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BACKGROUNDER

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Securities Disclosure Reform

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Abstract

The adverse impact of the current securities disclosure regime on small entrepreneurial and start-up firms, as well as on innovation, job creation, and economic growth is substantial. Moreover, disclosure requirements have become so voluminous that they obfuscate rather than inform. This Heritage Foundation Backgrounder *outlines a program of interim reforms to improve the existing disclosure regime. It recommends specific changes to Regulation A, crowdfunding, Regulation D, and the regulation of small public companies and of secondary markets to improve the current regulatory environment. This Backgrounder also outlines a program of fundamental reform that would dramatically simplify the existing disclosure regime to the benefit of both investors and issuers. This proposal would replace the current 14 disclosure categories with three disclosure regimes—public, quasi-public, and private—and disclosure under the first two categories would be scaled based on either public float or the number of beneficial shareholders.*

Key Points

- The current securities disclosure regime has a substantial adverse impact on entrepreneurship, innovation, and economic growth.
- The existing rules contain at least 14 different categories of firms issuing securities, each with a different set of exemption and disclosure rules.
- Reasonable, scaled mandatory disclosure requirements have a positive economic effect. Aspects of the current securities disclosure regime harm, rather than help, investors.
- Substantial improvements to Regulation A, Regulation Crowdfunding, Regulation D, and the regulation of public companies are required to improve the current system.
- Because the benefits of mandatory disclosure are so much smaller than usually assumed, policymakers need to adopt a more skeptical posture toward the existing disclosure regime. Fundamental reform would dramatically reduce the complexity and regulatory burden of the current system and enhance investor protection.

This *Backgrounder* examines the law and economics of mandatory disclosure requirements both in connection with securities offerings and the ongoing disclosure obligations of companies that have issued securities. It discusses both interim reforms to improve the existing disclosure system to the benefit of both investors and issuers, and fundamental reform to create a much simpler, more coherent disclosure regime. Disclosure requirements have become so voluminous that they obfuscate rather than inform, making it more difficult for investors to find relevant information. It is quite clear that existing regulations, usually imposed in the name of

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investor protection,[1] go beyond those necessary to deter fraud and achieve reasonable, limited, scaled disclosure for firms. The existing rules have a particularly negative impact on the ability of entrepreneurial firms to raise the capital they need to start, to grow, to innovate, and to create new products and jobs.[2]

The existing rules contain at least 14 different categories of firms issuing securities, each with a different set of exemption and disclosure rules. The categories are as follows:

- (1) Private companies using section 4(a)(2);
- (2)–(6) Private companies using Regulation D (Rule 504, Rule 505 (with and without non-accredited investors) and, primarily, Rule 506 (with and without non-accredited investors);[3]
- (7)–(8) Small issuer Regulation A companies (two tiers);
- (9)–(11) Crowdfunding companies (three tiers);
- (12) Smaller reporting companies;
- (13) Emerging growth companies; and
- (14) Fully reporting public companies.

Each of these categories has different initial and continuing disclosure obligations. The rules also create different classes of investors that can invest in securities offerings, and a host of other obligations that vary across the 14 categories. The existing disclosure regime is not coherent: In many cases smaller firms have greater disclosure requirements, and the degree and type of disclosure differs significantly by the type of offering even for firms that are otherwise comparable in all meaningful respects.

The Core Purpose of Securities Regulation

The core purpose of securities market regulation is deterring and punishing fraud, and fostering reasonable, scaled disclosure of information that is material to investors' choices. Fraud is the misrepresentation of material facts or the misleading omission of material facts for the purpose of inducing another to act, or to refrain from action, in reliance on the misrepresentation or omission.[4] A transaction induced by fraud (misrepresentation) is not voluntary or welfare enhancing in that it would not be entered into in the absence of the fraud (or would be entered into at a different price).[5] Federal law prohibits fraudulent securities transactions.[6] So do state "blue sky" laws.[7]

The second important purpose of securities laws is to foster disclosure to investors by firms that sell securities of material facts about the company needed to make informed investment decisions.[8] Appropriate mandatory disclosure requirements can promote capital formation, the efficient allocation of capital and the maintenance of a robust, public, and liquid secondary market for securities.[9] The reasons for this are that (1) the issuer is in the best position to accurately and cost-effectively produce information about the issuer;[10] (2) information disclosure promotes better allocation of scarce capital resources or has other positive externalities;[11] (3) the cost of capital may decline because investors will demand a lower risk premium;[12] (4) disclosure makes it easier for shareholders to monitor management;[13] and (5) disclosure makes fraud enforcement easier because evidentiary hurdles are more easily overcome.[14]

The baseline for measuring the benefits of mandatory disclosure is not zero disclosure. Firms would disclose considerable information even in the absence of legally mandated disclosure. It is, generally, in their interest to do so.[15] Even before the New Deal securities laws mandating disclosure were enacted, firms made substantial disclosures, and stock exchanges required disclosure by listed firms.[16] Firms conducting private placements today make substantial disclosures notwithstanding the general absence of a legal mandate to do so.[17] The reason is fairly straightforward: In the absence of meaningful disclosure about the business and a commitment, contractual or otherwise, to provide continuing disclosure, few would invest in the business and those that did so would demand substantial compensation for the risk they were undertaking by investing in a business with inadequate disclosure.[18] Voluntary disclosure allows firms to reduce their cost of capital and, therefore, they disclose information even in the absence of a legal mandate to do so.

Mandatory disclosure laws often impose very substantial costs. These costs do not increase linearly with company size. Offering costs are larger as a percentage of the amount raised for small offerings. They therefore have a disproportionate adverse impact on small firms. Moreover, the benefits of mandated disclosure are also less for small firms because the number of investors and amount of capital at risk is less. Since the costs are disproportionately high and the benefits lower for smaller firms, disclosure should be scaled so that smaller firms incur lower costs.[19]

Disclosure also has a dark side in countries with inadequate property-rights protection. In a study examining data from 70,000 firms, the World Bank found that, in developing countries, mandatory disclosure is associated with significant exposure to expropriation, corruption, and reduced sales growth.[20]

Nor should it be forgotten that many large businesses and large broker-dealers are quite comfortable with high levels of regulation because regulatory compliance costs constitute a barrier to entry, limiting competition from smaller, potentially disruptive, competitors.[21] Some have been quite forthright about this. As Goldman Sachs CEO Lloyd Blankfein, for example, said:

> More intense regulatory and technology requirements have raised the barriers to entry higher than at any other time in modern history. This is an expensive business to be in, if you don't have the market share in scale. Consider the numerous business exits that have been announced by our peers as they reassessed their competitive positioning and relative returns.[22]

The securities bar, accounting firms doing compliance work, and regulators all have a strong pecuniary interest in maintaining complex rules. One former Securities and Exchange Commission (SEC) Commissioner noted that:

> The other Commissioners seemed to feel that the staff was their constituency and that by supporting staff they were necessarily acting in the public interest....
>
> Most of my close business and personal friends are securities lawyers, and many of them are SEC alumni. I belong to a tight-knit community of interesting and decent people, whose livelihoods depend on the continued existence and vitality of the SEC.[23]

Empirical Measures of Disclosure Benefits. There is no small degree of truth in the observation of Georgetown law professors Donald Langevoort and Robert Thompson that "[m]ost all of securities regulation is educated guesswork rather than rigorous cost-benefit analysis because we lack the ability to capture the full range of possible costs or benefits with anything remotely resembling precision."[24] The benefits, and to a lesser extent the costs, of mandatory disclosure are difficult to measure although the benefits are probably substantially less than commonly thought.[25] The limited empirical literature examining the issue tends to find little, and often no, net benefit.[26] As Yale Law School Professor Roberta Romano has written, "the near total absence of measurable benefits from the federal regulatory apparatus surely undermines blind adherence to the status quo."[27]

On the other hand, the United States securities markets are the largest, deepest capital markets in the world. At more than $25 trillion in 2015, the U.S. stock market capitalization accounts for nearly two-fifths of global equity values.[28] The U.S stock market dwarfs the securities markets of most countries.[29] U.S. market capitalization as a percentage of national income is greater than that of all major developed countries' except Switzerland's.[30] U.S. private capital markets are broad and deep compared to those in other countries.[31] This implies that the U.S. securities regulatory regime is generally reasonable compared to those in most other countries, although other factors, such as property rights protection, taxation (of both domestic and foreign investors), the legal ability or willingness of banks to undertake equity investment, and the degree of corruption, should also be considered.

