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Committee on Financial Services

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Legislative Proposals to Enhance Capital Formation and Reduce Regulatory Burdens, Part II

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Chairman Garrett, Ranking Member Maloney, members of the Subcommittee, thank you for the opportunity to appear before you today. It is an honor and a privilege to appear before the Subcommittee today. I am the Founder and President of Fund Democracy, a nonprofit advocacy group for investors, and a Professor of Law at the University of Mississippi School of Law.

In this written submission, I have discussed various bills that are being considered by the Subcommittee as set forth in the table below. In addition, I have two general suggestions that apply the bills as a group.

First, when Congress amends the federal securities laws it should seek to do so pursuant to a consistent regulatory model, whatever that model might be. When enacted, the federal securities laws constituted a coherent regulatory structure based on the concept of public and private offerings and companies. However, the recent piecemeal, haphazard reforms have rendered the public-private distinction almost meaningless. The relevance of the size, type of securities and target market for an offering, as well as the size, float and operating history of an issuer, to the particular rules that apply to an offering or issuer has grown increasingly arbitrary and unpredictable. This approach cannot help but undermine efficient markets, suppress capital formation and drive investors further from the equity markets.

Second, Congress should be wary of assuming the role of regulator for itself. The Commission has far greater competence than Congress in promulgating detailed securities rules. The Commission also has the advantage of making administrative rather than statutory law, which provides the law with a critical degree of flexibility that statutory law cannot match. Congress should use statutes to establish broad parameters within which the Commission may or may be required to conduct detailed rulemaking.

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I. Fair Access to Investment Research Act of 2015

Section 5 of the Securities Act regulates non-exempt securities offerings by triggering certain requirements upon the "offering" of the securities. Section 5(c), for example, generally prohibits offers prior to the filing of a registration statement (this is known as the "quiet period"). The term "offer" is interpreted broadly, which means that even a broker-dealer's routinely published research reports can be offers under the Securities Act and, when published during the quiet period, can violate Section 5(c).

The Securities and Exchange Commission ("Commission" or "SEC") has adopted certain safe harbors for broker-dealer research that establish tiered requirements reflecting the potential for abuse in various situations. Rule 137 imposes limited requirements when the broker-dealer is not participating in the relevant issuer's offering, and Rule 138 proposes more stringent requirements when the broker-dealer is participating in the offering but the report does not address the particular securities being offered and is published in the regular course of the broker-dealer's business.

Rule 139 addresses the scenario that presents the greatest potential for abuse, where the broker-dealer is both participating in an offering and reporting on the securities offered. In this situation, the Commission requires that the issuer:

1. meet minimum float requirements or be a well-known seasoned issuer,
2. be a reporting company that is current on its periodic report filings, and
3. not be a blank check company, shell company or issuer or penny-stock issuer.

The Commission also requires that the report:

1. cover a substantial number of issuers in the industry or include a comprehensive list of securities currently recommended by the broker-dealer,
2. afford no more prominence to the issuer than to other issuers, and
3. be published in the regular course of the broker-dealer's business.

Finally, the Commission generally requires that the broker-dealer have previously issued a report on the issuer (known as the "initiation" or "re-initiation" requirement), *i.e.*, a report would not be part of a "regular course of business" if used to initiate coverage in connection with the offering.

The foregoing rules represent only one part of an extensive regulatory regime, which also includes Regulation AC and FINRA rules, that is designed to combat demonstrated abuses in connection with biased and manipulative analyst reports. Henry Blodget's infamous buy recommendations made in 1999 for Internet bubble securities that he privately described as "pieces of sh*t" are a stark reminder of the incentives of underwriters' conflicts of interest when publishing research,[1] as are years of research analysts' "recommendations" acting as nothing more than a signal repeater set to "buy."[2]

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[1] Complaint, *SEC v. Blodget*, Civ. Action No. 03-2947 (S.D.N.Y Apr. 23, 2003) *available at* https://www.sec.gov/litigation/complaints/comp18115b.htm.

[2] At the height of the Internet boom, for example, 74% of recommendations were buys and 2% were sells. *See* Brad Barber, Reuven Lehavy, Maureen McNichols and Brett Trueman, *Buys, Holds and Sells* at 3 (Sep. 2005).

Notwithstanding the foregoing, exchange-traded funds ("ETFs") raise special issues because the potential abuses arising from published research on registered investment company securities, especially those representing diversified investment companies, are different from abuses arising from published research on operating company securities. Registered investment companies are subject to a host of investor protection provisions, including mandatory fair value pricing, prohibitions on affiliated transactions, and limits on complex capital structures and leverage, that may mitigate some of the concerns that animate research report regulation. These differences could reasonably form the basis of different rules for investment company research reports.

