

**Statement of Donald C. Langevoort, Thomas Aquinas Reynolds
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Subcommittee on Capital Markets and Government-Sponsored
Enterprises, Committee on Financial Services, United States House of
Representatives**

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I am pleased that you have invited me to testify today on the vitally important topic of capital formation and investor protection. With the JOBS Act more than a year old, we still await rule-making by the SEC on many of its key provisions. While this wait is frustrating to all who wish to these reforms take effect, the careful analysis of costs and benefits and consideration of alternatives that should inform all good policy-making takes time, and cannot be rushed if it is to be done well.

However, the JOBS Act hardly exhausts the possibilities for innovations in capital-raising and secondary trading that can make our financial markets more robust and opportunities for honest entrepreneurship more compelling. The SEC's Advisory Committee on Small and Emerging Companies has made a number of recommendations for additional changes that, if appropriately crafted, would be positive steps forward. The regulatory demands of publicness on issuers are heavy, but often warranted for those companies with big enough footprints in our markets, our economy, and our society. Companies with smaller footprints require less precisely because the "externalities" they generate are so much smaller.¹

¹ Along with Professor Robert Thompson of Georgetown, I have written about this possibility in "Publicness in Contemporary Securities Regulation after the JOBS Act," Georgetown Law Journal, vol. 101, p. 337 (2013). We have a follow-up article in progress entitled "Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising," available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2132813.

We can limit the obligations for smaller companies to that which is truly value-relevant to reasonable investors.

As the Advisory Committee also recommends, we can also do more to facilitate the development of fair and efficient secondary trading markets for both non-public companies and smaller public companies. The main issues have to do with what level of ongoing disclosure and governance obligations (via listing standards) to place on the issuers whose shares are traded in such settings, which is not an easy task but could certainly be defined more coherently than the standards that apply today. You should be aware of some crucial policy choices here, however. If, as suggested as a possibility, this new market space is meant for “accredited investors” only, it will most likely have the effect of dampening interest in making an IPO precisely because it will be easier to offer shareholders enhanced liquidity while staying short of the new Section 12(g) trigger for regulation as a public company.² Marketplace developments that facilitate capital raising and secondary trading by private companies will have profound consequences for our public markets.

Regulatory reform efforts should continue. But it is essential that this be done with due regard for investor protection, and I would commend to you the SEC’s Investor Advisory Committee as another bipartisan voice worth listening to when its members reach consensus. While inefficient regulation raises the cost of capital, *good regulation lowers it*. Research in financial economics shows that investor trust is closely tied to capital formation and economic growth.³ Although that trust has proven resilient over time, it is not something that can be taken for granted. If it hits some

² The JOBS Act allows non-exchange traded companies to avoid registration under the Securities Exchange Act of 1934 so long as they have fewer than 2000 shareholders of record, not more than 500 of which are non-accredited investors.

³ Luigi Guiso et al., “Trusting the Stock Market,” *Journal of Finance*, vol. 63, p. 2557 (2008). In March 2013, according to the “Financial Trust Index” at Northwestern University and the University of Chicago, the trust level in the stock market was at 19%. See <http://financialtrustindex.org/resultswave18.htm>.

horrible tipping point and recedes because there is too much perceived risk of opportunism and abuse, capital formation will be damaged by poorly-crafted innovations, not enhanced. For all the honest entrepreneurs who deserve a better shot at low-cost funding, there are opportunists as well who not only threaten the financial well-being of targeted—sometimes vulnerable—investors but take funds away from legitimate enterprise, pollute the reputation of our markets generally, and create no jobs. No innovations in capital-raising will work unless they help investors tell the difference between good promoters and bad promoters, as well as between good business plans and dubious business plans. Credible information is necessary to enable investors to price the risk for all issuers. Otherwise this is just gambling, from which smart investors know enough to stay away. Special markets for small and emerging companies that pay insufficient attention to informational needs and investor protection do not do particularly well for investors in the long run.⁴

Although there are many imperatives in crafting the rules to promote entrepreneurship and capital formation, two are paramount. One is that we recognize the role of retirement savings as an at-risk target, a threat to which neither aging Americans nor our economy generally can afford. Wealth tests (for example, \$1 million for accredited investor status, or \$100,000 for enhanced participation in crowd-funding) may seem large at first glance, but not so much if that is all that there is for a lengthy retirement except for Medicare and Social Security. The other is the need for greater transparency in so-called private markets, so that there are can be

⁴ Recent research from the University of Chicago suggests that the London AIM market, for example, significantly underperforms firms on regulated exchanges in terms of post-listing returns and failure rates, especially where retail investor make up the majority of the investor base. See Joseph Gerakos et al., “Post-Listing Performance and Private Sector Regulation: The Experience of the AIM,” Feb. 2013, available at www.ssrn.com/abstract=1740809. Similarly, see Jay Ritter et al., “Europe’s Second Markets for Small Companies,” *European Financial Management*, vol. 18, p. 32 (2012).

better oversight and surveillance in the otherwise dark spaces where investments are promoted and sold with little or no regulation.⁵

Let me stress an uncomfortable truth: the main impediments to small business capital-raising are economic, not regulatory. Small businesses are very, very risky.⁶ Entrepreneurs rarely find the cost of equity or debt that rationally prices this risk to be particularly attractive. But we should beware of reforms driven by the desire to attract capital from less sophisticated investors simply because there are so many of them and they might be more excitable and less demanding. That story will not end well.

Balancing capital formation and investor protection is not easy. I commend members of the Subcommittee for their continuing attention to both of these goals.

⁵ See Jennifer Johnson, “Fleeing Grandma: A Regulatory Ponzi Scheme,” *Lewis & Clark Law Review*, vol. 16, p. 993 (2012). Professor Johnson tells of brokers who qualify retirees for accredited investor status by estimating the future stream of social security payments over their expected lifetime and discounting to present value in search of the requisite \$1 million.

⁶ In negotiated deals, sophisticated investors demand some combination of credible disclosure to assess the venture, which is expensive; control rights to reduce post-investment risk; and pricing to reflect the considerable risks that remain.