It is quite clear that existing regulations, usually imposed in the name of investor protection, go beyond those necessary to deter fraud and achieve reasonable, limited, scaled disclosure for small firms. Existing rules seriously impede the ability of entrepreneurial firms to raise the capital they need to start, to grow, to innovate, and to create new products and jobs.

Investor Protection Examined

"Investor protection" is a central part of the SEC's mission.[32] It is quite clear that existing regulations, usually imposed in the name of investor protection, go beyond those necessary to deter fraud and achieve reasonable, limited, scaled disclosure for small firms. A main problem is that the term "investor protection" is a very ambiguous term that can cover, at least, four basic ideas. The first is protecting investors from fraud or misrepresentation. This is a fundamental function of government. The second is providing investors with adequate information to make informed investment decisions. Although a legitimate function of the securities laws, this requires policymakers to carefully balance the costs (which are typically underestimated by regulators and policymakers) and benefits (which are typically overestimated by regulators and policymakers) of mandatory disclosure.[33]

The third is protecting investors from investments or business risks that regulators deem imprudent or ill-advised. This is not an appropriate function of government and can be highly counterproductive. The fourth is protecting investor freedom of choice or investor liberty and, thereby, allowing investors to achieve higher returns and greater liquidity. This primarily requires regulators to exercise restraint, or eliminate existing regulatory barriers, both in the regulation of primary offerings by issuers and of secondary market sales by investors to other investors. In practice, this aspect of investor protection is almost entirely ignored by state and federal regulators.

Disclosure requirements have become so voluminous that they obfuscate rather than inform, making it more difficult for investors to find relevant information.[34] Over the past 20 years, the average number of pages in annual reports devoted to footnotes and "Management's Discussion and Analysis" has quadrupled.[35] The number of words in corporate annual 10-Ks has increased from 29,996 in 1997 to 41,911 in 2014.[36] Very few investors, whether professional or retail, are willing to wade through lengthy disclosure documents, often running hundreds of pages of dense legalese, available on the SEC's EDGAR database[37] or multitudinous state blue sky filings in the forlorn hope that they will find something material to their investment decision that is not available elsewhere in shorter, more focused, more accessible materials. Many of these more accessible materials are, of course, synopses of both the mandated disclosure documents[38] and other voluntarily disclosed information, such as shareholder annual reports or materials provided to securities analysts by companies. But the fact that the vast majority of investors rely on these summary materials strongly implies that the legal requirements exceed what investors find material to their investment decisions.

The law should not, even in principle, adopt a regulatory regime that is designed to protect all investors from every conceivable ill. Even in the case of fraud, there needs to be a balancing of costs and benefits. Securities law should deter and punish fraud, but, given human nature, it can never entirely eliminate fraud. The only way to be certain that there would be no fraud would be to make business impossible. In other words, the socially optimal level of fraud is not zero.[39] While fraud imposes significant costs on the person who is defrauded, preventing fraud also has significant costs (both to government and to law-abiding firms or investors), and at some point the costs of fraud prevention exceed the benefits, however defined.[40] It is up to policymakers to assess this balance and make appropriate judgments in light of the evidence.

About three-fifths of the states conduct what is called "merit review."[41] Under merit review, state regulators decide whether a securities offering is too risky or too unfair to be offered within their state, effectively substituting their investment judgment for that of investors. Merit review is wrong in principle. Moreover, it is very unlikely that regulators make better investment decisions than investors. Lastly, merit review is expensive and it delays offerings considerably.[42]

In a free society, it is inappropriate paternalism for the government to prevent people from investing in companies that they judge to be good investment opportunities, or in which they may invest for reasons other than pecuniary gain (personal relationship or affinity for the mission of the enterprise).[43] It is a violation of their liberty and constrains their freedom. Citizens, not government, should be the judge of what is in their interest. This idea, however, is under sustained assault both by progressives and by "libertarian paternalists."[44] Both progressives and libertarian paternalists rely on the common sense findings of behavioral economics that people are not always rational, sometimes make poor decisions, and respond to sales pressure or disclosure documents differently.[45] Securities regulators are increasingly looking to this body of literature to inform or justify their actions.[46]

There are at least eight reasons to doubt that government regulators have better investment judgment than private investors investing their own money. First, there is the inability of a central regulatory authority to collect and act on information as quickly and accurately as dispersed private actors.[47] There is a reason why government has a reputation for being ponderous and slow to act.[48] In the context of securities regulation, it is highly doubtful that government regulators have a better understanding of business and the markets than those participating in those markets. Second, private investors have strong incentives to be good stewards of their own money, both in the sense of not taking unwarranted risks, and in the sense of seeking high returns. Investors may also seek to invest for reasons that do not involve pecuniary gain, including support of the persons launching an enterprise or support for a social enterprise that has a dual mission. Government regulators have an entirely different set of incentives.

Third, individuals, not government officials, know their own risk tolerance and their own portfolios. Investing in a riskier security[49] can reduce the overall risk of a portfolio if the security in question is negatively correlated or even not highly covariant with price movements of the overall portfolio.[50] Fourth, government officials are people too, and exhibit the same irrationality and tendency to sometimes make poor decisions as anyone else. There is absolutely no reason to believe that regulators are less subject to the concerns identified by behavioral economics and the "libertarian paternalists" than are others. Moreover, since most securities regulators are lawyers, and a legal education provides no training for making investment decisions, there is no particular reason to believe that they have any relevant "expertise" that will make their investment decisions objectively better than those investing their own money.

Fifth, as public-choice economics has demonstrated, government officials are not angels but act in their own self-interest.[51] This, too, is in keeping with basic common sense. Government officials have an interest in enlarging their agencies, increasing their power, and improving their employment prospects.[52] They are no more benevolent than any other group of people, including issuers and investors, and there is no reason to believe that government regulators will act in the interest of investors when those interests conflict with their own interests. The analysis of politics, and the politicians and regulators who conduct politics, should be stripped of its "romance."[53] Sixth, government officials making investments have a notoriously bad track record.[54] Perhaps the most famous example of poor entrepreneurial investment judgment by regulators is when securities regulators in Massachusetts barred Massachusetts citizens from investing in Apple Computer during its initial public offering.[55] The regulators had deemed it too risky of an investment.

Seventh, in their capacity as risk assessors, regulators have an increasingly obvious bad track record. In the most recent financial crisis, government regulators' judgment proved no better than that of private actors.[56] Eighth, it is a reasonable hypothesis that government regulators are unduly risk averse. There are at least two reasons for this: (1) Government tends to attract people who are risk averse. They have a lower risk tolerance than those making entrepreneurial investments.[57] (2) Government regulators' incentives tend to make them unduly risk averse. An investment that goes bad may make the headlines and their regulatory judgment may be criticized. An investment that never happens because it does not receive regulatory approval will not make the headlines, and their judgment will not be second-guessed.

Those states that do not undertake merit review rely on anti-fraud laws and the disclosure of the material facts by issuers but allow investors to make their own decisions, just as federal securities laws rely primarily on disclosure and anti-fraud enforcement.[58]

Current Investor-Protection Regime Is Counterproductive. While doing little to actually protect investors, the current array of state and federal regulatory excesses impose costly requirements and restrictions that have a disproportionate negative impact on small and start-up firms. Furthermore, although the Jumpstart Our Business Startups (JOBS) Act mitigated the problem, existing rules often, in practice, force these firms to use broker-dealers or venture capital firms to raise capital.[59] This often raises issuer costs. Being reliant on broker-dealers or venture capital firms to raise capital also increases the likelihood that the entrepreneur will lose control of the company he or she founded because these firms so often require large fees, a large share of the ownership of the company, or effective control of the firm when raising capital for new, unseasoned issuers. The law should allow entrepreneurs to effectively seek investors without reliance on broker-dealers or venture capital firms.

