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before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

Legislative Proposals to Increase
Access to Capital

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Chairman Crapo, Ranking Member Brown, members of the Committee, it is an honor and a privilege to appear before the Committee today. Thank you for this opportunity. I am a Professor of Law at the University of Mississippi School of Law, where I teach corporate and securities law. I have previously practiced securities law at the law firm of WilmerHale, been an Assistant Chief Counsel at the SEC, and testified before Congress on securities law issues on 24 prior occasions.

This testimony discusses aspects of four bills before the Committee:

- S. 2126, Fostering Innovation Act of 2017;
- S. 588, Helping Angels Lead Our Startups Act or the HALOS Act;
- S. 2347, Encouraging Public Offerings Act of 2018; and
- S. 1117, Consumer Financial Choice and Capital Markets Protection Act of 2017.

Executive Summary

One premise of the JOBS Act and some of the bills presented today is that excessive regulation wrought by the Sarbanes-Oxley and Dodd-Frank Acts has damaged U.S. capital markets by causing a dramatic decline in the number of U.S. IPOs and public companies. This is a myth. The facts simply do not support this claim. First, the analytical methods applied by those who make this claim are not empirically valid. Second, even if they were empirically valid, one could make an even more persuasive claim that regulation has *improved* the market for public companies in the U.S. The market capitalization of U.S.-listed companies has followed a steady upward climb interrupted only by market crashes and scandals. In both of the instances of short-term declines in market capitalization this century, it was balanced, effective regulation – the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010 – that helped restore investor confidence and return public market wealth to an upward path. At the same time that Congress claims to support increasing the number of IPOs and public companies, it proposes to de-regulate private capital markets, thereby providing greater incentives for companies to stay private.

The Fostering Innovation Act is fundamentally inconsistent with primary premise of the regulation of sales of securities to retail investors, which is that investors will be provided with access to material information about the offering and that the integrity of the information has been verified by an independent party. The Act will further fracture the meaning of "U.S. public company" – the world's gold standard – and continue to dilute the value of the U.S. financial markets. The Act's premise – that the additional cost of a 404(b) audit for companies with up to a ***$699 million public float*** is overly burdensome – has no sound basis. The academic literature shows that the economic benefits of Section 404(b) outweigh the costs, and the SEC has found that those costs have been steadily declining. The Act would likely affect less than 2% of public companies and would have no material effect on the number of IPOs or public companies.

The HALOS Act represents the de facto repeal of offering regulation. The Act will allow virtually any type of public entity to advertise and host an event that can be attended by any person for the purpose of any issuer pitching a securities offering. The Act permits public notices that specifically advertise a forum as a securities offering pitch (with only references to a "specific offering of security by" an issuer being prohibited). The Act purports to require that "no specific

information regarding an offering of securities by the issuer [be] communicated or distributed by or on behalf of the issuer," and then creates an exception that covers all of the essential specific information that an issuer would want to communicate regarding its offering. The Act fits a pattern of designing the system of private and public offerings so as to give informational advantages to large investors that are denied to retail investors. If all offerings are permitted to be public, all public offering information provided to investors should be publicly available.

The Encouraging Public Offerings Act would amend exemptions that will exacerbate the incoherent erosion of the distinction between registered and unregistered offerings and further disadvantage of retail investors vis-a-vis large investors. Expanding the category of issuers that are permitted to keep their registration statement secret while engaging in roadshows facilitates the communication of fraudulent or inaccurate information prior to the filing of a registration statement and provides large investors with a distinct informational advantage over retail investors. Current law permits an issuer to file a public registration statement a mere 15 days before its IPO and to make materials amendment even closer to that date. This already provides inadequate time for investors to evaluate an issuer's registration statement. The Act's shortening the time period will make this problem worse.

I testified before Congress in opposition to money market fund reforms before they were adopted by the SEC. My views have not changed, but circumstances have, and in light of those changed circumstances I cannot support the Consumer Financial Choice and Capital Markets Protection Act of 2017. My position is based on four concerns. First, in my opinion, there has not been a thorough empirical analysis of the likely effect of the Act. I recommend that Congress ask the SEC to conduct such an analysis. Second, I do not have faith in the SEC's ability to manage money market fund risk based on its actions before and after the Reserve Fund failed. Third, I am concerned that banking regulators would seize upon another money market fund failure (albeit highly unlikely) as an excuse to impose new regulations on all funds that could cripple America's mutual fund sector. Finally, Congress has stripped banking regulators of powers necessary for them to take appropriate emergency action in the event of another severe liquidity event, and the Act would impose even greater restrictions.

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I. The Myth of the Regulation's Adverse Effect on IPOs and Public Companies

One premise of the JOBS Act and some of the bills presented today is that excessive regulation wrought by the Sarbanes-Oxley and Dodd-Frank Act's has damaged U.S. capital markets by causing a dramatic decline in the number of U.S. IPOs and public companies. This is a myth.[1] The facts simply do not support this claim. First, the analytical methods applied by those who make this claim are not empirically valid. Second, even if they were empirically valid, one could make an even more persuasive claim that regulation has *improved* the market for public companies in the U.S. The market capitalization of U.S.-listed companies has followed a steady upward climb interrupted only by market crashes and scandals. In both of the instances of short-term declines in market capitalization this century, it was balanced, effective regulation – the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010 – that helped restore investor confidence and return public market wealth to an upward path.

The most harmful myth underlying some of today's bills is the apparent acceptance of invalid methodologies. Drawing a direct causal relationship between the number of U.S. IPOs and regulation and the Sarbanes-Oxley and Dodd-Frank Acts are not statistically valid. The incidence of IPOs depends on a wide variety of factors, many of which are generally unrelated.[2] There are just as many reasonable arguments that regulation has resulted in *more* IPOs and *more* public companies than there otherwise would have been.[3] But these conclusions would be just as statistically invalid as contrary conclusions.

Even if drawing such causal conclusions were statistically valid, the data do not support the conclusion that the Sarbanes-Oxley and Dodd-Frank Acts harmed public markets. For example, the bulk of the significant decline in U.S. IPOs from 1996 to the present occurred *before* the enactment of the Acts. The JOBS Act purported to be designed to increase the number of U.S. IPOs, but the number of U.S. IPOs is *lower* now than it was when the JOBS Act was passed. Critics contend that Section 404(b) of the Sarbanes-Oxley Act, the regulatory requirement most often cited as suppressing IPO activity, has made public company status too expensive for small firms, but ***Section 404(b) has never applied to***

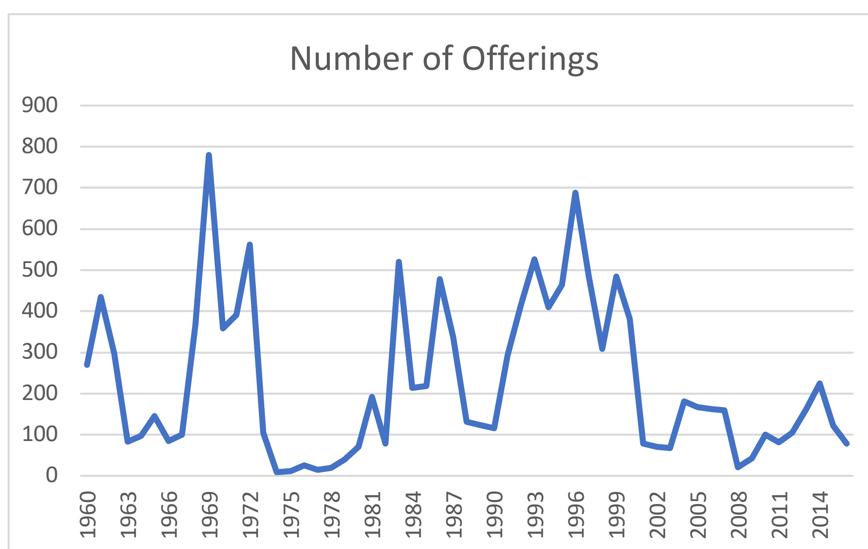
[1] Another influential myth is the outsized contribution that small businesses make to job creation. This topic is beyond the scope of my testimony other than to note that: (1) the relevant measure of value should be *net* job-creation, not job-creation, (2) many studies data show that small companies are *less effective* job-creators than are large companies, and (3) companies often increase net social wealth through *job-destruction* by producing goods and services at lower costs with fewer workers (and the efficient allocation of capital is necessary for quickly developing the market of resulting new jobs, such as servicing robots). *See, e.g.,* Robert Atkinson and Michael Lind, Big is Beautiful: Debunking the Myth of Small Business (MIT Press 2018); John Haltiwanger, Ron S. Jarmin and Javier Miranda, *Who Creates Jobs? Small versus Large versus Young*, 95 The Review of Economics and Statistics 347 (May 2013) (finding no systematic relationship between firm size and growth); Steven J. Davis, John Haltiwanger, and Scott Schuh, *Small Business and Job Creation: Dissecting the Myth and reassessing the Facts*, NBER Working Paper 4492 (October 1993). Some claims are so absurd as to be offensive, such as the suggestion that growing income gap between rich and poor Americans may be attributable to the American investors "being shut out of the most attractive offerings." *See* The Promise of Market Reform, NASDAQ at 2 (2017) ("income inequality could worsen as average investors become increasingly shut out of the most attractive offerings") (statement of NASDAQ President and CEO Adena Friedman).