The Fair Access to Investment Research Act of 2015 ("ETF Research Act") offers one approach to the regulation of ETF research reports, but it is too flawed to serve as the basis of reform in this area. The Act essentially destroys the foundation of Rule 139 by undercutting the Rule's most fundamental principles. It creates a *statutory* safe harbor, which precludes the kind of flexible, timely responsiveness that only *rule-based* regulation can provide and that is essential for the effective regulation of research conflicts. It insulates issuer-published reports that are distributed by broker-dealer, whereas Rule 139 covers only broker-dealer publications. It insulates issuer advertisements produced for the purpose of selling shares, whereas Rule 139 covers only broker-dealer research produced in the regular course of its business. It expressly insulates the reports even if they are initiated solely in connection with a particular offering, where Rule 139 excludes such reports. It insulates oral research reports, whereas Rule 139 excludes only written reports. It banishes FINRA from the regulation of research reports, whereas Rule 139 is designed to work in tandem with a comprehensive regulatory regime of which FINRA is an integral part.[3]

[3] It should also be noted that the Act's definition of "exchange-traded fund" is not accurate or consistent with the use of that term by the Commission, commentators or practitioners, *see* ETF Research Act Section 2 (adding subparagraph (f)(4)(B) to Securities Act Section 5), and not only because it includes unregistered pools of commodities, and currencies and derivatives thereof under new subparagraph (f)(4)(B)(iii)(II).

The foregoing flaws, which alone render the ETF Research Act's regulation of ETF research reports effectively inoperable, are not even its most significant weaknesses. The Act virtually destroys the entire fabric of legal accountability that would otherwise apply to ETF research reports. It insulates issuers and broker-dealers from private antifraud claims under the federal securities laws.[4] It precludes any SEC enforcement action under Section 17 that is based on a covered ETF research report.[5] Finally, the Act insulates issuers and broker-dealers from all claims under federal and state laws and regulations of which a necessary element is that the report be considered an offer, solicitation, or inducement of any person to purchase or sell any security.[6]

In effect, the ETF Research Act converts the Rule 139 safe harbor for broker-dealer publications made in the regular course of their business into a safe harbor for communications by an issuer for the sole purpose of promoting the sale of its securities. Due to the Act's effect on liability provisions, ETFs would need only willing broker-dealer accomplices to make offers that are free from Securities Act prospectus liability under Section 12, SEC enforcement action under Section 17, and liability from any legal claim that is based on the report being considered an "offer, solicitation or inducement."[7] While reform of the regulation of research reports on registered investment companies is long overdue, the Act does not provide a reasonable starting point for such reform.

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[4] *See* ETF Research Act Section 2 (adding subparagraph (f)(3)(A) to Section 5 of the Securities Act). Although this is the necessary effect of the Act's adding subparagraph (f)(3)(A) to Section 5 of the Securities, it is directly contradicted by new subparagraph (f)(3)(B)'s Rule of Construction, which states that excluding a covered ETF research report from being considered an "offer, solicitation or inducement" shall not limit the applicability of the antifraud provisions of the federal securities laws. However, because this Rule of Construction applies only to new subparagraph (f)(3)(A), it has no effect on new subparagraph (f)(1)'s elimination of prospectus liability under Section 12 because such liability arises from the meaning of "offer" under Section 2(a)(10).

[5] *See* ETF Research Act Section 2 (adding subparagraph (f)(3)(A) to Section 5 of the Securities Act). The issue regarding new subparagraph (f)(3)(B)'s Rule of Construction, *see supra* note 4, applies equally here.

[6] *See id*.

[7] The removal of section 12 liability for a reporting company is particularly incongruous in light of Congress's having, only three years ago, *created* Section 12 liability for crowdfunding and and Regulation A issuers.

II. Accelerating Access to Capital Act of 2015

Issuers use Form S-3 to conduct what are known as "shelf" offerings. An issuer may incorporate by reference its prior Exchange Act filings in Form S-3, which means that its financial information is deemed to be complete and current on an ongoing basis. This also means that the issuer can quickly take its registration statement "off the shelf" and sell shares (a "takedown") and thereby avoid many of the amendments and staff comments that that might otherwise delay an offering. Form S-3 benefits issuers by allowing them to take advantage of favorable market conditions in times of market volatility.

However, only certain issuers are eligible to use Form S-3. An issuer must be a reporting company, of course, because it otherwise would not have Exchange Act filings to incorporate by reference. The Commission requires that an issuer have been filing for at least one year. The Commission also generally requires that Form S-3 users have a public float of at least $75 million. An issuer with a smaller public float ("micro-cap issuer") generally can use Form S-3 only if its shares are traded on a national securities exchange ("exchange-traded"), provided that it is not a shell company and has not in the preceding year issued common equity in reliance on this exception in excess of one-third of the value of its public float (the "Exchange-Traded Exception").

