity	Percentage Decrease in Return on Equity By Going Public
$10 million	25 %	$2.5 million	$1 million	10 %	-60 %
$10 million	20 %	$2 million	$0.5 million	5 %	-75 %
$10 million	15 %	$1.5 million	$0	0 %	-100%
$20 million	25 %	$5 million	$3.5 million	17.5 %	-30 %
$20 million	20 %	$4 million	$1.5 million	7.5 %	-62.5 %
$20 million	15 %	$3 million	$1.5 million	7.5 %	-50 %
$30 million	25 %	$7.5 million	$6 million	20 %	-20 %
$30 million	20 %	$6 million	$4.5 million	15 %	-25 %
$30 million	15 %	$4.5 million	$3 million	10 %	-33 %

As shown in the table, the negative impact of continuing compliance costs on the return on equity for small companies, even those of substantial size, is negative and substantial. It reduces the return on equity even for fairly substantial companies by 20 to 100 percent. It is a particularly steep barrier for development stage companies that have limited current cash flow.

Another way of looking at this is to capitalize the $1.5 million annual cost. Using a discount rate of 10 percent, this additional $1.5 million cost is the equivalent of erasing $15 million from shareholders' equity.[8] This kind of shareholders' equity erasure cannot be justified by the higher price-earnings ratio a public company commands until expected risk-adjusted earnings are quite high.

Economic research has increasingly demonstrated that most of the job creation in the economy comes from young, dynamic companies. These companies need equity investment to launch and to grow. Some call these companies gazelles. A recent survey of the economics literature on the subject reached the conclusion that gazelles "create all or a large share of net new jobs."[9] These are the type of companies that seek outside investors either via Regulation D or in the public market. But the burdens imposed by

[8]The present discounted value of $1.5 million annually with a 10 percent discount rate is $15 million.
[9]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.

existing regulations (primarily Regulation S-K and Regulation S-X) effectively deny these companies access to the public market and make investors less willing to invest.

Chairman Garrett has drafted legislation designed to address this very important problem. The proposed legislation has two major components. First, it would require the SEC to issue a revised Regulation S-K to provide for better scaling of its disclosure requirements to reduce the burden on emerging growth companies and other small reporting companies and to simplify and modernize provisions of Regulation S-K that are duplicative, overlapping, outdated, or unnecessary. The SEC would be required to issue a final rule within six months. Second, the bill would require that the Commission conduct a study and provide a report to Congress about how to modernize regulation S-K and to propose a rule doing so within a year of the report being provided to Congress. The bill provides some detail about what the study should examine but provides the Commission great latitude.

There is reason to believe that the Commission itself is serious about addressing this problem. Section 108 of the JOBS Act required the SEC to study the issue. This report was released last December.[10] In it, the staff recommends "the development of a plan to systematically review (on either a comprehensive or a targeted basis, as discussed below) the disclosure requirements in the Commission's rules and forms, including Regulation S-K and Regulation S-X, and the related rules concerning the presentation and delivery of information to investors and the marketplace."[11]

In summary, this legislation is very constructive and the Commission is likely to be receptive to it. It might well launch a process that would substantially reduce unneeded impediments to smaller firms being able to access the public capital markets. I have three suggested improvements.

In its report, the Commission staff acknowledges the importance of considering cost and other economic considerations and sets forth a series of factors that should be considered. The problem is that regulation of the private capital market is done in a virtually data free environment and there is very little information regarding the *regulation* of smaller reporting companies. In other fields in which I work or have worked — tax, health care, labor and employment, immigration — there is robust data for policymakers to consider. Not so for securities regulators and you, the Members of this Committee. The SEC does a very bad job of collecting and making available to the public information about these markets. Thus, it will be difficult for the SEC Division of Economic and Risk Analysis to do this work well.