[2] *See, e.g.*, Tom Braithwaite. *SEC's Power to Revive IPO Market Limited Without Radical Measures*, On Wall Street (May 12, 2017) ("The dwindling numbers of public companies — down from more than 9,000 20 years ago to fewer than 6,000 today — is caused more by an increase in mergers.") ("*SEC's Power to Revive IPO Market*"); *Access to Capital and Market Liquidity*, Division of Economic and Risk Analysis, SEC at 4 (August 2017) ("*SEC Capital Access Report*" ("It is difficult to disentangle the many contributing factors that influence IPO dynamics.").

[3] An SEC report specifically rejected the hypothesis that "total primary market security issuance is lower after the enactment of the Dodd-Frank Act." *Id.* at 5.

the vast majority of U.S. IPOs or public companies because it has never applied to non-accelerated issuers.

The claim that the number of U.S. IPOs has declined reflects egregious cherry picking. Proponents of weakening regulation invariably choose a year between 1995 and 2000 from which to measure the change in the number of IPOs, but that period represents a significant departure from the average. As the chart below shows, the only year in which the number of IPOs exceeded the 1996 total *was 1969*. Using the reasoning of critics of regulation, the chart demonstrates that from 1974 to 2016 there was an *eight-fold increase* in the number of annual IPOs (from 9 to 78) as a result of enhanced regulation under the Sarbanes-Oxley and Dodd-Frank Acts. But this claim has no more empirical validity than the claim that these statutes have caused the number of U.S. IPOs to decline.



Additionally, the number of U.S. IPOs and the number of U.S. public companies are simply the wrong measures. Critics use these data to suggest that less capital is being raised in U.S. IPOs and less capital is represented by companies listed on U.S. exchanges. Both claims are false.

As the chart below shows, gross IPO proceeds[4] have followed a consistent zigzag pattern since the early nineties, before which gross proceeds were substantially lower than they are today. The aberrational high years of 1999 and 2000 included IPOs of Internet stocks with grossly inflated valuations that substantially contributed the market decline from 2000 to 2002. The amount in the years immediately before and immediately after the 2000 – 2002 period was the same ($34.4 and 34.2 billion, respectively) and, notably, those amounts are substantially lower than in the post-Dodd-Frank-Act of 2014 ($47.0 billion).[5] ***Excluding the Internet bubbles years of 1999 and 2000, 2014 set the all-time***

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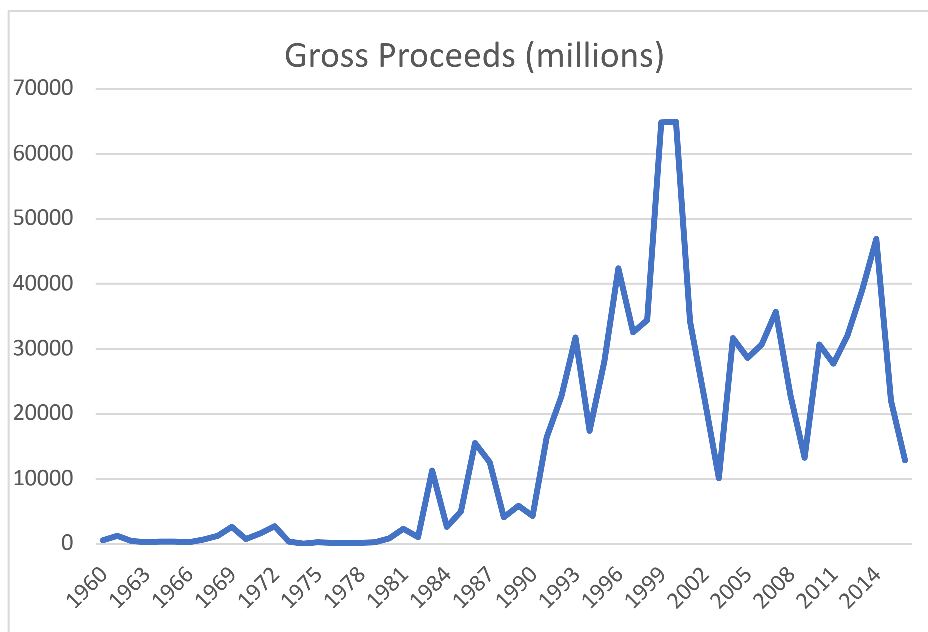
[4] I refer to gross proceeds in IPOs because that is the data that is accessible, but it is not an accurate measure of the amount raised in IPOs. Gross proceeds are typically substantially more than the amount of capital raised by an issuer. The amount of gross proceeds of an IPO is reduced by various expenses and, more significantly, by proceeds diverted to selling shareholders. An important but generally ignored function of IPOs is the freeing up of capital of early-stage investors that can be recycled back into the start-up market.

[5] *See* Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 200 for Issuers with Public Float Between $75 and $250 Million, Office of Chief Accountant, SEC at 94 (2011) ("2011 SEC Report") ("If 1999 and 2000 are eliminated as bubble years, the aggregate proceeds raised by IPOs recovered in 2004 and maintained that level through 2007, despite the drop in number of the number IPOs compared to the pre-2001 era.").

record for IPO gross proceeds. Recent data suggests that that record will be broken this year, with 1Q18 IPO proceeds totaling $15.6 billion,[6] and may even surpass the Internet Bubble's highs. Critics assign intrinsic value the number of IPOs, which is an arbitrary function of a very diverse set of factors, in derogation of the amount of capital actually raised. ***I submit that the success of our public markets in raising capital should be measured by the amount of capital raised.***



[6] Ryan Vlastellica, IPO Proceeds Hit 3-Year High in First Quarter, Fueled by Foreign Companies' Offerings, MarketWatch (Mar. 31, 2018) *available at* https://www.marketwatch.com/story/ipo-proceeds-hit-a-3-year-high-in-the-first-quarter-boosted-by-foreign-companies-2018-03-29.

The amount of capital represented by U.S.-listed companies tells an even more compelling story. ***The total market capitalization of U.S.-listed companies increased from $8.5 trillion in 1996 to $32.1 trillion in 2017, as shown in the chart below.*** The largest short-term declines in U.S.-listed company aggregate market capitalization were concurrent with the crash of the Internet Bubble and the Enron/Worldcom group of accounting scandals in one case, and with the Financial Crisis in the other. Market capitalization *rose* in the wake of the Sarbanes-Oxley and Dodd-Frank Acts. The decline in the number of listed companies ignores the fact that companies are simply much larger than two decades ago, which likely reflects changes in optimal firm size and the probability of a small company being acquired.[7] According the logic of critics, the perceived problem with the number of listed companies would be solved just as well by requiring that all listed companies be split into two.