The Private-Public Distinction

The securities laws draw a distinction between public and private companies, imposing a wide variety of disclosure obligations on public companies that are not imposed on private companies. Originally, this distinction was generally one between firms whose securities were traded on stock exchanges and those that were not. The Securities Acts Amendments of 1964[60] broadened the requirements to register and make periodic disclosures to any company with 500 or more shareholders of record.[61] The 2012 JOBS Act liberalized this rule by allowing a firm to have up to 2,000 accredited investors before being required to register.[62]

It is far from clear that the current "holder of record" method of drawing the distinction between public and private firms is the best. The number of beneficial owners, public float, or market capitalization—all metrics used in connection with other securities law provisions—are probably better than the traditional shareholder-of-record measure.[63] The number of holders of record bears little relationship to any meaningful criteria of when disclosure should be mandated or when disclosure or other requirements should be increased. Its primary virtue is ease of administration.

The distinction between public and private firms is probably best thought of as between a firm with widely held ownership (public) as opposed to closely held ownership (private).[64] Given the breadth of ownership, the aggregate value of investments made, the fact that management is a more effective producer of information than multiple outside investigators with limited access to the relevant facts absent mandatory disclosure, the agent-principle or collective-action problem and various other factors imposing greater disclosure obligations on larger, widely held firms is appropriate. It is, however, important that even the disclosure and other obligations of public companies be scaled. Compliance costs have a disproportionate adverse impact on small firms, and the benefits are correspondingly less because small firms have fewer investors with less capital at risk.

Interim Securities Regulation Reform

Fundamental securities regulation reform is necessary, and discussed below, under "Fundamental Securities Regulation Reform." In the interim, there are steps that should be taken to improve the regulatory environment for small firms seeking access to the capital markets. The major components of an interim disclosure reform program are outlined below.[65]

Reducing Barriers to Raising Private and Quasi-Public Capital. The Securities Act of 1933[66] makes it generally illegal to sell securities unless the offering is registered with the SEC.[67] Making a registered offering ("going public") is a very expensive proposition and well beyond the means of most small and start-up companies. In addition, the costs of complying with continuing disclosure and other obligations of being a registered, public company are quite high.[68] The act, however, exempts various securities and transactions from this requirement.

Regulation A. The original 1933 Securities Act contained the small-issue exemption that is the basis for Regulation A. Congress has increased the dollar amount of the exemption over the years.[69] Overly burdensome regulation by state regulators and, to a lesser extent, by the SEC combined with the opportunity for issuers to avoid burdensome blue sky laws since 1996[70] via Rule 506 of Regulation D rendered Regulation A a dead letter.[71] In 2011, only one Regulation A offering was completed.[72] SEC data show that between 2009 and 2012, companies used Regulation A to raise only $73 million. Comparably sized Regulation D offerings raised $25 billion and comparably sized public offerings raised $840 million.[73] Thus, in the aggregate, over that three-year period, Regulation A accounted for less than three-tenths of 1 percent of the capital raised in offerings of $5 million or less.[74]

Title IV of the JOBS Act demonstrates a clear, bipartisan consensus that this is unacceptable and that the section 3(b) small-issues exemption needed to be rethought to promote small-business capital formation. Title IV has come to be known as Regulation A+. It allows Regulation A offerings of up to $50 million. The SEC promulgated a rule implementing Title IV that went into effect on June 19, 2015.[75] This regulation creates two tiers, but only the more heavily regulated second tier would be blue sky exempt. Smaller, "Tier 1" companies remain subject to the expense and delay of blue sky laws. Moreover, secondary trading[76] of Tier 2 securities remains subject to blue sky laws. Congress should implement the following two Regulation A reforms:

1. Congress should pre-empt state registration and qualification laws governing all Regulation A company securities. These companies have substantial initial and continuing disclosure obligations. Congress should either define covered securities to include securities sold in transactions exempt pursuant to Regulation A, or define qualified purchasers to include all purchasers of securities in transactions exempt under Regulation A, or both. The recent Regulation A+ rule would do this for primary offerings of Tier 2 securities.

2. Congress should simplify the statutory small-issue exemption. Specifically, Congress should amend Securities Act section 3(b)(1) so that Tier 1 Regulation A offerings have reasonable requirements for offering statements and periodic disclosure, and that the provisions are self-effectuating without having to wait for the promulgation of SEC regulations. The current rules are nearly as complex as those governing smaller reporting companies.

Regulation D. The Securities Act provides an exemption for offerings "not involving any public offering." Regulation D, adopted in 1982, provides a safe harbor such that offerings that are compliant with the requirements of Regulation D are deemed not to involve a public offering.[77]

Regulation D has three parts. Rule 504[78] and Rule 505[79] were meant for use by small firms. Rule 504 allows firms to raise up to $1 million annually.[80] Rule 505 allows firms to raise up to $5 million annually.[81] In practice, 99 percent of capital raised using Regulation D is raised using Rule 506.[82] This is because Rule 506 offerings, in contrast to Rule 504 or Rule 505 offerings, are exempt from state blue sky registration and qualification requirements.[83] Issuers using Rule 506, therefore, do not have to bear the expense and endure the delay of dealing with as many as 52 regulators,[84] about three-fifths of whom engage in "merit review" where regulators purport to decide whether an investment is fair or a good investment. Regulation D has become the dominant means of raising capital in the United States, particularly for entrepreneurs.[85] According to SEC data, in 2014, registered (public) offerings accounted for $1.35 trillion of new capital raised, compared to $2.1 trillion raised in private offerings. Regulation D accounted for $1.3 trillion (62 percent) of private offerings in 2014.[86]

Most Regulation D offerings are sold entirely to accredited investors because selling to non-accredited investors triggers additional disclosure requirements under Regulation D and creates other regulatory risks.[87] In general, an accredited investor is either a financial institution or a natural person who has either income greater than $200,000 ($300,000 joint) or a residence exclusive net worth of $1 million or more.[88] There is a major push by liberal organizations and state regulators to increase these thresholds dramatically.[89]

Rule 506 also permits up to 35 "sophisticated investors" to purchase Rule 506 offerings. The problem is that the regulatory definition of what constitutes a sophisticated investor is very amorphous. It turns on whether the investor has such "knowledge and experience in financial and business matters" that the investor "is capable of evaluating the merits and risks of the prospective investment."[90]

Congress should prevent the promulgation of the Regulation D amendments proposed in July 2013.[91] These rules would substantially increase the regulatory burden for smaller companies seeking to use Regulation D and have no appreciable positive impact. They would require filing three forms instead of one, and would impose a variety of other burdensome requirements.[92] In addition, a proposed temporary rule would require the mandatory submission of written general solicitation materials, including Web pages.[93]

Crowdfunding. The story of the investment crowdfunding exemption is an object lesson in how a simple, constructive idea can be twisted by the Washington legislative process into a complex morass. Representative Patrick McHenry (R–NC) introduced his Entrepreneur Access to Capital Act on September 14, 2011.[94] It was three pages long—less than one page if the actual legislative language were pasted into a Word document. It would have allowed issuers to raise up to $5 million, and limited investors to making investments equal to the lesser of $10,000 or 10 percent of their annual income.[95] The exemption would have been self-effectuating, requiring no action by the SEC in order to be legally operative. The bill reported out of Committee and ultimately passed by the House was 14 pages long.[96] By the time the Senate was done with it, it had become 26 pages long.[97] Many of the additions were authorizations for the SEC to promulgate rules or requirements that it do so. The bill was incorporated into the JOBS Act as Title III. Firms may raise no more than $1 million annually using Title III crowdfunding.[98] So it is only an option for the smallest of firms. The PDF of the October 23, 2013, proposed crowdfunding rule is 585 pages long (although double-spaced) and sought public comments on well over 300 issues raised by the proposed rule.[99] On November 16, 2015, the SEC issued its final 685-page rule.[100] These rules were effective May 16, 2016.