The Accelerating Access to Capital Act of 2015 ("Access Act") would expand the number of micro-cap issuers that are eligible to conduct shelf offerings. Specifically, the Act would allow a micro-cap issuer to use Form S-3 if it was either (1) traded on a national securities exchange or (2) was not a shell company and had not in the preceding year issued common equity in reliance on this exception in excess of one-third of the value of its public float.

For a number of reasons, the Access Act would not be consistent with the efficient markets or capital formation or the protection of investors. One reason is that the

Act would directly conflict with the SEC's ongoing review of small company regulation. The Commission created the Exchange-Traded Exception in 2007 as part of that review and in response to input from its Advisory Committee on Smaller Public Companies and members of the micro-cap issuer community. After careful consideration of the interests of market efficiency, capital formation and investor protection, the Commission adopted the substantially liberalized Exchange-Traded Exception for the riskiest category of reporting companies.

The Commission settled on the three elements of the Exchange-Traded Exception as a combination of factors that comprised an adequate proxy for the market integrity that is a necessary predicate for shelf offerings. While shelf offerings benefit micro-cap issuers by enabling them to move quickly to take advantage of favorable market conditions, allowing micro-cap issuer to move quickly to market can also undermine market efficiency, impair efficient capital allocation and harm investors. Speedy access to markets facilitates accounting fraud, market manipulation, insider trading and sales of watered stock, all of which are abuses that occur with greater frequency among the micro-cap issuers that the Access Act would permit to conduct shelf offerings.

A long history of empirical research shows the heightened risks that micro-cap companies pose for markets and investors. In a 2006 study of SEC enforcement actions, researchers found that more than 80% of manipulation cases involved non-exchange-traded stocks.[8] The market capitalization of the New York Stock Exchange ("NYSE") far exceeds the combined capitalization of all non-exchange traded stocks, yet the NYSE accounted for less than 3% of market manipulation cases. The authors found a positive correlation between lower disclosure requirements and otherwise weaker regulation and the likelihood of manipulation, concluding that the "lack of disclosure requirements and regulatory oversight allows manipulators to operate with ease."

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[8] Rajesh Aggarwal and Guojon Wu, *Stock Market Manipulations,* 79 Journal of Business 1915, 1935 (2006). This total includes 29.58% of cases involving stocks for which market information was unavailable (and presumably were no traded on a national securities exchange).

A more recent study provided a detailed look at the characteristics of OTC (non-exchange-traded) stocks.[9] It found that volatility for OTC stocks was twice as high as the already very high volatility of NASDAQ Small Cap stocks.[10] It also found that a quarter of pink sheet stocks trade on 10% or less of trading days. When these stocks do trade, daily volume is about $100,000, which contributes to their exhibiting "episodes of extreme returns over the sample period (e.g., returns above 100% or below -95%)." The 2006 study found that the price of stocks with high volatility and low liquidity were easier to manipulate. These are defining characteristics of the stocks that the Access Act would allow to conduct shelf offerings.[11] Both the 2006 and more recent studies one found a positive correlation between market efficiency and liquidity on the one hand, and regulatory oversight on the other. These measures were higher for: reporting companies, companies headquartered in states with more rigorous merit review regimes, and companies that are published in securities manuals (a quasi-regulatory characteristic).[12]

The concerns highlighted by these studies are precisely the concerns that led the Commission to limit shelf offering access to micro-cap issuers. The Commission disallowed shell companies because they have no operating history or meaningful financial information; their susceptibility to market manipulation is self-evident. As discussed above, substantial offerings as a percentage of an OTC company's value have been specifically identified by researchers as characteristic of market manipulation and a key tool for market manipulators. These concerns are mitigated by the requirement that the securities be exchange-traded, which, as discussed above, correlates with a far lower incidence of market manipulation. From 1990 to 2001, for example, securities traded on

[9] *See* Ulf Brüggemann, Aditya Kaul, Christian Leuz, and Ingrid M. Werner, *The Twilight Zone: OTC Regulatory Regimes and Market Quality*, Fisher College of Business Working Paper No. 2013-03-09 (August 1, 2013) *available* at ssrn.com/abstract=2290492.

[10] *Id.* at 5.

[11] *See Stock Market Manipulations, supra*. The study discusses how creating the appearance of increased liquidity and volume and a rising stock price are common elements of market manipulation schemes, each of which is easier to accomplish for stocks with low liquidity and volume and highly volatile prices.