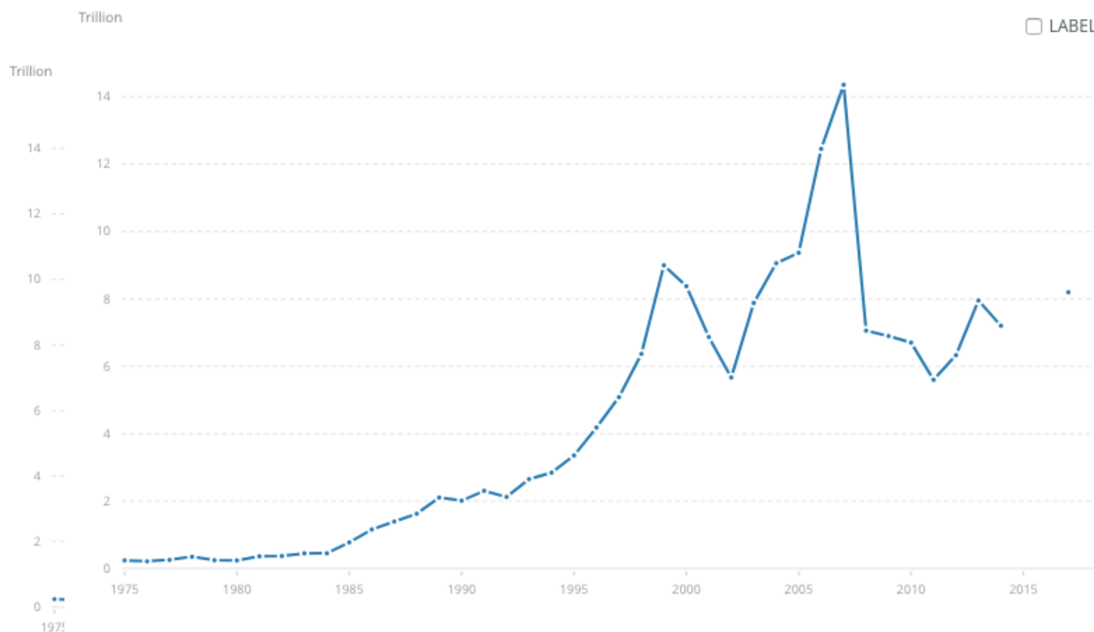
Market Capitalization of U.S.-Listed Companies
Source: World Bank[8]

[7] *See* Jay R. Ritter, Xiaohui Gao Bakshi and Zhongyan Zhu, *Where Have All the IPOs Gone?* (August 26, 2013) (published at 48 Journal of Financial and Quantitative Analysis 1663 (2013)) (decline in listings not caused by regulation; finding decline is correlated with the declining relative profitability of smaller firms and the higher incidence of acquisitions) *available at* ssrn.com/abstract=1954788.

[8] *Available at* https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?end=2017&locations=US&start=1980 (last visited June 21, 2018).

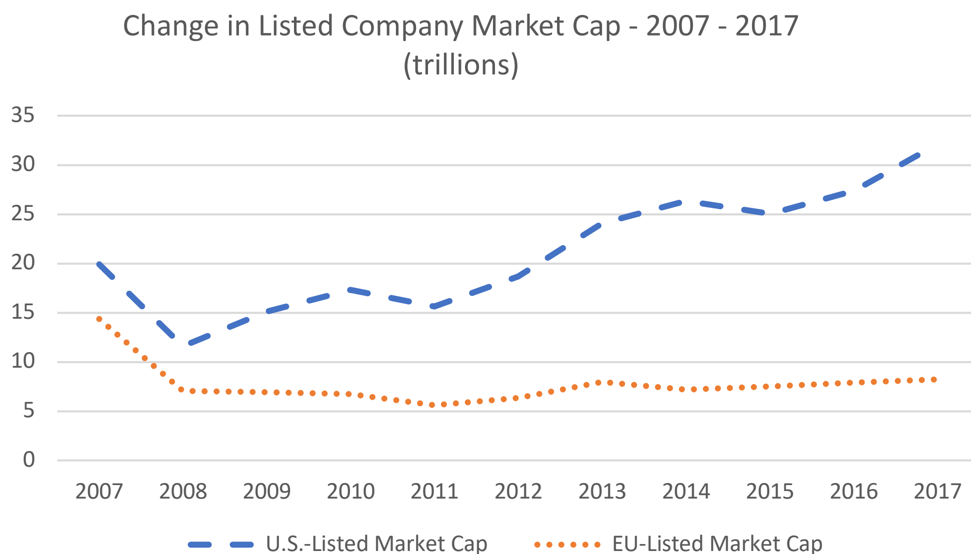
In comparison to the market capitalization of European-Union-listed ("EU-listed") companies, the U.S. public company market has been an unmitigated success. As shown in the chart below, from 1996 to 2017, the market capitalization of EU-listed companies rose from $4.2 to $8.2 trillion. In other words during the period in which critics claim that the U.S. public company market has been a failure, the market capitalization of U.S. public companies rose 278% ($8.5 to $32.1 trillion), while the market capitalization of our most advanced competitors' markets rose only 95% ($4.2 to $8.2 trillion). The Financial Crisis had a far more devastating effect on EU-listed than U.S.-listed companies, with the former reaching bottom after a 61% drop and the U.S. reaching bottom after only a 42% decline. After reaching their lows, the US market cap rose 136% ($11.6 to $27.4 trillion), while the EU market cap rose a relatively anemic 46% ($5.6 to $8.2 trillion). If the health of our listed companies is attributable to regulation, then it appears that the Dodd-Frank Act created a large advantage for U.S. public markets.

Market Capitalization of E.U.-Listed Companies
Source: World Bank[9]



[9] *Available at* https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?locations=EU (last visited June 21, 2018). This chart does not render properly on the World Bank's site; it omits the data point for 2016 and the line from 2015 to 2017 (the point at the far right is for 2017).

Thus, EU-listed companies had a substantially larger downturn and substantially weaker recovery after the Financial Crisis.[10] ***From 2007 to 2017, the EU market cap declined 43% ($14.4 to $8.2 trillion) while the U.S. market cap rose 61% ($19.9 to $32.1 trillion), as illustrated in the chart below.[11]***



As the chart shows, more than 70% of the recovery in U.S. market cap during the four years starting in 2007 occurred during the seven years from 2011 to 2017 – ***after the enactment of the Dodd-Frank Act.***[12] If the Dodd-Frank Act could be viewed as having had an effect on confidence in public companies, its effect has been to contribute to an extraordinary increase confidence in U.S. public companies relative to European public companies.

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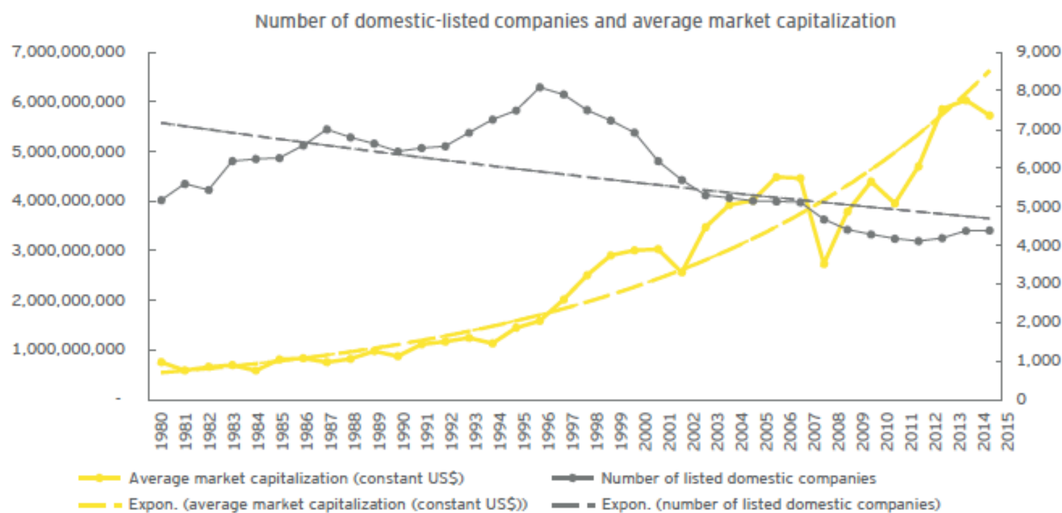
[10] As indicated in the charts, the EU market cap reached bottom in 2011, whereas the U.S. market cap reached bottom in 2008.