If Congress decides to work with the current crowdfunding statute rather than start over, there are at least eight changes that should be made if crowdfunding is to achieve its promise. Six of these changes relate to how the crowdfunding exemption operates.[101] The following two changes relate to disclosure rules for crowdfunding:[102]

1. Congress should eliminate the audit requirements in crowdfunding offerings over $500,000 required by Securities Act section 4A(b)(1)(D)(iii).

2. Congress should reduce the mandatory disclosure requirements on crowdfunding issuers. They are much too burdensome for the very small firms that are permitted to use Title III crowdfunding.

Congress would probably do better by simply starting over and replacing the existing Title III with a simpler statute more appropriately crafted for very small firms.

Other Improvements. Extremely small firms should not be forced to comply with complex securities laws, including mandatory federal disclosure requirements, to launch a business.

Congress should amend the Securities Act to create a statutory "micro-offering" safe harbor so that any offering is deemed not to involve a public offering for purposes of section 4(a)(2) if the offering (1) is made only to people with whom an issuer's officers, directors, or 10 percent or more shareholders have a substantial pre-existing relationship; (2) involves 35 or fewer purchasers; or (3) has an aggregate offering price of less than $500,000 (within a 12-month period).[103]

Reducing Regulatory Burdens on Small Public Companies

Regulation S-K[104] is the key regulation governing non-financial statement disclosures of registered (public) companies. The list of items to be disclosed pursuant to Regulation S-K runs to nearly a hundred pages of small type. Regulation S-X[105] generally governs public company financial statements in registration statements or periodic reports. The list of items to be disclosed pursuant to Regulation S-X runs to nearly a hundred pages of small type, not counting the many items incorporated by reference.[106] These two rules, including the various rules and accounting policies that they incorporate by reference (including those of the SEC, the Public Company Accounting Oversight Board, and the Financial Accounting Standards Board), impose the vast majority of the costs incurred by public companies.

The SEC 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."[107] This is probably a significant underestimate for many firms.

Costs of this magnitude make going public uneconomic for most smaller firms. Table 1 shows the composition and magnitude of the costs, according to the SEC. It also shows that the costs are disproportionately higher for firms conducting offerings of $50 million or less.

Although there have been some efforts to scale disclosure requirements, notably the emerging growth company provisions contained in Title I of the JOBS Act and the smaller reporting company rules promulgated by the SEC, public company compliance costs have grown sufficiently high that many smaller firms are "going private."[108] Sarbanes–Oxley (2002),[109] Dodd–Frank (2010),[110] and other legislation and regulatory actions have contributed to these costs. Moreover, U.S. initial public offering costs are considerably higher than those abroad.[111] Congress should implement the following public-company disclosure reforms:

1. Pre-empt blue sky registration and qualification requirements with respect to public companies not listed on national exchanges,

2. Increase the smaller reporting company threshold from $75 million to $300 million of public float and confirm the "accelerated filer" definition,[112]

3. Make all emerging growth company advantages permanent for smaller reporting companies, and

4. Improve the disclosure requirements under Regulation S-K for smaller reporting companies.[113]

TABLE 1

IPO-Related Fees

AS A PERCENTAGE OF OFFERING SIZE, 1996–2012

	All Offerings (N=4,868)	Offering $5 Million to $50 Million (N=2,017)	Offering More than $50 Million (N=2,851)
Total Fees	9.55%	11.15%	8.44%
Compliance Fees	1.39	1.91	1.03
Registration Fees	0.03	0.04	0.02
Blue Sky Fees	0.03	0.07	0.01
Accounting Fees	0.53	0.72	0.40
Legal Fees	0.80	1.08	0.60
Underwriter Fees	6.45	6.87	6.17
Printing Fees	0.32	0.47	0.22

NOTE: Figures exclude offerings from non-Canadian foreign issuers and blank-check companies.
SOURCE: U.S. Securities and Exchange Commission, Division of Economic and Risk Analysis, "Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act," *Federal Register*, Vol. 79, No. 15, January 23, 2014, p. 3978, https://www.gpo.gov/fdsys/pkg/FR-2014-01-23/pdf/2013-30508.pdf (accessed December 15, 2016).

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Fundamental Securities Regulation Reform

There is a need to fundamentally rethink the regulation of small-company capital formation. The SEC is considering reforms to the current disclosure regime. It has completed a congressionally mandated study,[114] and in April 2016 issued a Regulation S-K Concept Release seeking public comment on 340 specific issues.[115] This process, while constructive, is unlikely to result in fundamental reforms. Congress must develop and implement a coherent scaled disclosure regime.

This new disclosure framework should address both initial and continuing disclosure. It should be integrated across the various exemptions and categories of reporting companies such that larger firms with more investors and more capital at risk have greater disclosure obligations. Congress should consider 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 the regulation of issuers.

Congress should reduce the number of categories of firms issuing securities. There are currently 14 categories, each with its own set of exemptions and disclosure rules. One possibility is to establish the following three categories: (1) Private, (2) Quasi Public, and (3) Public. (See Table 2.)

In a regime consisting of such categories, companies would report based on the category they were in (private, quasi-public, or public). Blue sky laws regarding registration and qualification would be pre-empted in all cases, but state anti-fraud laws would remain operative. Private companies would have no legally mandated disclosure requirements. Disclosure requirements would be negotiated by the private parties involved much as they usually are now. A company would be deemed private if it did not engage in general solicitation, was below some specified number of beneficial owners,[116] or perhaps, some measure of non-insider share value (analogous to public float)—threshold A—and its shares were not traded on a national securities exchange, venture exchange, or alternative trading system (ATS).

Public companies could engage in general solicitation and would be (1) above a specified measure

TABLE 2

Proposal for a Reformed Disclosure Regime

Type of Issuer	Type of Solicitation		Size (Public Float/Number of Beneficial Owners)		Secondary Market Status
Private	Private	*and*	Below specified Threshold A	*and*	Not traded on a National Securities Exchange, a Venture Exchange, or an Alternative Trading System (ATS)
Quasi-Public	General	*or*	Above specified Threshold A	*and*	Not traded on a National Securities Exchange; may be traded on a Venture Exchange or an ATS
Public (Registered)	General	*and*	Above specified Threshold B	*or*	National Securities Exchange traded

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of size (threshold B) or (2) have shares traded on a national securities exchange. Disclosure obligations would be scaled based on some measure of size (probably public float). This is the category into which most full-reporting companies, smaller reporting companies, emerging-growth companies, and perhaps some Regulation A+ companies would fall.

Companies that were neither "public" nor "private" would be intermediate "quasi-public" companies. They could engage in general solicitation and sell to the public. Disclosure obligations would be scaled based on some measure of size (perhaps public float if traded on a venture exchange or an ATS; the number of beneficial owners otherwise). These are the kind of companies that are meant to use the crowdfunding, Rule 505, and Regulation A exemptions, and would include some companies that are smaller reporting companies today.

Disclosure obligations would be scaled within the quasi-public and public category (larger and smaller). Registration statements would be dramatically simplified, describing the security being offered, but the annual (10-K), quarterly (10-Q), and major event (8-K) reporting would become the core of the disclosure system rather than registration statements (except in the case of initial quasi-public offerings (transitioning from private company status) or initial public offerings (transitioning from private or quasi-public status)).

Although it is far from clear that they should be retained, some accredited investor limitations measuring wealth, income, or sophistication could be applied to private offerings should policymakers wish to limit those who may invest in private companies. In that case, however, something similar to the current section 4(a)(2) exemption should remain combined with a statutory exemption for micro issuers. Otherwise, two guys starting a bar would run afoul of the securities laws. Such a regime would constitute a major improvement over the current one. It would be simpler, result in fewer regulatory difficulties and costs, protect investors, and promote capital formation.