Two relatively small steps could be required of the SEC to help address this data gap. The legislation could require a survey of smaller reporting companies. This survey should seek information both from firms that recently undertook an IPO and those who have

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[10]U.S. Securities and Exchange Commission, "Report on Review of Disclosure Requirements in Regulation S-K," December 20, 2013, http://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf (accessed April 7, 2014).
[11]Ibid., p. 95.

been registered companies for some time. It should seek to determine which aspects of Regulation S-K and Regulation S-X are the major cost drivers and seek input about what should be changed. In addition, the Commission should begin to collect and publish data regarding its enforcement actions relating to both the private securities markets and the public market. The Commissioners, Congress, and the public need actual information — not anecdotes — about what types of disclosures, misrepresentations, or omissions are the source of enforcement actions, what types of issuers and exemptions give rise to enforcement actions, what are the frequency and severity of different types of violations, and whether it is the primary or the secondary market that is the source of most problems.

Second, the legislation should seek a study of these issues by the Government Accountability Office (GAO). The GAO has a well-deserved reputation for dispassionate and useful analysis and information collection. I think it would be very useful to this committee and the public to have an independent source of information regarding Regulation S-K and an independent analysis.

Third, I would recommend that both the SEC and the GAO be asked to consider the recommendations of the SEC Advisory Committee on Small and Emerging Companies[12] and the recommendations of the SEC Government-Business Forum on Small Business Capital Formation.[13]

SBIC Advisers Relief Act of 2014 (H.R. 4200)

The SBIC Advisers Relief Act of 2014 (H.R. 4200) amends the Investment Advisers Act of 1940 to include advisers of Small Business Investment Companies (SBICs) in the class of venture capital funds and private funds that are exempt from SEC registration. Although I am familiar with SBICs, I should hasten to add that I am by no means an expert on SBICs.

Government loans and loan guarantees to private businesses are inappropriate, particularly when the federal fiscal situation is so grave. Thus, I do not support that aspect of the SBIC program. SBICs do, however, raise billions of private dollars that they then invest in small business and, in this sense, they are an important part of small firm capital formation. They are a form of venture capital firm and it is appropriate to treat them as such for purposes of the Investment Advisers Act of 1940. Exemption from SEC registration is further justified by the fact that SBICs are regulated by the Small Business Administration.

Increased Threshold Amounts for Compensatory Benefit Plans

[12]Stephen M. Graham and M. Christine Jacobs, Committee Co-Chairs, letter to SEC Chairman Elisse B. Walter, "Recommendations Regarding Disclosure and Other Requirements for Smaller Public Companies," March 21, 2013, http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-032113-smaller-public-co-ltr.pdf (accessed April 7, 2014).
[13]U.S. Securities and Exchange Commission, Final Reports of the SEC Government-Business Forum on Small Business Capital Formation, http://www.sec.gov/info/smallbus/sbforumreps.htm (accessed April 7, 2014).

The committee is considering draft of legislation to amend SEC Rule 701.[14] Rule 701 only applies to private companies maintaining a written compensatory benefit plan for the participation of their employees, directors, general partners, trustees (where the issuer is a business trust), officers, or consultants and advisors, and their family members who acquire such securities from such persons through gifts or domestic relations orders. Under the rule, a compensatory benefit plan is any purchase, savings, option, bonus, stock appreciation, profit sharing, thrift, incentive, deferred compensation, pension, or similar plan. Under present law, if an issuer sells more than $5 million of securities in any consecutive 12-month period, then the issuer is required to provide additional disclosures to investors. The discussion draft would require the SEC to increase that threshold to $20 million.

For medium-sized firms the $5 million limit is a significant constraint on their ability to compensate employees and attract talent. Increasing the limit is warranted to help these firms grow and create jobs, to compete with larger public companies, and to provide new and innovative products to consumers. Employees, officers, directors, and others who will benefit from this proposal are better situated than ordinary investors to know the future prospects of the company and are less in need of voluminous disclosures than outside investors. It is important to remember that Rule 701 transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws. The SEC's Government-Business Forum on Small Business Capital Formation has expressed support for this idea on a regular basis.