[11] Due to the gap noted *supra*, I have assumed equal increases from 2014 to 2015 and 2015 to 2016. *See also* Looking Behind the Declining Number of Public Companies, Ernst & Young at 2 (May 2017) ("Looking Behind the Numbers") ("among the smaller number of foreign companies that do list on an exchange outside their home country, ***twice as many choose U.S. markets as those that list in any other jurisdiction***" (emphasis added)(EY Vice Chair Lee Brorsen); "foreign companies today overwhelmingly choose the U.S. when they list outside of their home markets. Companies based in the U.S. rarely elect to list anywhere else.").

[12] The U.S. market cap rose $5.7 trillion from 2008 to 2010 ($11.6 to $17.3 trillion) and $14.8 trillion from 2010 to 2017 ($17.3 to $32.1 trillion). *See* Looking Behind Numbers, *supra,* at 2 & 3 ("More than half of the decline in the number of public companies since 1996 can be attributed to the post-dot-com bubble era of business failures and delistings that immediately followed an extraordinary number of IPOs" (EY Vice Chair Lee Brorsen); "delisting rates are much lower than immediately the dot-com boom"); Craig Doidge, G. Andrew Karolyi and Rene Stulz, *The U.S. Listing Gap*, Fisher College of Business, WP 2015-03 -07 at 1 (June 2016) (finding lower delisting rates after dot-com boom and delisting rate increased after 1996 "mostly as a result of an unusually high pace of merger activity among public firms").

As shown in the chart below, the large decline in the number of U.S. public companies has been accompanied by a large increase in their average market capitalization.[13]



Source: World Bank, excluding investment funds and trusts.

Nonetheless, critics contend that it is not total wealth that matters but the number of companies representing that wealth, apparently believing that the guiding principle of capitalism is to maximize the *distribution of capital* across the largest number of companies rather than the greatest *creation of capital* by public companies.[14] ***It is not clear why these critics would rather that U.S. public markets be poorer with more public companies than wealthier with fewer public companies.***

Another aspect of the IPO/public company myth is that there is a objectively determinable number of IPOs and public companies that is optimal, and recent levels are lower than that number. Rationally arguing for more IPOs or public companies requires a rational theory of how more IPOs and/or more public companies creates greater social wealth. In terms of the actual *value* of U.S. public companies, ***fewer*** public companies has correlated with ***greater*** net social wealth. The only rationale provided by critics of current regulatory requirements is that some prior larger number of IPOS and public companies over a cherry-picked period is what the number *should* be – simply because the number was larger during that period. The average number of IPOs from 1960 to 2016 was about 227, yet the ubiquitous comparisons to IPOS in the late 1990s implies that critics believe the ideal number would be around twice the average without any rational basis for that claim.

Indeed, there has been a decline in the number of IPOs beginning in 2001. The average from 2001 to 2016 was 114 IPOs, less than half the average of 272 from 1960 to 2000. Five of the six years with the lowest number of IPOs coincided with the market downturns following the bursting of the Internet Bubble and scandals of 2001 – 2002, and the Financial Crisis. The drop-off from 2000 to 2001

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[13] Looking Behind the Numbers, *supra*, at 4.

[14] *See* The U.S. Listing Gap, *supra*, at 1 (If the "optimal firm size is increasing as a result of technological changes, . . . the drop in listed firms likely has nothing to do with the benefits and costs of being a public company and might even be a positive development for the economy. ").

alone was from 382 IPOs to 79 IPOs. However, even excluding the years 2001, 2002, 2003, 2008 and 2009 yields an average of 140 IPOs – still barely half of the earlier period's 272 IPOs.

There is no question that there has been a meaningful drop-off in the number of IPOs, but the cause of this drop-off and the separate question of whether this is a positive or negative development are different matters. The total amount of gross IPO proceeds during the 16-year period with half the average number of IPOs was many multiples of the total amount of gross proceeds raised in the preceding 41 years, which means that we are raising much more capital but fewer companies are doing it. The timing of the ups and downs of IPOs seems to reflect market downturns and crises, but it does not fit a theory of regulation-induced declines or increases. As noted above, the data suggest that the decline is due partly to the facts that companies are larger, acquisitions are more frequent, and private capital markets have grown substantially.

A more rational approach might consider the actual amount of wealth represented by the public company market, that is, assuming that what we value is increasing the wealth of public companies rather than distributing wealth among a larger number of public companies. As creators and repositories of wealth, the modern history of U.S.-listed companies has been a virtually unmitigated success. The largest short-term declines and the largest short-term increases in U.S.-listed company value have occurred immediately before and immediately after the enactment of laws that critics claim have had the effect of reducing net social wealth. The JOBS Act and bills currently pending appear to reject the net creation of social wealth as a measure of the health of public company markets, preferring instead to apply the more socialist metric of the number of public companies across which public market wealth is spread.

A rational approach might also consider that the essential difference between registered and unregistered offerings is that the former can be sold without qualification to retail investors. In my opinion, the right number of IPOs and public companies would be the number naturally occurring in a free market (i.e., as set by the forces of supply and demand, rather than being determined by Congress, regulators, issuers or stock exchanges), consistent with investor protection (i.e., ensuring access to, and the integrity of, information about public offerings and public companies). In contrast, the JOBS Act and currently pending bills seek to increase the number of IPOS and public companies by reducing access to and the integrity of information provided to retail investors. (At the same time, Congress is undermining the premise that *unregistered* offerings are *not* made to retail investors.)

The JOBS Act and the currently pending bills create the appearance that claims regarding the effect of the Sarbanes-Oxley and Dodd-Frank Acts on the number of IPOs and public companies are disingenuous – nothing more than the product of interest group politics. ***Congress previously enacted and now again proposes legislation that purports to be intended to increase the number of IPOs and public companies while pairing that legislation with law that will inevitably reduce number of IPOs and public companies***. Congress has systematically made raising capital through unregistered offerings, which are the principal alternative to conducting an IPO,[15] substantially more attractive,[16] while also claiming a desire to increase the number U.S. IPOs and public companies. For example, the

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[15] *Why the Decline in the Number of Listed American Firms Matters*, The Economist (Apr. 22, 2017) ("Airbnb has raised billions from private markets and has 26 external investors. It will make gross operating profits of $450m this year . . .") *available at* https://www.economist.com/business/2017/04/22/why-the-decline-in-the-number-of-listed-american-firms-matters.

[16] *See* Looking Behind the Numbers, *supra*, at 2 (in recent years, "we find that a surge in private capital and the unique characteristics of many of today's new companies have made it easier to grow outside the public equity market for longer than historically was feasible").

JOBS Act created a new exemption for crowdfunding, raised the limit for Reg A offerings from $5 to $50 million and preempted state regulation, and permitted general solicitation and advertising in private offerings.[17] A reporting company is not allowed to use Reg A, which means that a small issuer contemplating raising $50 million in an IPO gives up the possibility of later raising that amount under Reg A.[18] In other words, a private company that seeks to raise $50 million on the public markets surrenders the ability to later raise $50 million in a Reg A offering, but the reverse does not hold.