Fundamental Reform: More Detailed Guidance

To accomplish disclosure reform while maintaining the basic current exemption structure, Congress would need to amend:

1. **Securities Act Schedule A** (which currently contains a list of 32 disclosure requirements and is about five pages long);

2. **Securities Act sections 7 and 10** (relating to registration statements and prospectuses); and

3. **Securities Exchange Act sections 13, 14, 14A, 16, and 21E** (relating to periodic and other reports, proxies, shareholder approvals, disclosure concerning directors, officers, and principal shareholders, and the safe harbor relating to forward-looking statements).[117]

A revised Schedule A would list all disclosure requirements applicable to a fully reporting public company and also indicate which provisions did not apply to smaller reporting companies and companies falling into other categories. It would, in effect, become the roadmap with which companies had to comply for disclosure requirements.

Implementing the complete reform program outlined above would involve substantial changes to other provisions in the law, notably sections 3, 4, and 4A of the Securities Act (relating to exempted securities, exempted transactions, and crowdfunding, respectively). This would replace the current patchwork of 14 different categories, each with a different set of exemption and disclosure rules, with three major issuer categories (private, quasi-public, and public), and two scaled disclosure categories (larger and smaller) within the quasi-public and public exemption categories.

Conclusion

Because the benefits of mandatory disclosure are so much smaller than usually assumed, policymakers need to adopt a more skeptical posture toward the existing disclosure regime. The costs are significant and have dramatically increased in recent years. The adverse impact on small and start-up entrepreneurial firms, innovation, job creation, and economic growth are substantial. Moreover, disclosure requirements have become so voluminous that they defeat their alleged purpose. They obfuscate rather than inform.

Because the costs are disproportionately high and the benefits lower for smaller firms, disclosure should be scaled so that smaller firms incur lower costs. The current system—a set of 14 different disclosure regimes—is incoherent. In many cases, under current law, smaller firms have greater disclosure requirements than large firms, and the degree and type of disclosure differs significantly by the type of offering even for firms and offerings that are otherwise comparable in all meaningful respects.

Blue sky laws raise costs and create delays. States that engage in merit review are particularly problematic. There is ample evidence that blue sky laws are one of the central impediments to both primary offerings by small companies and secondary market trading in small company securities by investors. There is little evidence that the registration and qualification provisions of state blue sky laws protect investors. In fact, there is evidence that they hurt investors. State blue sky registration and qualification provisions should be pre-empted by Congress with respect to companies that have continuing reporting obligations, including public companies and those issuing securities under Regulation A or under Regulation Crowdfunding.

This *Backgrounder* outlines a program of interim reforms to improve the existing disclosure regime. It recommends specific changes to Regulation A, crowdfunding, Regulation D, and the regulation of small public companies and of secondary markets that, taken as a whole, would dramatically improve the current regulatory environment.

This *Backgrounder* also outlines a program of fundamental reform that would dramatically simplify the existing disclosure regime to the benefit of both investors and issuers. This proposal would replace the current 14 disclosure categories with three disclosure regimes—public, quasi-public, and private—and disclosure under the first two categories would be scaled based on either public float or the number of beneficial shareholders.

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Endnotes

1. There are exceptions. For example, the conflict mineral disclosure requirements do nothing to "protect investors." See Securities and Exchange Commission, 17 C.F.R. §240.13p-1, and "Conflict Minerals," Final Rule, November 13, 2012, http://www.sec.gov/rules/final/2012/34-67716.pdf (accessed November 15, 2016). See also David R. Burton, "How Dodd–Frank Mandated Disclosures Harm, Rather than Protect, Investors," Heritage Foundation *Backgrounder* No. 4526, March 10, 2016, http://www.heritage.org/research/reports/2016/03/how-doddfrank-mandated-disclosures-harm-rather-than-protect-investors.
2. For a more complete discussion of the economic importance of entrepreneurship and existing impediments to entrepreneurship, see David R. Burton, "Building an Opportunity Economy: The State of Small Business and Entrepreneurship," testimony before the Committee on Small Business, U.S. House of Representatives, March 4, 2015, http://www.heritage.org/research/testimony/2015/building-an-opportunity-economy-the-state-of-small-business-and-entrepreneurship.
3. Rule 502(b) imposes significantly greater disclosure requirements on issuers that sell to non-accredited investors in both Rule 505 and Rule 506(b) offerings.
4. *Restatement of the Law Second, Torts*, Vol. 3 (Philadelphia, PA: American Law Institute, 1977), § 525 Liability for Fraudulent Misrepresentation; § 526 Conditions Under Which Misrepresentation Is Fraudulent (Scienter); § 529 Representation Misleading Because Incomplete; and §551 Liability for Nondisclosure.
5. Securities fraud was illegal long before New Deal–era federal securities laws or even earlier state blue sky laws were enacted. Stuart Banner, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690–1860* (Cambridge, MA: Cambridge University Press, 2002). See also Frank H. Easterbrook and Daniel R. Fischel, "Mandatory Disclosure and the Protection of Investors," *Virginia Law Review*, Vol. 70 (1984), p. 669, http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2176&context=journal_articles (accessed November 15, 2016); Gordon Walker, "Securities Regulation, Efficient Markets and Behavioural Finance: Reclaiming the Legal Genealogy," *Hong Kong Law Journal*, Vol. 36, No. 3 (2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1099512 (accessed November 15, 2016); and Paul G. Mahoney,*Wasting a Crisis: Why Securities Regulation Fails* (Chicago: University Of Chicago Press, 2015).
6. Securities Exchange Act of 1934 section 10(b) [15 U.S. Code § 78j(b)], regulation of the use of manipulative and deceptive devices. See also 17 C.F.R. 240.10b-5, Employment of manipulative and deceptive devices.
7. State securities laws are known as blue sky laws. For a discussion of the history of blue sky laws, see Jonathan R. Macey and Geoffrey P. Miller, "Origin of the Blue Sky Laws," *Texas Law Review*, Vol. 70, No. 2 (1991), pp. 347–397, http://digitalcommons.law.yale.edu/fss_papers/1641/ (accessed November 15, 2016), and Paul G. Mahoney, "The Origins of the Blue Sky Laws: A Test of Competing Hypotheses," UVA *Law & Economics Research Paper* No. 01-11, December 2001, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=296344 (accessed November 15, 2016). See, for instance, section 501 of the 2002 Uniform Securities Act, http://www.uniformlaws.org/shared/docs/securities/securities_final_05.pdf (accessed October 31, 2016).
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42. Rutheford B. Campbell Jr., "The Insidious Remnants of State Rules Respecting Capital Formation," *Washington University Law Quarterly*, Vol. 78 (2000), pp. 407–434, http://digitalcommons.law.wustl.edu/cgi/viewcontent.cgi?article=1439&context=lawreview (accessed November 16, 2016); Henry G. Manne and James S. Mofsky, "What Price Blue Sky: State Securities Laws Work Against Private and Public Interest Alike," in *The Collected Works of Henry G. Manne*, Vol. 3 (Liberty Fund, 1996); Therese H. Maynard, "The Future of California's Blue Sky Law," *Loyola of Los Angeles Law Review*, Vol. 30 (1997), pp. 1531–1556, http://digitalcommons.lmu.edu/cgi/viewcontent.cgi?article=2067&context=llr (accessed November 16, 2016); Mark A. Sargent, "A Future for Blue Sky," *University of Cincinnati Law Review*, Vol. 62 (1993), pp. 471–512; James S. Mofsky and Robert D. Tollison, "Demerit in Merit Regulation," *Marquette Law Review*, Vol. 60 (1977), pp. 367–378; James S. Mofsky, *Blue Sky Restrictions On New Business Promotions* (Matthew Bender & Company, 1971); and John P. A. Bell and Stephen W. Arky, "Blue Sky Restrictions on New Business Promotions," *The Business Lawyer*, Vol. 27, No. 1 (November 1971), pp. 361–365.
43. A discussion of the role of benefit corporations (or benefit LLCs) and social enterprises is beyond the scope of this *Backgrounder*. However, it is the strong contention of the author that if there is full disclosure, and investors understand the dual mission of the enterprise, investors should be free to invest in such enterprises, and the founders of such enterprises should be free to sell securities in such enterprises.
44. Christine Jolls, Cass R. Sunstein, and Richard H. Thaler, "A Behavioral Approach to Law and Economics," Yale Law School *Faculty Scholarship Series Paper* No. 1765, 1998, http://digitalcommons.law.yale.edu/fss_papers/1765 (accessed November 16, 2016); Richard H. Thaler and Cass R. Sunstein, "Libertarian Paternalism," American Economic Association Papers & Proceedings, May 2003, Cass R. Sunstein and Richard H. Thaler, "Libertarian Paternalism Is Not An Oxymoron," *The University of Chicago Law Review*, Vol. 70 (2003), pp. 1166–1187, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=405940 (accessed November 16, 2016); and Ted O'Donoghue and Matthew Rabin, "Studying Optimal Paternalism, Illustrated by a Model of Sin Taxes," American Economic Association Papers & Proceedings, May 2003, pp. 186–191. See also Glen Whitman, "Against the New Paternalism: Internalities and the Economics of Self-Control," Cato Institute *Policy Analysis* No. 563, February 22, 2006, http://object.cato.org/sites/cato.org/files/pubs/pdf/pa563.pdf (accessed November 16, 2016).
45. Jolls, Sunstein, and Thaler, "A Behavioral Approach to Law and Economics," and Russell B. Korobkin and Thomas S. Ulen, "Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics," *California Law Review*, Vol. 88, No. 4 (2000), pp. 1051–1144, http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1490&context=californialawreview (accessed November 16, 2016).
46. See, for example, Kara M. Stein, "Remarks Before the Consumer Federation of America's 27th Annual Financial Services Conference," U.S. Securities and Exchange Commission, December 4, 2014, http://www.sec.gov/News/Speech/Detail/Speech/1370543593434#.VITlxsmwU0Q (accessed November 16, 2016); Library of Congress and U.S. Securities and Exchange Commission, "Annotated Bibliography on the Behavioral Characteristics of U.S. Investors," August 2010, https://www.sec.gov/investor/locinvestorbehaviorbib.pdf (accessed November 16, 2016); and Securities and Exchange Commission Investor Advisory Committee, Minutes of May 17, 2010, meeting in Washington, DC, http://www.sec.gov/spotlight/invadvcomm/iacmeeting051710-agenda.pdf (accessed November 16, 2016).
47. Friedrich A. Hayek, "The Pretence of Knowledge," Prize Lecture to the Memory of Alfred Nobel, December 11, 1974, http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1974/hayek-lecture.html (accessed November 16, 2016); Friedrich A. Hayek, *Individualism and Economic Order* (1948), http://mises.org/books/individualismandeconomicorder.pdf (accessed November 16, 2016); Friedrich A. Hayek, "The Use of Knowledge in Society," *American Economic Review*, Vol. 34, No. 4 (September 1945), pp. 519–530, http://www.econlib.org/library/