Well-Known Seasoned Issuer Definition

The committee is considering draft legislation to require the SEC to revise the definition of a Well-Known Seasoned Issuer (WKSI) to reduce this threshold from $700 million to $250 million, thus enabling more issuers to take advantage of the benefits of WKSI designation. At this time, I do not have enough information about the implications of this proposal to provide useful input to the committee.

Conflict Minerals and Extractive Resources Disclosures

The committee is considering draft legislation to amend the Securities Exchange Act of 1934 to exempt emerging growth companies and non-accelerated filers from disclosures relating to conflict minerals and extractive resources.

In my judgment, the securities laws are sufficiently complex. The purpose of securities law is to protect investors from fraud and misrepresentation and to promote capital formation by ensuring orderly, honest markets and by requiring the disclosure of information material to investment decisions. Policymakers need to resist the temptation to introduce requirements that are extraneous to the core purposes of the securities laws. Disclosures relating to conflict minerals and extractive resources do not promote the purposes underlying securities regulation. This constructive proposal removes a burden on small issuers that has nothing to do with the purposes of securities regulation.

[14] 17 CFR 230.701.

Rule 144

The committee is considering draft legislation requiring the SEC to amend Rule 144 to reduce from 6 months to 3 months the mandatory holding period before which restricted securities issued by an SEC reporting company may be resold to the public. The discussion draft would also amend Rule 144 to allow the public resale of restricted securities originally issued by a shell company starting two years after the date on which the company files a Form 8-K with the SEC disclosing that it is no longer a shell company. Finally, the discussion draft would amend Section 18(b) of the Securities Act of 1933 to include in the definition of "covered securities" exempt from state regulation any security offered or sold in compliance with Rule 144A.

At this time, I do not have enough information about the implications of this proposal to provide useful input to the committee.

Small Company Freedom to Grow Act

The committee is considering draft legislation entitled the "Small Company Freedom to Grow Act." The discussion draft would amend the SEC's Form S-1 registration statement to allow a smaller reporting company to incorporate by reference any documents the company files with the SEC after the effective date of the Form S-1. The discussion draft would also amend the SEC's Form S-3 to allow a smaller reporting company to register a primary securities offering exceeding one-third of the aggregate market value of voting and non-voting common equity held by non-affiliates of the registrant, and to eliminate the restriction that the smaller reporting company have a class of common equity securities listed and registered on a national securities exchange. Finally, the discussion draft would amend Section 18(b) of the Securities Act of 1933 to include in the definition of "covered securities" exempt from state regulation securities issued by smaller reporting companies and emerging growth companies that are not listed or authorized for listing on a national securities exchange.

Allowing incorporation by reference of documents filed with the SEC after the effective date of the Form S-1 will reduce the administrative burden on issuers without having any appreciable negative impact on the information available to investors. Allowing smaller reporting companies to register securities offerings exceeding the one-third aggregate market value test eliminates an artificial barrier to capital formation.

The aim of section 4 of the draft legislation is laudatory. It aims to preempt state Blue Sky laws with respect to unregistered securities offered by registered companies that are smaller reporting companies or emerging growth companies. It seeks a report from the SEC within 45 days about how to do it. The burden of Blue Sky laws, especially in merit review states, is enormous. Blue Sky regulation has effectively killed Rule 504, Rule 505, and Regulation A. Since the companies in question are registered companies subject to rigorous federal disclosure requirements, there is no good reason to also subject them to 51 different sets of Blue Sky laws and 51 different regulators.

It seems that simply defining "covered security" to include securities offered by smaller reporting companies or emerging growth companies in the bill and seeking SEC input before actually reporting the bill out of committee would be a more direct approach.