The JOBS Act also increased the threshold for the number of shareholders that trigger registration by thousands,[19] which has removed a common impetus for becoming a public company.[20]

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[17] *See id.* at 3 ("Legislation enacted over the last five years has made it easier for emerging companies to stay private longer by relaxing certain regulatory requirements and encouraging more private financing."). The SEC Chairman reported that, from the date of the applicable 2015 JOBS Act amendments through March 31, 2018, $798 million was raised under Reg A and $68.7 million through crowdfunding under Reg CF, and that $147 billion was raised under Rule 506 in 2017. *See* Oversight of the U.S. Securities and Exchange Commission, Hearing before the Committee on Financial Services, U.S. House of Representatives at 5 (June 21, 2018) (testimony of SEC Chairman Jay Clayton) *available at* https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission. If the SEC's Reg A estimate is based on Form 1-U, it may substantially understate the amount raised because there is evidence that some Reg A issuers ignore the Form 1-U filing requirement (although the difference may be due to long offer periods). *See* Amit Singh, *A Year End Look at Equity Crowdfunding in 2017,* Stradling: Attorneys at Law at 4 (2018) (finding only 13 Form 1-Us filed for 122 qualified Reg A offerings in 2017); *SEC Capital Access Report*, *supra*, at 6 (reporting amount raised by 56 Reg A issuers during period with 97 qualified offerings). If the SEC estimate is based on Form D filings, it underestimates the amount raised because Rule 506 issuers often ignore the Form D filing requirement and, in any case, they are not required to report the total amount raised. *See id.* at 37 – 38 (acknowledging unreliability of Form D data but basing amount-raised estimate on Form D). Based on my review of crowdfunding issuers that also conducted a Rule 506 offering, issuers frequently ignore the Form D filing requirement. If the SEC estimate of Reg CF offerings is based on Form C-U filings, I can attest that, based on my research, the estimate is not accurate. *See id.* at n. 76 (acknowledging that estimate of amount raised in Reg CF offerings is based on Form C-U). To illustrate the problems with SEC data, in a 2017 report the SEC staff used Form C-U to estimate that, as of January 15, 2017, Form C-Us for 33 offerings had been filed for crowdfunding filings initiated prior to Dec. 31, 2016, which showed an aggregate amount raised of "approximately $10 million." Vladimir Ivanov and Anzhela Knyazeva, U.S. Securities-Based Crowdfunding under Title III of the JOBS Act, SEC Division of Economic and Risk Analysis at 1 (Feb. 28, 2017). My analysis shows the total raised for issuers that filed a Form C-U prior to the SEC's cutoff of January 15 was $9,239,648.30, which is lower than the SEC's total because the total raised is often adjusted downward after the Form C-U has been filed. My analysis also shows that an additional $9,642,880.00 was raised by 30 filers that never filed a Form C-U, and another $7,639,401.65 was raised by filers that filed a Form C-U after the SEC data cutoff of January 15, 2017.

[18] This will no longer be the case when the SEC adopts rules pursuant to Section 508 of the Economic Growth, Regulatory Relief and Consumer Protection Act. Limited data on Reg A+ offerings shows questionable performance to date. *See* Corrie Driebusch and Juliet Chang, *IPO Shortcuts Put Burden on Investors to Identify Risk*, Wall Street Journal (Feb. 6, 2018) *available at* https://www.wsj.com/articles/ipo-shortcuts-put-burden-on-investors-to-identify-risk-1517913000.

[19] As a practical matter, the number-of-shareholders trigger has never applied to the actual number of a company's shareholders as because the SEC interprets it to apply literally to shareholders *of record* (i.e, street name) rather than to actual shareholders. For example, 1 million Americans could own shares of a private company through Merrill Lynch, but they would count as only 1 shareholder under the SEC's interpretation of the shareholder trigger. Historically, private company shares have been held directly, but this may have changed with the expansion of secondary trading markets. *See The Future of Capital Formation,* Hearing before the Representatives Committee on Oversight and Government Reform, U.S. House of Representatives at 10 (May 11, 2011) (testimony of SEC Chairman Mary Schapiro) ("shareholders of most private companies, who generally hold their shares directly").

[20] *See SEC's Power to Revive IPO Market*, *supra* ("At the margin, the last attempt to loosen IPO rules is partly responsible. As part of the sprawling Jobs Act in 2012, lawmakers lifted the level at which private companies are forced to provide public financial statements from 500 to 2,000 shareholders. Hitting the previous limit was a catalyst to previous IPOs including Google and Facebook, which decided that if they went to the trouble of publishing accounts they might as well enjoy the advantages of being public. With the new rules, companies can get older and bigger before feeling any

These reforms are in addition to the expansion of the amount of capital that can be accessed through unregistered offerings due to: (1) the increase in accredited investors since Reg D was adopted in 1982, (2) the shift for retail investors from direct ownership to mutual funds, and (e) the shift for institutional investors to private investment companies (e.g., hedge funds and private equity) and Rule 144A investments.[21] Earlier this year, Congress further disadvantaged IPOs by expanding the potential for (1) private venture capital funding by raising the limit on the number of investors that trigger investment company registration and (2) unregistered offerings to employees by doubling the 12-month dollar limit above which Rule 701 disclosures must be provided (as under Reg A, a company must surrender the ability to make offers to employees under Rule 701 if it becomes a reporting company).[22] Congress has repeatedly provided for investment limits to be raised to match inflation, while leaving the $1 million minimum net worth for accredited investors and $5 million minimum for qualified purchasers unchanged for decades. In 2015, Congress substantially deregulated secondary markets in unregistered securities,[23] and the size of these markets has exploded,[24] further eroding the advantages enjoyed by public companies. Congress has been relentless in making IPOs more unattractive relative to unregistered offerings.

The SEC has found that the excess capital raised in unregistered offerings over registered offerings is growing. It found that capital raised in equity and debt exempt securities offerings exceeded the amount raised in registered offerings by 21.6% from 2009 to 2011, which gap increased to 26% from 2012 to 2016[25] The total amount raised in exempt offerings was $1.16 trillion in 2009, $1.87 trillion in 2015, and $1.68 trillion in 2016.[26] An Ernst & Young biotech expert concisely answered the question of why more companies are staying private as follows: "Because they can."[27]

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pressure."). Similarly, the SEC previously permitted issuers to exclude compensatory stock options from being counted under Section 12(g). 17 C.F.R. 701. *See* Rule 12h-1. The SEC also permits Reg A filers to exclude Reg A securityholders from being counted. *See* Amendments to Regulation A: A Small Entity Compliance Guide*, Securities and Exchange Commission (June 18 2015, as modified May 16, 2016) *available at* https://www.sec.gov/info/smallbus/secg/regulation-a-amendments-secg.shtml. These various interpretive positions and counting rules have rendered the shareholders test under Section 12 of the Exchange Act virtually meaningless.

[21] *See* Looking Behind the Numbers, *supra*, at 3 (investors with large amounts of capital have turned to the private market in search of investment opportunities in high-growth companies"); The Promise of Market Reform, *supra,* at 3 (private capital assets under management increased from $356 billion in 2002 to $1.822 trillion in 2015); Elizabeth de Fontenay, *The Deregulation of Private Capital*, 68 Hastings L.J. 445, 467 (April 2017) ("Over time, Regulation D has proven to be the exception that swallows the rule").

[22] *See* Sections 504 & 507 of the Economic Growth, Regulatory Relief and Consumer Protection Act.

[23] Section 76001 of the Fixing America's Surface Transportation Act ("FAST Act") permitted relatively unrestricted trading of securities held by accredited investors provided that the issuer is not a reporting company (codified at Securities Act Section 4(a)(7), (d) & (e)).

[24] *See Secondary Market for Shares in Pre-IPO Unicorns Is Booming*, Reuters (Dec. 19, 2016) (tradable shares of largest private companies increased from $11 to $35 billion from 2011 to 2016; $1.4 billion in secondary market transactions in 2015, $1.2 billion in 2016) *available at* https://venturebeat.com/2016/12/19/secondary-market-for-shares-in-pre-ipo-unicorns-is-booming/.

[25] *See SEC Capital Access Report*, *supra*, at 5 - 6.

[26] *See id.* at 5.

[27] Proceedings of SEC Small and Emerging Companies Advisory Committee at 120 & 121 (Feb. 15, 2017) (statement of Glen Giovannetti, EY Global Biotechnology).