[12] *Id.* at 6.

the NASDAQ Capital (Small Cap) Market accounted for 1.9% of market manipulation cases, in comparison with non-exchange-traded securities' 80%-plus share.[13]

The Commission originally proposed a 12-month, 20%-of-value limit on an issuer's offerings, but ultimately increased the limit to 33.3% only because "of the additional protection afforded by the new requirement . . . [that] the registrant hav[e] a class of common equity securities listed and registered on a national securities exchange."[14] The SEC staff also based this percentage limit on its finding that the 33.3% limit was well above the median 12-month percentage-of-value of takedowns in 2006 for companies with a public float from $75 to $140 million.[15] The current shelf offering rules reflect careful analysis of the costs and benefits of allowing micro-cap issuers to access public markets with virtually no opportunity for market review.

The volatility of micro-cap company stocks makes shelf-offering eligibility for such companies particularly inadvisable. Shelf offerings are intended to enable companies to access markets more quickly and take advantage of optimal market conditions. In the context of stocks that are inherently volatile, the ability to take advantage of optimal market conditions is more aptly characterized as the ability to opportunistically exploit random upswings in prices that have little relationship to intrinsic value. The market in non-exchange-traded microcap stocks already has the empirical characteristics of a lottery.[16] The median share price for an OTC stock is $1.01. As a group, OTC stocks had returns from 2001 to 2010 of "-27% and -37% (annualized), respectively, indicating that the majority of the firms exhibits a negative performance."[17] Betting on micro-cap stocks is already like picking the lame horse to win the race.

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[13] *Id.* at 1935.

[14] 72 FR 73534, 73538 (Dec. 27, 2007).

[15] *Id*. at note 42.

[16] *Twilight Zone, supra,* at 20 (describing OTC securities "small 'penny-stocks' with lottery-like payoffs, that is, negative average stock returns and high return volatility.").

[17] *Id.* at 5.

Helping micro-cap companies to sell shares at the top of extreme, irrational upswings in price will move the odds further against investors and make investing in micro-caps like betting on the lame horse when it is ten lengths behind halfway through the race.

Non-exchange-traded micro-cap securities already provide market manipulators with the perfect petri dish of infrequent trading, low trading volume, high volatility, usually negative performance, extreme performance swings, and penny stock prices. The Access Act will further enrich the micro-cap market as a breeding ground for market manipulation and thereby unfairly inhibit capital formation for currently shelf-eligible micro-cap companies and inflict significant losses on unsuspecting investors.

III. Main Street Growth Act

A. Venture Exchanges

Congress has granted the Commission broad authority to regulate securities exchanges. Under that authority, the Commission has created two categories of exchanges. A small number of exchanges register with the Commission and are known as national securities exchanges. These include exchanges such as the NYSE and NASDAQ. The vast majority of exchanges are not registered and are regulated by the Commission as Alternative Trading Systems ("ATS"). This regulatory structure provides issuers with a broad range of venues on which to list their shares and investors with a broad range of venues on which to buy and sell securities. Both groups have substantial freedom to operate their exchanges as they see fit.

Over the last two decades, the regulation of securities exchanges has been in greater flux than any other area of securities regulation. Some would attribute this to market factors and technological advances. In my view, the changes are the direct result of regulatory flexibility and responsiveness. Constant change in the regulation of exchanges reflects both Congress's decision to delegate regulation of the structure and

operation of securities exchanges to the Commission, and the Commission's active and continuous exercise of that delegated authority.

In the Main Street Growth Act, Congress now proposes not only take back the broad authority it has granted to the Commission but also to codify minute elements of exchange regulation. The Commission has created a dual structure for regulating exchanges as national securities exchanges and alternative trading systems and two primary sources of law in the form of Regulation NMS and Regulation ATS. The Act would create a complete exemption from both Reg NMS and Reg ATS while also dictating to the penny the increments at which securities must trade.

By prohibiting penny trading increments and requiring nickel increments, the Main Street Growth Act rules out precisely the flexibility that the Commission has demonstrated and continues to demonstrate regarding the regulation of price increments at which securities trade. On May 6, the Commission approved a tick-size pilot for small company stocks under which more than 1,000 companies shares will trade in five-cent increments. The pilot demonstrates the SEC's commitment to exploring the optimal set of rules for trading increments, while the Act does the opposite by forbidding one tick size and mandating another. Establishing mandatory or prohibited tick sizes is well outside of Congress's competence and represents the kind of inflexible trading regime that will put the U.S. at a competitive disadvantage with other securities markets.

The Main Street Growth Act rejects Regulation NMS wholesale only to re-incorporate aspects such as the dissemination of last sale and quote information on fair, reasonable and not unreasonably discriminatory terms. The Act then makes another about face by prohibiting the exchange from submitting "any data" to a securities information processor, regardless of whether the exchange believes that, as a business matter, a securities information processor might provide the most efficient means of disseminating quotes and transaction data. The Act thereby substitutes Congress's business judgment for the judgment of exchange management, a likely sign of regulatory rent-seeking by

firms with monopolistic intentions. Whatever its purpose, the Main Street Growth Act will weaken U.S. competitiveness in international markets.