Fostering Innovation Act of 2013 (H.R. 2629)

The Fostering Innovation Act of 2013 would amend Rule 12b-2 so that companies with a public float of either (1) less than $250 million with no annual revenue restriction or (2) between $250 million and $700 million and less than $100 million in annual revenue are deemed "non-accelerated filers." The definition of accelerated filer currently is a firm with a public float of $75 million or more.[15]

Section 989G of the Dodd–Frank Wall Street Reform and Consumer Protection Act[16] exempts non-accelerated filers from section 404(b) of the Sarbanes–Oxley Act of 2002. Section 404(b) imposes very high costs and is of very limited utility with respect to small companies. In these companies, a small executive team of a very few persons controls the company. If they want to abscond with company funds, a loose-leaf binder on the shelf is not going to stop them. Yet these internal control assessment loose-leaf binders can cost a quarter of million dollars or more to produce. Section 404(b) is best thought of as the accountants' and management consultants' full-employment provision. As a practical matter, it does little to protect investors in small firms but imposes extremely high costs on law-abiding firms.

The legislation would amend the definition of accelerated filer in Rule 12b-2 to more reasonable levels and eliminate one of the worst sources of compliance costs for small public companies. A similar measure was included in the bipartisan American Growth, Recovery, Empowerment and Entrepreneurship (AGREE) Act during the last Congress.[17]

JOBS Act Implementation

SEC implementation of the JOBS Act is much too slow, in some cases already nearly a year and a half behind the pace required by Congress. And the rules being proposed by the Commission are often so voluminous and complex that they will undermine the laudable purposes of the JOBS Act. Below, I discuss the SEC proposed rules relating to Regulation A, Regulation D, and crowdfunding.

Regulation A Plus

The Commission is to be commended for recognizing the debilitating problems with the existing Regulation A, taking congressional concerns about the small issue exemption seriously and making a concrete proposal to rectify the problem. However, unless the proposed rule is modified in substantial ways, it will be of only limited value to issuers

[15] 17 CFR §240.12b-2.
[16] 15 U.S. Code §7262.
[17] S. 1866, H.R. 3476, 112th Congress.

seeking to raise capital. My comments regarding the proposed rule may be summarized as follows.

- The Commission's regulation of small business capital formation and entrepreneurship is of macroeconomic significance.
- Overregulation by state regulators and the Commission has destroyed the usefulness of Regulation A (as well as Regulation D Rules 504 and 505).
- The proposed rule is a modest step in the right direction, of potential value to firms making Tier II offerings between $5 million and $50 million, but for various reasons will be of much less value than the Commission appears to believe unless the proposed rule is revised.
- The Commission should broaden the scope of its qualified purchaser definition, otherwise Tier I will be an illusion and remain just as unhelpful to small business capital formation as Regulation A is currently.
- The Commission needs to resist calls by state regulators to narrow the scope of its qualified purchaser definition and to otherwise over-regulate small business capital formation and entrepreneurship.
- The Commission needs to reduce the regulatory burden on Tier II issuers. Given the fact that the proposed Tier II compliance burdens are similar, although less, to the burdens imposed on small public companies, it is likely to be the case that many issuers will find the proposed rule to be of little value and continue either to use Rule 506 or become a registered company.
- The Commission should reject the proposed investor limitations as inconsistent with the disclosure and fraud prevention principles of federal securities law, as having no statutory basis, and as inconsistent with congressional intent. The Commission should not get into the business of providing investment advice, it should not mandate that people maintain a particular portfolio, and it should not mandate the level of risk that they may choose to undertake.
- The Securities Exchange Act section 12(g)(1) thresholds must be relaxed for Regulation A offerings; if they are not, then Tier II will be of very limited utility except for small offerings substantially below the $50 million cap because per investor sales amounts will have to be extremely high if the current section 12(g) limits are maintained. The interaction of the section 12(g)(1) thresholds and the investor limitations are likely to make offerings anywhere near the $50 million cap simply infeasible. The presumption of Commission staff that broker-dealers will typically hold Regulation A securities in street name, thus reducing the number of holder of record substantially, is entirely unwarranted. The Commission has authority to take action rectifying this problem under section 36 of the Securities Exchange Act.
- It currently takes 8 months, on average, to qualify a Regulation A offering. For a start-up business, this is an eternity. If the Commission wants Regulation A to work, then it must, as a management matter, dramatically reduce both the complexity of and length of time it takes to navigate the qualification process.