Today's bills reflect the same contradiction between the asserted purpose of increasing the number of IPOs and public companies while making a further reduction in IPOs and public companies far more likely. The HALOS Act will necessarily *reduce* the number of IPOs and public companies by making it easier for small businesses to identify accredited and non-accredited investors for current and potential offerings. As one commentator has stated:

> [T]he carrot for companies to go public had always been access to cheaper capital because the securities law regime gave public companies the exclusive right to raise money from the general public. Nevertheless, the regulatory thrust in recent decades has been to markedly loosen the restrictions on capital raising and trading on the private side.[28]

The claim that the Sarbanes-Oxley and Dodd-Frank Acts have harmed public markets is based on empirically invalid methodologies and cherry-picked data and reflect the view that is it not net capital creation that matters, but rather the number of IPOs and public companies. The fact that this claim is based on mere mythology is exposed by Congress's repeated enactment of legislation it claims will increase the number of IPOs and public companies while enacting legislation that will likely have the effect of reducing the number of both.

II. Fostering Innovation Act of 2017

The Fostering Innovation Act of 2017 ("FIA/404(b) Act") is fundamentally inconsistent with primary premise of the regulation of sales of securities to retail investors, which is that investors will be provided with access to material information about the offering and that the integrity of the information has been verified by an independent party. The Act will further fracture the meaning of "U.S. public company" – the world's gold standard – and continue to dilute the value of the U.S. financial markets. The Act's premise – that the additional cost of a 404(b) audit for companies with up to a ***$699 million public float*** is overly burdensome – has no sound basis.

The FIA/404(b) Act would extend, for up to about five years, the emerging growth company ("EGC")[29] exemption from Section 404(b)'s requirement of an auditor's attestation as to a public company's assessment of the effectiveness of its internal controls.[30] An EGC's exemption would

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[28] *The Deregulation of Private Capital, supra*, at 466.

[29] An EGC is a company that has less than $1.07 billion in gross annual revenue. A company generally remains an EGC until it has more than $1.07 billion in gross annual revenue, the end of the fiscal year in the year of fifth anniversary of the EGC's IPO, or – as is more likely -- it becomes a large accelerated filer (i.e., has a $700 million float as of the end of the second quarter of its fiscal year). *See* 17 C.F.R. § 240.12b-2.

[30] Section 404(a) of the Act requires an internal control report that includes an assessment of the effectiveness of a company's financial reporting internal control structure and procedures. Section 404(b) requires an auditor's attestation as to this 404(a) assessment.

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

(a) RULES REQUIRED.—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—

normally expire no later the end of the fiscal year following the fifth anniversary of its IPO (a "five-year EGC"), but the Act would temporarily extend the exemption for a non-large-accelerated-filer, five-year EGC that has less than $50 million in 3-year average gross fiscal year revenues. The temporary exemption would run until the earlier of the end of a fiscal year in which the company's 3-year average gross revenues exceeds $50 million and the date that it becomes a large accelerated filer, but in no event later than the tenth anniversary of its IPO.

It is not clear how the FIA/404(b) Act will facilitate capital formation or, more precisely, increase the number of public companies. First, it will apply to only a narrow sliver of companies. The SEC and subsequently the Dodd-Frank Act previously exempted non-accelerated filers from Section 404(b). This exemption covers companies with a public float of less than $75 million, which means that five-year EGCs that have less than a $75 million float would be unaffected by the Act. The Act will extend the 404(b) exemption only for EGCs that have a public float of at least $75 million *and* have 3-year average gross annual revenues of less than $50 million.[31] The category of above-$75-million-float, below-$50-million-in-revenues constitutes a narrow cross-section of companies.

This narrow cross-section would be further reduced because the Act applies only to EGCs that conducted their IPO in the preceding five years. There were about 750 IPOs over the last five calendar years, of which about 600 were EGCs.[32] So it would be only the above-$75-million-float, below-$50-million-in-revenues companies in this subset of 600 EGCs that remained EGCs for which the Act would temporarily extend the 404(b) exemption. It would not be surprising if less than a few dozen of the 4,000+ that are listed in the U.S. fit these criteria.

The CFO of aTyr Pharma reportedly testified that the FIA/404(b) Act would affect about 200 biotech companies,[33] but the actual number could not be remotely close to 200. Biotech

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> (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
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> (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Section 404, Sarbanes-Oxley Act of 2002.

[31] Companies can avoid reaching the $75 million cutoff by manipulating their public float, in some cases illegally. *See* 2017 SEC Report at 94 – 95. Thus, some companies avoid the attestation by engaging in the kind of accounting abuses that an attestation would deter or detect. Creating a $50 million cutoff for a 404(b) exemption will likely trigger similarly manipulative conduct. It would be preferable – whatever the cutoff is – to limit it to a single metric and to a metric to which GAAP are not overly susceptible. As discussed *infra* in footnote 37, the trigger for becoming an accelerated filer is arbitrary.

[32] Lia Der Marderosian, 2017 IPO Report (May 25, 2017) (85% of IPOs from 2012 to 2016 involved an EGC) *available at* https://corpgov.law.harvard.edu/2017/05/25/2017-ipo-report/.

[33] *See Lawmakers Asked to Broaden Sarbanes-Oxley Section 404(b) Exemption*, Reuters (July 19, 2017)("*Lawmakers Asked to Broaden*") *available at* https://tax.thomsonreuters.com/media-resources/news-media-resources/checkpoint-news/daily-

companies do, in fact, make up a large percentage of IPOs, but there were only about 200 biotech IPOs during the entire five-year period from 2013 through 2017. [34] It is obvious that not every one of these companies will have started as EGCS and, five years after their IPOs, (1) have continued to be EGCs, (2) not have been acquired or gone bankrupt, (3) have a market cap of between $75 and 700 million, and (4) have 3-year average gross revenues of less than $50 million (an "FIA/404(b) company").

I reviewed the current status of 25 biotech companies that conducted IPOs in the first seven months of 2013. [35] These companies would or would have become five-year EGCs around the date of this hearing, so this group provides a small sample of the number of companies that might be eligible if the FIA/404(b) had been law in the first half of this year. Of these 25 companies, 9 had become large accelerated filers, 5 were acquired, 2 were non-accelerated filers, 2 had 3-year average gross revenues in excess of $50 million, and 1 went bankrupt.[36] Of the remaining 6, 2 had ceased to be EGCs, leaving only 4 of the original 25 (16%) for which the FIA/404(b) Act would provide a temporary 404(b) extension.[37] Applying this percentage to the 200 biotech IPOs implies that the Act would exempt 32, a far cry from 200.

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newsstand/lawmakers-asked-to-broaden-sarbanes-oxley-section-404b-exemption/. The article is a bit ambiguous as the purpose of the reference.

[34] There appear to be varying definitions of what constitutes a biotech IPO. John Carroll, *The Best — and Worst — Biotech IPOs in the Class of 2017*, Endpoints News (Aug. 22, 2017) (22 biotech IPOs year-to-date) *available at* https://endpts.com/the-best-and-worst-biotech-ipos-in-the-class-of-2017/ ; Biotech IPOs: Outliers, Value Creation, and the Dispersion of Returns, Life Sci VC (Sep. 27, 2017) (159 biotech IPOs from 2013 through 2016) *available at* https://lifescivc.com/2016/09/biotech-ipos-outliers-value-creation-dispersion-returns/; Brad Loncar, Biotech IPO Class of 2017 (individual investor's blog reporting 40 biotech IPOs in 2017) *available at* http://www.loncarblog.com/biotech-ipos-class-of-2017; Mark Terry, The 2017 Biotech IPO Winners and Losers, BioSpace (Dec. 21, 2017) (44 biotech IPOs in 2017 including healthcare issuers) https://www.biospace.com/article/unique-the-biggest-biotech-ipo-winners-and-losers-in-2017/; Arlene Weintraub, *The Biotech IPO Boom Will Continue, Nasdaq Execs Predict*, Forbes (Nov. 10, 2018) (26 biotech IPOs in 2016; 30 in 2017 to date); John Carroll, *The top 10 biotech IPOs of 2013*, FierceBioTech (undated) (39 biotech IPOs in 2013) *available at* https://www.fiercebiotech.com/special-report/top-10-biotech-ipos-of-2013.