Essays/hykKnw1.html (accessed November 16, 2016); and Friedrich A. Hayek, "Economics and Knowledge," *Economica* (February 1937), pp. 33–54, http://www.econlib.org/library/NPDBooks/Thirlby/bcthLS3.html (accessed November 16, 2016).

48. Peter H. Schuck, *Why Government Fails So Often: And How It Can Do Better* (Princeton, NJ: Princeton University Press, 2014); Clifford Winston, *Government Failure versus Market Failure: Microeconomics Policy Research and Government Performance* (Washington, DC: American Enterprise Institute and the Brookings Institution, 2006); and William S. Peirce, *Bureaucratic Failure and Public Expenditure* (Academic Press, 1981).

49. A security with a high degree of unique risk (as opposed to market risk or systemic risk).

50. This is often called a negative beta or low beta investment. For a discussion of these issues, see, for example, "Introduction to Risk, Return and the Opportunity Cost of Capital," in Richard A. Brealey, Stewart C. Meyers, and Franklin Allen, *Principles of Corporate Finance*, 8th Edition (New York: McGraw–Hill, 2006), and most introductory finance textbooks.

51. Gordon Tullock, Authur Seldon and Gordon L. Brady, *Government Failure: A Primer in Public Choice* (Washington, DC: Cato Institute, 2002).

52. For a specific discussion of this issue with respect to securities regulation, see Enriques and Gilotta, "Disclosure and Financial Market Regulation."

53. William F. Shughart, "Public Choice," in David R. Henderson, ed., *Concise Encyclopedia of Economics* (Liberty Fund, 2007), http://www.econlib.org/library/Enc/PublicChoice.html (accessed November 16, 2016). James M. Buchanan, *The Collected Works of James M. Buchanan*, *The Logical Foundations of Constitutional Liberty*, Vol. 1, (Liberty Fund, 1999), p. 46, from a lecture originally given at the Institute for Advanced Studies in Vienna, Austria, in 1979. "My primary title for this lecture, 'Politics without Romance,' was chosen for its descriptive accuracy. Public choice theory has been the avenue through which a romantic and illusory set of notions about the workings of governments and the behavior of persons who govern has been replaced by a set of notions that embody more skepticism about what governments can do and what governors will do, notions that are surely more consistent with the political reality that we may all observe about us. I have often said that public choice offers a 'theory of governmental failure' that is fully comparable to the 'theory of market failure' that emerged from the theoretical welfare economics of the 1930's and 1940's."

54. Burton W. Folsom Jr. and Anita Folsom, *Uncle Sam Can't Count: A History of Failed Government Investments, from Beaver Pelts to Green Energy* (Broadside Books, 2014); Howard Pack and Kamal Saggi, "The Case for Industrial Policy: A Critical Survey," World Bank *Policy Research Working Paper* No. 3839, February 2006, http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-3839 (accessed November 16, 2016). ("Overall, there appears to be little empirical support for an activist government policy even though market failures exist that can, in principle, justify the use of industrial policy.")

55. Richard E. Rustin and Mitchell C. Lynch, "Apple Computer Set to Go Public Today: Massachusetts Bars Sale of Stock as Risky," *The Wall Street Journal*, December 12, 1980, http://online.wsj.com/public/resources/documents/AppleIPODec12_1980_WSJ.pdf (accessed November 16, 2016).

56. For example, then Federal Reserve Board Chairman Ben Bernanke said in February 2008, "Among the largest banks, the capital ratios remain good and I don't anticipate any serious problems of that sort among the large, internationally active banks that make up a very substantial part of our banking system." "Fed Chairman: Some Small US Banks May Go Under," CNBC, February 28, 2008, http://www.cnbc.com/id/23390252 (accessed November 16, 2016). Only seven months later, the Emergency Economic Stabilization Act of 2008 established the Troubled Asset Relief Program (TARP), with Bernanke's support, to bail out the big banks.

57. Michael J. Roszkowski1 and John E. Grable, "Evidence of Lower Risk Tolerance Among Public Sector Employees in Their Personal Financial Matters," *Journal of Occupational and Organizational Psychology*, Vol. 82, No. 2 (June 2009), pp. 453–463.

58. There is, however, a creeping introduction of a type of merit review into federal securities laws. Notably, Title III of the JOBS Act limits investments to a specified percentage of income or net worth, and the new Regulation A+ rules would do the same. It does not take too much imagination to envision a federal regulatory regime that has specified diversification or other requirements for most investors that would seriously limit investors' options, and which most entrepreneurs starting a business with their own funds would fail. Indeed, FINRA Rule 2111 relating to suitability requirements already imposes the broad outlines of such a system for transactions recommended by a broker-dealer. The recently finalized Department of Labor fiduciary standards under the Employee Retirement Income Security Act (ERISA) raise similar issues. Department of Labor, "Definition of the Term 'Fiduciary'; Conflict of Interest Rule—Retirement Investment Advice," Final Rule, *Federal Register*, Vol. 81, No. 68 (April 8, 2016), pp. 20946–21002, http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28806 (accessed November 16, 2016).