A more detailed analysis is available in my comments to the Commission regarding the proposed rule.[18] Issues discussed include the economic importance of small business capital formation, the qualified purchaser definition, Tier I offerings and Blue Sky laws, the investment limitation, the section 12(g) triggers, the content of the offering, circular and continuing disclosure requirements, qualification, the North American Securities Administrators Association Coordinated Review System, fraud and small issuers, venture exchanges, insignificant or immaterial violations, the testing the waters provisions and confidentiality, and valuation.

Regulation D

Regulation D, although imperfect, works well. In important respects, it has become the most important means of raising capital in the U.S., particularly for the young, dynamic companies that contribute the most to economic growth and job creation. In the JOBS Act, Congress made the policy judgment that the restrictions in Regulation D should be relaxed to some degree. Yet the proposed rules will sharply reduce the positive economic effects of the constructive changes made by Congress. If combined with substantial increases in the accredited investor thresholds that the SEC is contemplating and regarding which the SEC has sought comments in this proposed rule, then the SEC will almost certainly negate most of the positive impact of the JOBS Act.[19]

The proposed amendments to Regulation D are not going to affect only affluent accredited investors. The proposed rule and its potential progeny can be expected to have a macroeconomically significant negative impact on the U.S. economy and to adversely affect millions of people.

The simple fact that these unwarranted rules contain within them over 100 issues regarding which the Commission is seeking comments from the public is illustrative of the fact that they are overly complex and will materially increase the burden on small and start-up business. No matter how the Commission resolves these issues, they are issues that counsel for small firms must become familiar with and address in their Regulation D filings and, of course, for which they will bill their clients. If the proposed rules are adopted, using Regulation D (particularly with general solicitation) will become notably more expensive and fewer issuers will be able to raise the capital needed to innovate and create jobs.

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[18]Comments of David R. Burton on Proposed Rule Regarding Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, March 21, 2014, http://www.sec.gov/comments/s7-11-13/s71113-52.pdf (accessed April 7, 2014).

[19]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, http://www.heritage.org/research/reports/2014/02/dont-crush-the-ability-of-entrepreneurs-and-small-businesses-to-raise-capital (accessed April 7, 2014).

A more detailed analysis is available in my comments to the Commission regarding the proposed rule.[20] Issues discussed include the size and importance of the Regulation D capital market, securities regulation administration, the purpose of securities regulation, the accredited investor net worth and income tests, general solicitation in Rule 506(c) offerings[21] and the proposed temporary rule for mandatory submission of written general solicitation materials, the proposed additional Form D filings, the proposed mandatory legends, the ability to cure and sanctions, improved data collection, the SEC economic analysis, and the Small Business Regulatory Enforcement Fairness Act.

Crowdfunding

Crowdfunding has the potential to substantially improve very small firms' access to capital provided that the regulatory framework adopted by the Commission does not impose prohibitive costs on either issuers or funding portals. It also will enable ordinary investors access to investments in start-up companies that ordinarily only accredited investors have access to. The primary advantages of crowdfunding are that it will enable small firms to access small investments from the broader public (i.e., from non-accredited investors) and that resale of the stock will not be restricted after one year. If, however, the regulatory costs associated with crowdfunding are too high, then issuers will either use other means to raise capital or be unable to raise capital and ordinary investors will be denied the opportunity to make these investments.

Firms using crowdfunding will almost invariably be the smallest of small businesses. More established firms or those seeking more than $1 million will use Regulation D or, perhaps, Regulation A+. If the Commission over-regulates crowdfunding, it will frustrate the bipartisan intention of Congress and the President and impede both the ability of small firms to raise the capital they need to create jobs, innovate, and contribute to the prosperity of the country and the ability of small investors to invest in the firms with the most potential growth. This is no idle possibility. The history of the small issues exemption and Regulation A demonstrates that over-regulation can destroy the usefulness of an exemption. Regulation A as currently constituted is seldom used.[22] It is simply too costly.