[35] I included 22 biotech IPOs from: Luke Timmerman, *The Biotech IPO Scorecard: Who's Up, Who's Down in 2013*, Exome June 3, 2013) (listing 22 biotech IPOs to date) *available at* https://www.xconomy.com/national/2013/06/03/the-biotech-ipo-scorecard-of-2013-whos-up-whos-down/, and 3 biotech IPOs from other sources. *See* Steven Shore, *Risk Lovers Find Life in Biotechs*, Aust., Financial Rev., 2013 WLNR 21272812 (Aug. 28, 2013) (13 biotech IPOs in 2Q13, which exceeds number in 1Q13); Pamela Taulbee, *A Time to Test Biotechs' Strength*, The Deal, 2013 WLNR 22166341 (Aug. 23, 2013) (16 biotech IPOs to date); *Fate Therapeutics Joins Biotech IPO Conga Line, Reaching for $69M*, Xconomy, 2013 WLNR 20181374 (Aug. 14, 2013) ("30 life sciences companies have successfully gone public, more than double the annual rate of biotech IPOs seen in the wake of the 2008 financial crisis"); Biotechnology Industry Organization News Release, *JOBS Act Breathes New Life into Biotech*, State New Service (Aug. 14, 2013) (23 biotech IPOs as of August 1); David Thomas, *The Return of the Biotech IPO*, Biotechnow (August 5, 2013) (illegible list of 22 biotech IPOs to date)*available at* http://www.biotech-now.org/business-and-investments/inside-bio-ia/2013/08/the-return-of-the-biotech-ipo.

[36] The bankrupt company is Kalobios (of Martin Shkreli fame), which came out of bankruptcy and changed its name to Humanigen. Humanigen is currently a smaller reporting company with a market cap of approximately $61 million; as reconstituted it would still be exempt from Section 404(b). *See* Humanigen Annual Report (Mar. 27, 2018) *available at* https://www.sec.gov/Archives/edgar/data/1293310/000121465918002397/p31318010k.htm.

[37] A company ceases to be an EGC if its public float exceeds $700 million at the end of its 2nd fiscal quarter, i.e., on June 30. One of these companies, based on its 2Q outstanding shares reported in its quarterly report and its trading price on Yahoo Finance, had a public float of approximately $730 million in mid-June 2014 that dropped sharply to $702 million by the end of the month. I have not been able determine whether the company's market cap at the end of 2Q14 was

Approximately 85% of IPOs involve an EGC, so assuming about 750 IPOs from 2013 through 2017, about 600 would have involved EGCs. Of these, about 200 were biotech companies (I have assumed that all biotech IPOs involved an EGC), which leaves 400 non-biotech IPOs. It is very likely that a far lower percentage of these companies than biotech companies would be FIA/404(b) companies. The aTyr's CFO is correct that biotech companies are far more likely to benefit from the FIA/404(b) Act because they have a long gestation period during which they may have zero or de minimis revenues and substantial R&D expenditures (and this is consistent with my review of the filings discussed above). If non-biotech EGCs remain FIA/404(b) Act companies after five years at one-half the rate of biotech companies (8%), another 32 would benefit from the Act, bringing the total to 64 – ***or 1.5% of the 4,336 U.S.-listed companies as of the end of 2017***. If the non-biotech rate is one-fourth of the biotech rate, the total would be 48. These estimates are better than back-of-the-envelope numbers, but not by much. I submit that Congress should have a more precise estimate of the number of EGCs that would actually benefit from the FIA/404(b) Act before making it law.

Second, the Act is likely to have no effect on behavior of businesses other than to create an incentive to manage revenues so as to remain below the $50 million cutoff and to enable improper accounting practices to continue to go undetected and undeterred. The mere possibility that a 404(b) exemption may continue to be available *five years after its IPO* is not likely to affect an EGC's decision whether to conduct an IPO. It also strains credulity that the availability of a temporary exemption under the Act would affect an EGC's decision, for example, about whether to de-list. The 4 companies cited

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less than $700 million. For example, the company's quarterly reports shows 29,738,391 outstanding shares at the end of 2Q14, and Yahoo Finance shows a closing share price of $23.60 on June 30, 2014, which would reflect a market cap of $701,826,027.60. *See* Oncomed Quarterly Report (Aug. 7, 2014) *available at* https://www.sec.gov/Archives/edgar/data/1302573/000119312514299534/d736146d10q.htm#tx736146_2.; Yahoo Finance (June 21, 2018) *available at* https://finance.yahoo.com/quote/OMED?p=OMED (last visited June 21, 2018); *see also Oncomed Pharmaceuticals Keeps Rising: Up 10.3% in 3 Days*, Global Round Up (July 2, 2014) ($725.5 million market cap). However, a July 2 article states that its closing price was $23.30, which would bring its market cap under $700 million. *See Oncomed Pharmaceuticals SVP Sells 1,500 Shares of Stock*, Am. Banking & Mkt. News (July 1, 2014) ($23.30 closing share price on June 30, 2014 and $688.6 million market cap). The company had a public float of approximately $766 million in mid-June 2015 that dropped sharply to approximately $640 million as of June 29. A July 1 article reports that its share price was $22.50 on June 30, *see* Logan Wallace, *Oncomed Pharmaceuticals VP Sells 1,800 Shares of Stock*, Ticker Report (July 1, 2015), which, when multiplied by its reported 30,116,633 end-of-2Q15 outstanding shares, would imply a market cap of $677,624,242.50. I have assumed that Oncomed is a qualified EGC, although I also note that the SEC has found that companies manipulate their public float in order to affect their regulatory status. *See* 2017 SEC Report at 95 – 96. This manipulation results partly from the ability of issuer's to affect their status by manipulating their trading price one day each year as a consequence of an EGC's market cap being arbitrarily measured as of a single day – the last day of its second fiscal quarter (a company can subsequently return to being a non-large-accelerated filer at the end of the fiscal year, but this does not change the loss of EGC status). This arbitrary trigger produces absurd results, such as allowing a company to remain an EGC even if its average market cap consistently exceeds $700 million, or stripping a company of EGC status if its average market cap is consistently below $700 million. My review of the stock prices of 2013 biotech EGC IPOs suggests that the effect of this arbitrary trigger is much greater for such companies, possibly because, for example, the announcement of approval or non-approval of a drug or device can cause wild swings in market cap. It would be more efficient and fairer to firms such as aTyr to base accelerated status (only for EGC purposes) on, for example, a company's rolling 6-month average market cap, which would prevent briefly aberrant trading from triggering heightened regulatory requirements or allowing companies to escape applicable regulation while also reducing the ability and incentive for companies to manipulate their stock price to maintain their EGC status.

above have raised hundreds of millions of dollars; the additional cost of a Section 404(b) attestation would be vanishingly small in comparison to that amount.[38]

Third, empirical analysis has demonstrated the value of a 404(b) attestation at the same time that the cost of 404(b) compliance has steadily declined. If anything, existing exemptions should be peeled back in order to begin restoring the coherence of public company regulation. The cost savings experienced by the small handful of companies that avail themselves of the FIA/404(b) Act's temporary exemption is likely to be far smaller than losses associated with accounting restatements and the adverse effect on the reputation of U.S. financial markets, the confidence of investors and the integrity of financial reporting.

One incidental benefit of the existing Section 404(b) exemption for non-accelerated filers is that it has provided ample data with which analyze the exemption's effect. Studies have found that firms subject to Section 404(b) have lower restatement rates[39] -- about 2/3 that of non-404(b) firms.[40] Non-accelerated filers have had a substantially higher incidence of adverse management reports.[41] Section 404(b) compliance costs have been declining since an initial increase after the Sarbanes-Oxley Act became law.[42]

Congress has no reason to take the evaluation of Section 404(b)'s demonstrated efficiency away from regulators, as regulators have demonstrated their attentiveness to this issue and take action as appropriate. It was the SEC, not Congress, that exempted non-accelerated filers prior to the Dodd-Frank Act. In 2007, the PCAOB issued guidance on Audit Standard 5,[43] which the SEC found has had the "intended effect of reducing the compliance burden and improving the implementation of Section 404, including the requirements of Section 404(b) for the studied group of issuers."[44] In 2009, the SEC

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[38] The auditing expenses for aTyr were reportedly $270,000, *see Lawmakers Asked to Broaden*, *supra*, and Section 404(b) on average results in an additional expense of 35% of that amount, which would be $94,500. *See* Hongmei Jia, Hong Xie, and David A. Ziebart, An Analysis of the Costs and Benefits of Auditor Attestation of Internal Control over Financial Reporting (October 2014) ("An Analysis of the Costs and Benefits").