B. State Preemption for Venture Securities

Section 3(b) authorizes the Commission to exempt certain small offerings from provisions of the Securities Act. Under this authority, the Commission exempted offerings of up to $5 million under Regulation A. This exemption has been in place for decades and offerings under it have been subject to state regulation[18] for just as long.

In the JOBS Act, Congress required the Commission to create a Section 3(b) exemption for offerings of up to $50 million. Accordingly, the Commission recently adopted amendments to Regulation A that will become effective on June 19. New Regulation A creates separate rules for offerings in any 12-month period of up to $20 million ("Reg A") and up to $50 million ("Reg A+"). Notably, in the JOBS Act Congress chose to leave state regulation of Regulation A offerings undisturbed. And possibly out of consideration of concerns expressed regarding the state registration process, the national organization for state regulators, NASAA, began work on streamlined, multi-state protocols for Regulation A offerings to reduce compliance costs for small companies seeking to raise capital. The members of NASAA approved the Coordinated Review Program for Regulation A Offerings on March 7.

Nonetheless, the Commission decided to exempt Reg A+ offerings from state regulation. The JOBS Act granted the Commission the authority to grant such an exemption, but only for securities that are offered or sold to "qualified purchasers," a term that has historically meant, and can reasonably *only* mean a purchaser who has the financial sophistication or resources to make the investor protection provisions at issue unnecessary. The Commission read that provision differently and, in a remarkable

[18] For purposes of simplicity, this discussion uses the term "state regulation" to refer to registration requirements as opposed to anti-fraud enforcement authority. The latter would be unaffected by the Main Street Growth Act.

demonstration of regulatory chutzpah, defined "qualified purchaser" as any investor in a Reg A+ offering. The Commission apparently reasoned that the act of investing in a Reg A+ offering itself renders an investor "qualified" to invest in a Reg A+ offering. The Main Street Growth Act would codify the SEC's extra-legal state exemption and take it one step further by extending it to all Reg A offerings ("Venture Security Exemption").

There is no evidence that the Venture Security Exemption is appropriate or necessary. The claimed Regulation A registration delays that some have blamed on the states pale in comparison to the empirically demonstrated delays imposed by the Commission. The Venture Security Exemption is legislative overkill, as it ignores NASAA's recent adoption of streamlined registration protocols that, if Congress was concerned about the burdens of state registration, could be required as a condition of a state's exercising regulatory authority. The only effect of the Venture Security Exemption will be to reduce investor protection by eliminating the important role played by states as the primary regulator for Reg A and A+ offerings.

The SEC staff will submit a report to the Commission on the effect of Reg A and A+ on, among other things, the amount of enforcement actions take in connection with these offerings and "whether any additional investor protections are necessary for either [Reg A or A+]." Yet Congress would charge ahead without regard to these findings and cut back on investor protections before a single offering under the new rules has even begun. The Venture Security Exemption not only ignores what the Commission may find in the future, it also ignores what the Commission concluded in just the last few months. Even the Commission, in its overreaching exercise of nonexistent exemptive authority, was forced to recognize that state registration was appropriate and necessary for the protection of investors at least in Reg A offerings. But before the ink is dry on that finding, Congress proposes to remove state regulation from the entire Regulation A playing field.

Congress should address state preemption in the context of Regulation A, but not by expanding it. Rather, it should restore the bipartisan basis for the JOBS Act, which

was the continued state regulation of Regulation A offerings of all sizes. It should also repeal the SEC's absurd interpretation of the meaning of "qualified purchaser" and further define that term as meaning purchasers who are "qualified" to invest in the relevant securities based on the characteristics of the "purchaser."

IV. Regulatory Review Act

The Regulatory Review Act would require the Commission to evaluate and vote on all "significant regulations" (presumably "major rules" under 5 U.S.C. § 804(2)) within five years and every ten years thereafter. I agree that the Commission should regularly revisit the efficacy of its rules and other regulatory actions to ensure that they continue to promote efficient markets, facilitate capital formation and effectively protect investors. The Commission has granted many exemptions and adopted many exemptive rules, for example, that contravene all three of these goals. In addition, conducting such reviews on at least at ten-year schedule is reasonable. Indeed, when granting exemptions or adopting rules, the Commission should identify the metrics by which it intends to measure their efficacy.

In my view, however, the Regulatory Review Act is unnecessary. The Commission already conducts retrospective reviews under the Regulatory Flexibility and Paperwork Reduction Acts.[19] The agency also voluntarily complies with Executive Order 13563, which requires it to develop a plan for the retrospective review of rules to identify those "that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them" as appropriate.[20]

If the Regulatory Review Act were to progress further, it could be improved in significant respects as follows:

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[19] *See* 5 U.S.C. § 610, 44 U.S.C. § 3506.