The Commission is underestimating the costs imposed by the proposed rule. The sum total of the costs that will be imposed by the proposed rule are likely to be near, or exceed, the point where issuers will find crowdfunding to be uneconomic. As one commentator put it, there is the need to be "light" and if problems appear in the future,

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[20]Comments of David R. Burton on Proposed Rule Regarding Amendments to Regulation D, Form D and Rule 156 under the Securities Act, November 4, 2013, http://www.sec.gov/comments/s7-06-13/s70613-462.pdf (accessed April 7, 2014).
[21]See also Comments of David R. Burton on Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, October 5, 2012, http://www.sec.gov/comments/s7-07-12/s70712-118.pdf (accessed April 7, 2014).
[22]U.S. Government Accountability Office, "Factors That May Affect Trends in Regulation A Offerings," GAO–12–839, July 2012.

then tailored changes to the crowdfunding rules can be crafted.[23] There is every reason to believe that the proposed rule, while not as "heavy" as it might be, is not sufficiently "light" to make crowdfunding the success that Congress and the President intended it to be.

A more detailed analysis is available in my comments to the Commission regarding the proposed rule.[24] Issues discussed include the economic analysis of the proposed rule, the $1 million aggregate offering limitation, joint income or net worth rules, issuer reliance on intermediaries' efforts to determine the applicable investor limits, accredited investors, mandatory legends, prior exempt offerings, the application of Generally Accepted Accounting Principles, voluntary higher standard financial statements, the role of the American Institute of Certified Public Accountants and the Public Company Accounting Oversight Board, adverse and qualified accounting opinions, material events, continuing disclosure reporting obligations for micro-offerings, the terms of offering definition, valuation methodology, intermediary interests in issuers, background checks and due diligence, educational materials, fidelity bonds, broker-dealer registration exemptions, funding portals,[25] anti-money laundering rules, insignificant deviations from regulatory requirements, and the application of the section 12(g) triggers.

Future Reforms

We currently have a patchwork quilt of exemptions and requirements with various and sometimes conflicting requirements. There is a need to rethink the regulation of small company capital formation so that there is a coherent, rational system of exemptions and reasonable scaled disclosure that considers 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 over-regulation.

The Heritage Foundation has established a Securities Regulation Working Group composed of small business people, attorneys, broker-dealers, policy analysts, and others from around the country who are concerned about entrepreneurship and small business capital formation to craft recommendations about how to accomplish this goal.

There are intermediate steps that can be taken to improve the situation.[26]

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[23] Andrew A. Schwartz, "Keep It Light, Chairman White: SEC Rulemaking Under the Crowdfund Act," 66 Vanderbilt Law Review En Banc 431 (2013).

[24] Comments of David R. Burton on Proposed Rule Regarding Crowdfunding, February 3, 2014, http://www.sec.gov/comments/s7-09-13/s70913-192.pdf (accessed April 7, 2014).

[25] See also Comments of David R. Burton to FINRA on proposed funding portal rules, February 3, 2014, http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticecomments/p443447.pdf (accessed April 7, 2014).

[26] For a reasonably detailed analysis of intermediate steps that can be taken, see David R. Burton, "Ideas for Improving Small Businesses' Access to Capital," National Small Business Association, September 10, 2013 http://www.nsba.biz/wp-content/uploads/2013/09/NSBA-White-Paper-on-Improving-Small-Business-Access-to-Capital.pdf (accessed April 7, 2014). A few of the ideas discussed need to be amended in light of events over the past six months and some of them are the subject matter of legislation being considered in this hearing or previously reported out of this Committee.