59. Examples would include the SEC's continued limitations on paying finders (or private placement brokers) who bring capital to a small business, limits on peer-to-peer lending, the unduly restrictive rules governing Regulation D general solicitation, and the crowdfunding rules (and proposed FinCEN rules) that would make non-broker-dealer funding portals uneconomic. Moreover, the sheer complexity of SEC and FINRA regulation of broker-dealers acts to limit competition and to create a cartel, resulting in higher broker-dealer fees than would exist in a genuinely competitive market. Regarding the proposed FinCEN rules, see David R. Burton comments to FinCEN Director Jennifer Shasky Calvery on "Amendments to the Definition of Broker or Dealer in Securities," June 3, 2016, https://www.regulations.gov/contentStreamer?documentId=FINCEN-2014-0005-0006&attachmentNumber=1&disposition=attachment&contentType=pdf (accessed November 17, 2016). Regarding crowdfunding, see David R. Burton, comments to SEC Secretary Elizabeth M. Murphy on "Crowdfunding," February 3, 2014, https://www.sec.gov/comments/s7-09-13/s70913-192.pdf (accessed November 17, 2016). With respect to the other issues, see David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation *Backgrounder*, forthcoming.

60. Public Law 467, 88th Cong., 2nd Sess. (August 20, 1964). See also Richard M. Phillips and Morgan Shipman, "An Analysis of the Securities Acts Amendments of 1964," *Duke Law Journal* (1964), http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1941&context=dlj (accessed November 17, 2016).
61. See section 12(g) of the Securities Exchange Act. Note: "Holder of record" is not the same as beneficial owner. Most investors hold their stock under "street name" so that all of the stock held by various customers of a particular broker-dealer is held on the records of the company as one holder of record—the broker-dealer. In addition, many investors may combine to form and invest in a special-purpose vehicle that, in turn, actually invests in the company. The special-purpose vehicle counts as only one shareholder of record. The regulations do not require the issuer to "look through" the special-purpose-vehicle investor. In addition, mutual funds, closed-end funds, or private-equity funds are, in effect, entities that represent the investment of many individual investors, yet they, too, would constitute just one holder of record.
62. In addition, under the JOBS Act, investors who bought securities pursuant to the Title III crowdfunding exemption are not counted toward the section 12(g) limit.
63. For a discussion of these issues, see Donald C. Langevoort and Robert B. Thompson, "'Publicness' in Contemporary Securities Regulation After the JOBS Act," *Georgetown Law Journal*, Vol. 101 (2013), pp. 337–386, http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1985&context=facpub (accessed November 17, 2016).
64. Regulation A and crowdfunding securities are public in the sense they may be sold to all investors, and the securities are not restricted securities (in the case of crowdfunding, after one year). They are not public in the sense that the issuer is not subject to the requirements of a reporting company. The term quasi-public is meant to encompass these types of companies, and companies that would be in a similar situation under alternative regulatory regimes.
65. They are discussed in greater detail (along with many non-disclosure-related reforms) in Burton, "Improving Entrepreneurs' Access to Capital."
66. The Securities Act of 1933 (May 27, 1933), Public Law 73–22, 48 Stat. 74, 15 U.S. Code §77a et seq. (as amended through Public Law 112–106, April 5, 2012), https://www.sec.gov/about/laws/sa33.pdf (accessed November 17, 2016).
67. See the Securities Act of 1933, §5.
68. The SEC 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." Proposed Rules, "Crowdfunding," *Federal Register*, Vol. 78, No. 214 (November 5, 2013), p. 66509 (col. 2), http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf (accessed November 17, 2016).
69. Securities Act of 1933, §3(b); 15 U.S. Code 77c(b). It was originally $100,000 and was increased to $300,000 in 1945, to $500,000 in 1970, to $2 million in 1978, and to $5 million in 1980. In 2012, the JOBS Act created section 3(b)(2), which allows certain Regulation A offerings to raise as much as $50,000,000. This is so-called Regulation A+.
70. See section 102 of the National Securities Markets Improvement Act of 1996 [Public Law 104–290, October 11, 1996] incorporating the Capital Markets Efficiency Act of 1996 as section 18(b)(4)(E) of the Securities Act (15 U.S. Code 77r(b)(4)(E)), (treating as covered securities those securities not involving a public offering under Securities Act section 4(a)(2)). Rules 504 and 505 were promulgated under Securities Act section 3(b) and therefore transactions using these rules are not blue sky exempt.
71. See, for instance, Rutheford B. Campbell Jr., "Regulation A: Small Businesses' Search for a Moderate Capital," *Delaware Journal of Corporate Law*, Vol. 31 (2006), pp. 77–123, http://uknowledge.uky.edu/cgi/viewcontent.cgi?article=1125&context=law_facpub (accessed November 17, 2016); Stuart R. Cohn and Gregory C. Yadley, "Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns," *New York University Journal of Law and Business*, Vol. 4, No. 1 (Fall 2007), pp. 1–87, http://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1257&context=facultypub (accessed November 17, 2016); and Government Accountability Office, "Factors that May Affect Trends in Regulation A Offerings," GAO-12-839, July 2012, http://www.gao.gov/assets/600/592113.pdf (accessed November 17, 2016).
72. Government Accountability Office, "Factors that May Affect Trends in Regulation A Offerings," p. 9.
73. "Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act," *Federal Register*, Vol. 79, No. 15 (January 23, 2014), p. 3928, http://www.gpo.gov/fdsys/pkg/FR-2014-01-23/pdf/2013-30508.pdf (accessed November 17, 2016).
74. $73 million of $25,840 million. If section 4(a)(2) private offerings made without use of the Regulation D safe harbor were considered, the percentage would be substantially lower still.
75. "Amendments for Small and Additional Issues Exemptions Under the Securities Act," *Federal Register*, Vol. 80, No. 75 (April 20, 2015), pp. 21806–21925, http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-07305.pdf (accessed November 17, 2016).
76. A primary offering is when a company (an issuer) sells securities to an investor. A secondary offering is when an investor sells a security to another investor. A secondary market is a market, such as a stock exchange, where investors trade securities among themselves.
77. "Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers of Sales" (Release No. 33-6389), *Federal Register*, Vol. 47 (March 16, 1982), p. 11251. Regulation D is found at 17 C.F.R. §230.500 through §230.508.
78. 17 C.F.R. §230.504. See also Securities and Exchange Commission, "Fast Answers: Rule 504 of Regulation D," http://www.sec.gov/answers/rule504.htm (accessed November 17, 2016).
79. 17 C.F.R. §230.505. See also Securities and Exchange Commission, "Fast Answers: Rule 505 of Regulation D," http://www.sec.gov/answers/rule505.htm (accessed November 17, 2016).
80. Rule 504 offerings are exempt from the additional disclosure requirements for sales to non-accredited investors. See Rule 504(b)(1). General solicitation is permitted only in certain specified circumstances.