[20] *See Improving Regulation and Regulatory Review*, Executive Order 13563 (Jan. 18, 2001).

1. The SEC's review should not be required every ten years regardless of when a rule was adopted, but rather within ten years of every ten-year anniversary of the rule's adoption. As currently drafted, the Act would require a review for any rules adopted immediately or not long before the ten-year deadline.

2. The Act appears to require that the Commission submit a report on every vote every ten years. If that is the case, then the reporting requirement should be amended to apply on a rolling basis (*e.g.,* assuming review under the schedule suggested under #1 *supra*, a single report should be provided every one or two years) and to permit multiple votes to be included in a single report.

3. The Act's requirement of both an SEC review and report renders the SEC vote both redundant and excessively burdensome. If the Commission reviews its rules and then reports on its reviews, then a non-vote will provide a clear an indication of its position.

4. Any SEC vote should be deemed not to be final agency action for purposes of judicial review. Permitting judicial review of SEC votes under the Act would substantially interfere with the SEC's ability to carry out its mission.

5. Some of the Act's substantive standards should be removed because they are not consistent with the statutory standards that would have applied in the original rulemaking. Otherwise, the original evaluation and subsequent review may work at cross purposes. For example, SEC rulemakings are not subject to a statutory determination as to whether a rule is (or is not) "outmoded," "ineffective," "insufficient," or "excessively burdensome." These terms are perfectly appropriate as general standards of review, as reflected in Executive Order 13563. Nonetheless, their use as statutory standards will conflict with the different standards that apply to the original adoption of a rule. They will also create legal uncertainty due the lack of judicial precedent regarding their meaning.

6. The Act should be amended to clarify that the APA does not apply. The application of the APA would cripple the SEC"s ability to accomplish its mission.

7. The requirement that the Commission review all of its significant rules within five years should be deleted as the agency does not have the capacity to conduct such a review in that timeframe.

V. Encouraging Employee Ownership Act of 2015

Rule 701 exempts small, nonreporting issuer offerings to the issuer's employees as part of a written compensatory benefit plan from Section 5 of the Act. Within certain dollar limits, these offerings are subject to virtually no federal securities regulation. The securities need not be registered. Issuers are not required to provide *any* disclosure to employees other than a copy of the plan. Nor is there any restriction on the wealth or sophistication of investors.

The dollar amount of a Rule 701 offering may not exceed the greatest of the following amounts during any 12-month period:

- $1 million;
- 15% of the total assets of the issuer; or
- 15% of the outstanding amount of the class of securities being offered and sold in reliance on Rule 701.

In addition, Rule 701 offerings may not exceed $5 million in any 12-month period unless certain disclosures are provided, including primarily information about the risks of the securities and the financial statements required for a Regulation A offering. Rule 701 offerings are not integrated with any other offerings. Nor are Rule 701 securities counted in determining whether a company must register and report under the Exchange Act.

The Encouraging Employee Ownership Act of 2015 ("Employee Ownership Act") would increase Rule 701's disclosure trigger from $5 million to $10 million. In other words, an issuer making a $10 million offering every year would not be required to provide employees with the same unaudited information that Regulation A filers have for decades been required to file for smaller offerings or even with "[i]nformation about the risks associated with investment in the securities sold."[21]

[21] Securities Act Rule 701(e).

These disclosure requirements cannot reasonably be viewed as too burdensome for an issuer that must have at least $34 million in total assets.[22] Congress recently enacted crowdfunding legislation that would require substantially more disclosure by a hot dog stand with almost no capital to raise $10 thousand, and these offerings would still be subject to a $2,000 limit on investments by certain investors. Congress now proposes to allow nonreporting companies with at least $34 million in assets to raise up to $10 million with no disclosure or any limits on employees' investments or sophistication.

The most striking problem with the Encouraging Employee Ownership Act is that it would "encourage" employees to overconcentrate their retirement accounts in employer stock while failing to help achieve the legitimate goals of employee ownership. The benefit of employee ownership is the alignment of interests between employers and their employees. Employees who have a direct economic stake in their success should be both more productive and more satisfied with their work.[23] As a result, employers should be more profitable. I learned this early in my career, as my first job out of college was with Science Applications International Corporation, one of America's most successful employee-owned businesses. Congress should seek to facilitate employee equity ownership and, while reasonable minds may disagree as to how employee share purchases should be regulated, some relaxation of normal public offering rules is appropriate.

However, Rule 701 is not designed to promote the benefits of employee ownership. The Rule and the Act are premised on the assumption that greater sales of employer stock, regardless of the effect on the breadth of employees' ownership or the

[22] In order to make a $5 million offering, a company must have at least $34 million in assets so that the offering will not exceed the value of 15% of the issuer's total assets ($15\% * 33 < 5 < 15\% * 34$). It is possible, although highly unlikely, that the issuer would have less than $34 million in assets if it had at least $34 million in Rule 701 securities outstanding including the securities sold in the offering, in which case it could rely on the alternative 15% test under the Rule.