1) Create a statutory exemption for business brokers to the broker-dealer registration requirements.[27] The January 31, 2014, SEC no action letter is a very positive step in this direction.[28]
2) Create a statutory exemption to the broker-dealer registration requirements for finders who are not "engaged in the business of effecting transactions in securities for the account of others" or of "buying and selling securities" and, as a integral component of that exemption, provide a bright-line safe harbor such that small finders are not deemed to be engaged in the business of being a securities broker or a dealer.
3) Create a statutory definition of accredited investor that prevents the current thresholds for natural persons from being increased. In other words, make the current accredited investor income and net worth standards statutory.
4) Either define NSMIA covered securities to include securities sold in transactions exempt under Rule 504, Rule 505, and Regulation A (in addition to Rule 506) or define qualified purchasers to include all purchasers of securities in transactions exempt under Rule 504, Rule 505, and Regulation A (in addition to Rule 506), or both.
5) Allow persons to definitively qualify as a sophisticated investor for purposes of Rule 506 by passing an exam or meeting other bright line tests. There is strong reason to believe that the SEC is considering constructive change in this regard.[29]
6) Amend the Securities Act to create a safe harbor so that any offering (within a 12-month period) is exempt if it

    - is made to people with whom the issuer (or its officers and directors) has a substantial pre-existing relationship;
    - involves 35 or fewer other persons; or
    - is less than $500,000.

7) Permit Peer-to-Peer (P2P) Lending portals to provide loans to small businesses without filing a registration statement. The key substantive point here is that a loan is a loan not a security. And whether that loan is from a

[27]See Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2013 (H.R. 2274), and David R. Burton, "Don't Overregulate Business Brokers," Heritage Foundation *Backgrounder* No. 2883, February 19, 2014, http://www.heritage.org/research/reports/2014/02/dont-overregulate-business-brokers.
[28]See SEC no action latter, January 31, 2014, http://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf (accessed April 7, 2014).
[29]The SEC is considering modifying the definition of accredited investor to include persons in "possession of professional certifications or degrees, such as a CFA, CPA, or a securities license, which some believe may provide an individual with the knowledge and sophistication needed to be an accredited investor, presumably irrespective of the person's financial wherewithal." Keith F. Higgins, Director, Division of Corporation Finance, keynote address at the 2014 Angel Capital Association Summit, March 28, 2014, http://www.sec.gov/News/Speech/Detail/Speech/1370541320533#.U0G8mVeh1Mg (accessed April 7, 2014).

bank, a credit union, a non-bank lender or an individual via a P2P lending portal should not matter. The SEC has adopted the absurd position that lending $10,000 to a small business via a P2P lending portal requires the filing of a separate registration statement.

8) Amend the Bank Secrecy Act to make it clear that federal "Know Your Customer" and anti-money laundering laws do not apply to finders, business brokers, or crowdfunding Web portals that do not hold customer funds. These rules are tremendously burdensome and requiring funding portals, for example, to comply with them even though they are prohibited by law from holding customer funds is likely to mean that only broker-dealers will become funding portals, a result at variance with the clear intent of Congress when it adopted the JOBS Act.
9) Improve SEC collection of data on private placements and Regulation A offerings (relating to offering amounts, enforcement, and compliance costs) and ensure the data is published regularly without materially increasing the administrative burden on issuers.
10) Improve SEC collection of data on the regulation of and regulatory costs incurred by small public companies.
11) Conduct the following studies by the GAO:

    - Examine whether bank regulators inappropriately treat small business loans as disproportionately risky, thereby discouraging bank lending to small firms. Generally, bank regulators deny this but small business owners frequently report this as a reason given by bankers for not lending and some community bankers have raised the issue.
    - Determine the typical compliance costs incurred by issuers in various Regulation D filings and Regulation A filings.
    - Determine the typical compliance costs incurred by private placement issuers because of Blue Sky laws.
    - Determine the typical compliance costs incurred by small capitalization public companies.
    - Determine and quantify the primary sources of fraud or other violations in private placements and the percentage of offerings that involve fraud.
    - Determine and quantify the primary sources of fraud or other violations for smaller reporting companies and the percentage of offerings that involve fraud.

Thank you for the opportunity to appear today and discuss these important issues.

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