81. Rule 505 allows up to 35 non-accredited investors, but investments by non-accredited investors trigger additional disclosure requirements under Rule 502(b).
82. Vladimir Ivanov and Scott Bauguess, "Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009–2012," U.S. Securities and Exchange Commission, July 2013, p. 7, http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf (accessed November 17, 2016).
83. This has been true since the passage of The National Securities Markets Improvement Act (NSMIA) of 1996, which amended section 18 of the Securities Act (15 U.S. Code 77r) to exempt from state securities regulation any "covered security." 15 U.S. Code 77r(b)(4)(E) provides that a "security is a covered security with respect to a transaction that is exempt from registration under this subchapter pursuant to…commission rules or regulations issued under section 77d(2) of this title, except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under section 77d(2) of this title that are in effect on September 1, 1996. Section 77d(2) is a reference to section 4(2) of the Securities Act (now section 4(a)(2)), to wit, transactions by an issuer not involving any public offering. Only Rule 506 of Regulation D relied on this provision. See "Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers of Sales," *Federal Register*, Vol. 47 (March 16, 1982), p. 11251. Rule 504 and Rule 505 rely instead on section 3(b) of the Securities Act. See 17 C.F.R. 230.504(a) and 17 C.F.R. 230.505(a). Accordingly, Rule 504 and Rule 505 offerings are not treated as covered securities by the SEC or the state regulators.
84. Fifty states, the District of Columbia, and the SEC.
85. Ivanov and Bauguess, "Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009–2012," pp. 7–9, and 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.
86. Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, "Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009–2014," U.S. Securities and Exchange Commission, October 2015, https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf (accessed November 17, 2016).
87. Rule 502(b).
88. 17 C.F.R. 230.501(a) [SEC Rule 501]).
89. For details, see Burton, "Don't Crush the Ability of Entrepreneurs and Small Businesses to Raise Capital."
90. Rule 501(e) excludes all accredited investors from the calculation of the number of purchasers. Rule 506(b)(2)(ii) requires that "each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description." The shorthand for this requirement is that each purchaser must be a "sophisticated investor."
91. Release No. 33–9416; Release No. 34– 69960; Release No. IC–30595; File No. S7–06–13; RIN 3235–AL46, "Amendments to Regulation D, Form D and Rule 156," *Federal Register*, Vol. 78, No. 142 (July 24, 2013), pp. 44806–44855, and Release No. 33-9458; Release No. 34–70538; Release No. IC–30737; File No. S7–06–13; RIN 3235–AL46; "Amendments to Regulation D, Form D and Rule 156; Re-Opening of Comment Period," *Federal Register*, Vol. 78, No. 192 (October 3, 2013), p. 61222, http://www.sec.gov/rules/proposed/2013/33-9416.pdf (accessed November 17, 2016).
92. However, filing a simple closing Form D indicating the amount actually raised is justified by the need to have improved information about this critical market.
93. This requirement would apply to companies making 506(c) offerings as permitted by Title II of the JOBS Act. See David R. Burton, comments to SEC Secretary Elizabeth M. Murphy on "Amendments to Regulation D, Form D and Rule 156," November 4, 2013, http://www.sec.gov/comments/s7-06-13/s70613-462.pdf (accessed November 17, 2016).
94. H.R. 2930, 112th Cong., http://www.gpo.gov/fdsys/pkg/BILLS-112hr2930ih/pdf/BILLS-112hr2930ih.pdf (accessed November 17, 2016).
95. It also excluded crowdfunding investors from the holders-of-record count, pre-empted blue sky laws, and entitled issuers to rely on investor self-certification for income level.
96. H.R. 2930, 112th Cong.
97. Senate Amendment to Title III of H.R. 3606, http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606eas/pdf/BILLS-112hr3606eas.pdf (accessed November 17, 2016).
98. Securities Act, Section 4(a)(6).
99. There were 284 actual requests for comment, but many of them are multipart requests. Securities and Exchange Commission, "Proposed Rules: Crowdfunding," October 23, 2013, http://www.sec.gov/rules/proposed/2013/33-9470.pdf (accessed November 17, 2016).
100. "Securities and Exchange Commission: Crowdfunding," *Federal Register*, Vol. 80, No. 220 (November 16, 2015), pp. 71388–71615, https://www.sec.gov/rules/final/2015/33-9974.pdf (accessed November 17, 2016).
101. For a detailed discussion, see Burton, "Improving Entrepreneurs' Access to Capital."

102. The other proposed changes are: (1) Permit funding portals to be compensated based on the amount raised by the issuer; (2) make it clear that funding portals are not issuers and not subject to the issuer liability provisions; (3) repeal the restriction on providing investment advice entirely or, alternatively, explicitly permit "impersonal investment advice," and make it clear that a portal may bar an issuer from its platform if the portal deems an offering to be of inadequate quality without fear of liability to issuers or investors and that this would not constitute providing prohibited investment advice; (4) reduce the administrative and compliance burden on funding portals; (5) allow intermediaries to rely on good-faith efforts by third-party certifiers for purposes of complying with the investment limitation in section (4)(a)(6)(B); and (6) amend the Bank Secrecy Act to make it clear that federal "Know Your Customer" rules do not apply to finders, business brokers, or crowdfunding Web portals that do not hold customer funds.
103. The micro-offering exemption incorporated into the House-passed H.R. 2357 (114th Cong.), while constructive, is much too narrow. Very few firms will qualify for the exemption. H.R. 4850 (114th Cong.) would have had a much more pronounced positive impact for small firms.
104. 17 C.F.R. Part 229.
105. 17 C.F.R. Part 210.
106. For a short discussion of each item, see Securities and Exchange Commission Division of Corporation Finance, *Financial Reporting Manual*, March 17, 2016, https://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf (accessed November 17, 2016).
107. Proposed Rules, "Crowdfunding," *Federal Register*, Vol. 78, No. 214 (November 5, 2013), p. 66509 (col. 2).
108. See, for instance, Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation*, November 30, 2006, http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (accessed November 18, 2016); Ehud Kamar, Pinar Karaca-Mandic, and Eric Talley, "Going-Private Decisions and the Sarbanes–Oxley Act of 2002: A Cross-Country Analysis," Kauffman–RAND Institute for Entrepreneurship Public Policy, February 2008, http://www.rand.org/content/dam/rand/pubs/working_papers/2008/RAND_WR300-2.pdf (accessed November 18, 2016); and Robert P. Bartlett III, "Going Private but Staying Public: Reexamining the Effect of Sarbanes–Oxley on Firms' Going-Private Decisions," *University of Chicago Law Review*, Vol. 76, No. 1 (2009), pp. 7–44, https://lawreview.uchicago.edu/sites/lawreview.uchicago.edu/files/uploads/76.1/76_1_Bartlett.pdf (accessed November 18, 2016).
109. The Sarbanes–Oxley Act of 2002, Public Law 107–204, July 30, 2002.
110. The Dodd–Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, July 21, 2010.
111. See, for instance, Michele Meoli et al., "The Cost of Going Public: A European Perspective," *International Journal of Economics and Management Engineering*, Vol. 2, No. 2 (May 2012).
112. 17 C.F.R. 240.12b-2. The SEC, to its credit, recently proposed increasing the threshold to $250 million. See "Amendments to Smaller Reporting Company Definition," Proposed Rule, *Federal Register*, Vol. 81, No. 127 (July 1, 2016), pp. 43130–43154, https://www.gpo.gov/fdsys/pkg/FR-2016-07-01/pdf/2016-15674.pdf (accessed November 18, 2016).
113. David R. Burton, "Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth," Heritage Foundation *Backgrounder* No. 2924, June 20, 2014, http://www.heritage.org/research/reports/2014/06/reducing-the-burden-on-small-public-companies-would-promote-innovation-job-creation-and-economic-growth.
114. Securities and Exchange Commission, *Report on Review of Disclosure Requirements in Regulation S-K, as Required by Section 108 of the Jumpstart Our Business Startups Act*, December 2013, https://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf (accessed November 18, 2016).
115. "Business and Financial Disclosure Required by Regulation S–K," Concept Release, *Federal Register*, Vol. 81, No. 78 (April 22, 2016), https://www.gpo.gov/fdsys/pkg/FR-2016-04-22/pdf/2016-09056.pdf (accessed November 18, 2016).
116. There would need to be a reasonable, administrable look-through rules if beneficial ownership were to replace the holder of record threshold. However, since in the contemplated regulatory regime, the impact of the step up from private to quasi-public status would not be as discontinuous as the step up from private to public today, this break point would be of less importance.
117. In addition, conforming amendments elsewhere in the Securities Act and the Securities Exchange Act would need to be made.