[23] *See* Mark Iwry, *Promoting 401(k) Security*, 7 Tax Policy & Options 1, 2 – 3 (Sep. 2003) ("many believe that employee holding of company stock tends to align employees' interests with shareholders', giving employees an incentive to be more productive") *available at* http://taxpolicycenter.org/UploadedPDF/310876_promoting_401k_security.pdf.

concentration of employer stock in an employee's retirement, is an unmitigated good. It is not. At some point, an employee's additional purchases of employer stock will produce declining marginal benefits. One reason is the collective action problem. An employee receives the benefit of the additional company value they create only in proportion to the employee's ownership stake (the rest is shared with all other shareholders).[24] It is not clear at what rate or in what degree the utility of an employee's stake in a business declines at that stake grows, but the utility necessarily yields declining benefits at some tipping point.

What is clear, in contrast, is that concentration risk increases as the percentage of an employee's portfolio invested in employer stock grows.[25] It is a virtual cliché among financial planners that an investor should not invest more than 10% of their assets in the stock of a single company, and in no event should invest more than 10% in the stock of same firm on which the employee relies for their income. Following these rules becomes critically important when investing for retirement.

Additionally, employees are subjective to cognitive biases regarding investment in their employers' stock. Employees are likely to overestimate their employer's likely future performance and underestimate their employer's bankruptcy risk. They are more likely to trust their employer than to trust other issuers. Employees' rose-colored views of their employers may have a positive effect on productivity, morale and overall well-being, but they inevitably distort employees' evaluation of employer stock as an investment.

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[24] *Id*. at 3 ("Because in most firms few individual employees can realistically expect to have any noticeable impact on the company's stock price, any incentive effect for most employees might ordinarily be achieved by owning a limited number of shares, enough to give employees some sense of identification with shareholders and some personal interest in the value of the stock").

[25] Concentration risk will almost always increase with additional purchases of employer stock because very few employees will have additional funds to invest in other options so as to keep the percentage of their assets in non-employer-stock at the same level.

This perfect storm of cognitive biases will cause the Encouraging Employee Ownership Act to "encourage" employees to do exactly what they should not do – overconcentrate their retirement accounts in employer stock. As Mark Iwry, Deputy Assistant Secretary for Retirement and Health at the Treasury Department, has explained:

> Employer stock can play a useful part within a diversified portfolio. It often provides substantial returns, offsets some workers' tendency to allocate their assets entirely to guaranteed investment contracts or money market funds, and aligns workers' interests more closely with those of shareholders, possibly boosting productivity and morale. But over the years, mounting accumulations of employer stock in retirement plans have become too much of a good thing. In the many 401(k) plans that offer investment in company stock, roughly 30 percent of all assets is invested in that stock.[26]

In 2012, 8.4% of employees had more than 50% of their 401(k) accounts invested in employer stock where such investment was an option, and 5.6% had invested more than 90% of their accounts in employer stock.[27] These percentages have steadily declined (from 21.3% and 12.4%, respectively, in 1998),[28] but it will be cold comfort to the retiree impoverished by their employer's bankruptcy that fewer other Americans are experiencing the same fate than previously.

At the same time that Congress prohibits companies from investing more than 10% of defined benefit plan assets in their own stock, a policy that ultimately protects only the company, its shareholders and the government, and *not* employees (whose pensions are government-insured), Congress offers tax incentives for employees to invest

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[26] *Promoting 401(k) Security*, *supra*, at 1 (citation omitted).

[27] Jack VanDerhei and Sarah Holden, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2012*, 394 Employee Benefit Research Institute Issue Brief at 37 (2013) *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_012-13.No394.401k-Update-2012.pdf. The 8.4% and 5.6% data points may seem counterinteruitive, but they are correct – employees who invest more than 50% in employer stock are far more likely than not to invest more than 90% in employer stock. The overconcentration concern is mitigated for small company 401(k), where employer stock is generally not an investment option. *Id.* at 18 (in 2012, less than 1% of participants in small plans were offered company stock). However, the same data for Rule 701 securities may be different because the Rule is specifically designed for small companies.

[28] *Id*. at 37.

up to 100% of their retirement assets in company stock. Now Congress would further undermine employees' retirement security by increasing the special benefits to employers of selling stock to employees rather than in the marketplace. This incentive would follow closely on the footsteps of the added incentive created by the JOBS Act for employers to issue stock to employees as means of raising capital without triggering Exchange Act registration. Both distort retirement investing in harmful ways without having any necessary relationship to expanded employee stock ownership.

Retirees in the U.S. are facing a declining standard of living as Social Security becomes actuarially untenable and income from robust defined benefit plans are replaced with meager 401(k) plans (or, even worse, IRAs managed by broker-dealers subject only to a suitability obligation). It is remarkable that Congress would even consider further encouraging employees to overconcentrate their retirement accounts in the stock of a single issuer, especially where employees are particularly susceptible to distorting investment biases.

Rule 701 is oblivious to considerations of employee overconcentration in employer stock,[29] as it is indifferent to whether a $5 million offering is purchased by 5 million employees or only one. Rule 701's structure fails to encourage broad employee ownership, because it speaks only to the sale of *more stock* and not to the sale of stock to *more employees*, while implicitly encouraging employees' overconcentration in employer stock in their retirement plans.

Congress can do better, as it *knows* that investor risk is partly a function of the investor's degree of diversification. Congress recently passed legislation that, with respect to investor eligibility requirements, reflected such a forward-thinking, diversification-based model. The JOBS Act limits investors' eligibility to buy crowdfunded securities based on the amount of the particular issuer's securities and all

[29] Similarly, the SEC's definition of "accredited investor" is based on the value of an investor's net investments, not their makeup. The effect is to allow an individual with $1 million in investments to bet (and lose) all of it in a single private offering, while an individual with $999,999 in investments cannot allocate even an appropriately small portion of their portfolio to such investments.

crowdfunded securities combined that the investor purchased in the preceding 12 months. Yet now Congress proposes to allow the same individual who cannot purchase more than $2,000 in securities from a single crowdfunding issuer to purchase an unlimited amount of securities from their employer. This is not the kind of encouragement Congress should be providing.

In summary, the Act does not make it easier or less costly to allow *more employees* to own company stock. Rather, it makes it easier and less costly to allow employees to own (and employers to issue) *more stock*. Rule 701 should be amended, but not under a guiding principle of encouraging employees' over-concentration in company stock. Rather, Rule 701 should be amended to support the legitimate principle of promoting broad but prudent employee ownership of company stock. Rule 701 offerings should "encourage" offerings that actually increase the number of employees who own company stock while "discouraging" offerings that result in overconcentration in the percentage of employees' portfolios invested in company stock. The Encouraging Employee Ownership Act does precisely the opposite.

VI. Small Business Mergers, Acquisitions, Sales and Brokerage Simplification Act of 2015

The Small Business Mergers, Acquisitions, Sales and Brokerage Simplification Act of 2015 ("M&A Act") would exempt broker-dealers from registration who are in the business of effecting transactions on behalf of "eligible privately held companies." The Act defines such companies as nonreporting companies with either EBITDA of less than $25 million or revenues of less than $250 million.

One objection to the M&A Act is that it is unnecessary, as the Commission has already (and inadvisably) provided no-action relief that is fairly co-extensive with the Act. A more serious objection is that the Act would harm small businesses by effectively de-licensing the M&A professionals on which these businesses rely for advice about

complex, corporate transactions. The structure of M&A compensation is complex and rife with opportunities for abuse, the cost of which will often dwarf any potential savings realized from reducing broker-dealers' regulatory burdens. Permitting unlicensed M&S advisers to negotiate deals with unsophisticated small business owners will simply result in a greater transfer of wealth from the latter group to the former.

The M&A Act is an open invitation to fraudsters as it imposes no restrictions on bad actors' providing M&A advice to unsuspecting business owners. The Act would allow brokers who have been barred from the industry to continue to hold themselves as qualified professionals to the business owners that rely on them. There is no rational basis for barring bad actors in virtually every other similar situation but not in this context. The M&A Act would also permit the use of shell companies in connection with eligible transactions, notwithstanding that shell companies are commonly employed by fraudsters to take advantage of small business owners.

The effect of the M&A Act would be to create a parallel industry of unregistered M&A brokers who seek to avoid the costs of registration. The costs of broker-dealer registration are high, and many M&A broker-dealers therefore would have a strong incentive to forego registration in order to maximize their profitability. These broker-dealers would also gain a cost advantage over their competitors, which would create an unlevel playing field and lead to strictly law-generated fragmentation in the industry.

The incentive for M&A advisers to break away from regulated firms will be exacerbated by the size of the market to which the exemption would apply. The M&A Act's definition of "eligible privately held companies" would create a large market in which M&A advisers could operate. The revenue test of $250 million would include very large companies. The EBITDA test would include even larger companies because early stage companies may grow to enormous size and even conduct IPOs without any earnings.

Successful small business owners invest a lifetime of sweat equity in their businesses. The sale of their businesses will likely be the most important financial event in their lives. The M&A Act will facilitate advisers' skimming a larger share of the proceeds of the small business owner's life's work and far too often turn this once-in-a-lifetime event into a personal and financial disaster.