[39] *See* A. L. Nagy, *Section 404 Compliance and Financial Reporting Quality*, 24 Accounting Horizons 441 (2010) (negative correlation between Section 404(b) compliance and materially misstated financial statements); Yuping Zhao, Jean C. Bedard and Rani Hoitash, *SOX 404, Auditor Effort, and the Prevention of Financial Report Misstatements* (SOX 404, Auditor Effort, and the Prevention of Financial Report Misstatements (2017) *available at* ssrn.com/abstract=2693619.

[40] *See* 2011 SEC Report, *supra*, at 86 ("Section 404(b)-compliant issuers that reported effective ICFR experienced a financial restatement rate of 5.1%, while Section 404(a)-only issuers experienced a restatement rate of 7.4%" (quoting Audit Analytics, Restatements Disclosed by the Two Types of SOX 404 Issuers: (1) Auditor Attestations Filers and (2) Management-Only Report Filers (Nov. 4, 2009))).

[41] *See id.* at 87 & note 181 (citing Audit Analytics, SOX 404 Dashboard Year 6 Update, Oct. 2010, available at http://www.complianceweek.com/s/documents/AASOX404.pdf; "Audit Analytics report that adding this population of 3,066 Section 404(a) reports to the 3,356 Section 404(b) reports, the adverse percentage of the total population of 6,422 disclosures becomes 14.6%.").

[42] *See id.*

[43] The "expressed purpose of this guidance was to "help auditors apply the provisions of [AS 5] to audits of smaller, less complex public companies" and to provide "direction to auditors on scaling the audit based on a company's size and complexity." *Id.* at 23 (quoting Staff Views - An Audit of Internal Control that is Integrated with an Audit of the Financial Statements: Guidance for Auditors of Smaller Public Companies (Jan. 23, 2009)).

[44] *Id.* at 4.

reported on its findings of widespread support for Section 404(b) attestation and the tangible benefits it provided.[45]

In 2011, the SEC issued a report on ways to reduce the costs and burdens of 404(b) compliance for accelerated and large accelerated issuers. Its conclusion is worth quoting in full:

> The Staff believes that the existing investor protections for accelerated filers to comply with the auditor attestation provisions of Section 404(b) should be maintained (i.e., no new exemptions). There is strong evidence that the auditor's role in auditing the effectiveness of ICFR improves the reliability of internal control disclosures and financial reporting overall and is useful to investors. The Staff did not find any specific evidence that such potential savings would justify the loss of investor protections and benefits to issuers subject to the study, given the auditor's obligations to perform procedures to evaluate internal controls even when the auditor is not performing an integrated audit. Also, while the research regarding the reasons for listing decisions is inconclusive, the evidence does not suggest that granting an exemption to issuers that would expect to have $75-$250 million in public float following an IPO would, by itself, encourage companies in the United States or abroad to list their IPOs in the United States.[46]

This report was required by the Dodd-Frank Act, presumably because Congress wanted the SEC's expert opinion.

In 2013, a General Accounting Office report echoed the SEC's finding that restatements were higher among companies that were exempt from Section 404(b).[47] In 2016, the SEC proposed liberalizing the standards for scaled disclosure by small public companies in order "to promote capital formation and reduce compliance costs for smaller registrants while maintaining investor protections" and again evaluated the cost and burdens of compliance with Section 404(b) in light of more recent research.[48] The proposal will be voted on by the Commission in two days.[49] ***Just last week, Chairman Clayton stated that the Commission was "taking a fresh look at the thresholds that trigger the requirement contained in Section 404(b) of the Sarbanes-Oxley Act to have an auditor provide an attestation report on internal control over financial reporting."***[50] It is not clear why Congress feels the need to pull the rug out from under the SEC.

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[45] *See* SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, SEC Office of Economic Analysis (September 2009) *available at* http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

[46] 2011 SEC Report, *supra*, at 8.

[47] *See* Internal Controls, GAO-13-582 (July 2013).

[48] *Id.* at 10, 24.

[49] *See* Open Meeting Agenda, SEC (June 20, 2018).

[50] Oversight of the U.S. Securities and Exchange Commission, Hearing before the Committee on Financial Services, U.S. House of Representatives at 5 (June 21, 2018) (testimony of SEC Chairman Jay Clayton).

In the meantime, the evidence of Section 404(b)'s value has continued to mount. A 2014 study found that Section 404(b) decreased companies' cost of debt while increasing compliance modestly and that Section 404(b) companies had higher valuation premiums and credit ratings.[51] A 2016 study found that from 2007 to 2014 the cost of Section 404(b) noncompliance ($856 million in lower future earnings) was more than twice the cost of compliance ($338 million) before taking into account an additional $935 million cost arising from the delay in aggregate market value decline due to untimely internal control disclosure.[52]

The FIA/404(b) Act would undermine investor confidence just as it has reached all-time highs. The Center for Audit Quality 2017 Main Street Investor Survey found that 85% of investors have confidence in U.S. capital markets and 83% had confidence in investing in U.S. publicly traded companies – both all-time survey records since the Financial Crisis.[53] In the aftermath of the Crisis, these confidence levels were only 61% and 70%, respectively.[54]

The CAQ's survey also found that:

- 78 percent of investors say they are confident in audited financial information released by publicly held companies, and

- Investors register exceptional degrees of confidence in the ability of external auditors, audit committees, and stock exchanges to fulfill their investor protection roles.[55]

While 85% of investors had confidence in U.S. capital markets, only 54% expressed confidence in capital markets outside the U.S.[56] – ***where Sarbanes-Oxley requirements do not apply.*** Further diluting the basis for investor confidence in U.S. capital markets will weaken this global competitive advantage.

Attacks on Section 404(b) are primarily based on the argument that savings on compliance costs can be invested in a company's core business, such as additional research and development. That is true,

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51 *See* An Analysis of the Costs and Benefits, *supra.*

52 *See* Weili Ge, Allison Koester and Sarah McVay, The Benefits and Costs of Sarbanes-Oxley Section 404(b) Exemption: Evidence from Small Firms' Internal Control Disclosures (September 2016). Some commentators fail to acknowledge that an attestation could have any benefit. For example one study contends that the "net compliance costs of Section 404(b) are negative because firms' public float is abnormally bunched just below the $75 million public float cutoff, on the assumption that if the net effect were positive, firms would choose to be above the $75 million. *See* Dhammika Dharmapala, Estimating the Compliance Costs of Securities Regulation: A Bunching Analysis of Sarbanes-Oxley Section 404(b) (October 2016). This analysis provides no meaningful insight into the "net" effect of Section 404(b). The benefit of Section 404(b) compliance is not only an premium on a company's stock price (and a premium based on empirical analysis, not guesses by CEOs), it is also the deterrence and detection of misreporting and fraud. Studies consistently show a higher incidence of restatements among companies that are not subject to Section 404(b), but the study's author appears to assume that this imposes zero cost on investors. The Enron/Worldcom scandals suggests otherwise.

53 *See* CAQ 2017 Main Street Investor Survey, Center for Audit Quality (October 2017).

54 *Id.*

55 *Id.*

56 CAQ at 4.

but it is an argument equally applicable to the requirement to provide audited financial statements, file quarterly reports, and meet other requirements of being a public company. If the term "public company" is to *mean* something, then the costs of a Section 404(b) exemption must be weighed along with the benefits. Congress has recently made much of the importance of balancing the costs and benefits of regulation. Research generally shows that the cost of higher audit fees is greatly exceeded by the operating losses and inflated valuations that accompany misstated financials. The costs of 404(b) compliance has steadily declined and the SEC has demonstrated a balanced, well-informed approach to evaluating the costs and benefits of the attestation requirement.

Consider again aTyr Pharma, a company that had a $75 million IPO in 2015.[57] It is a good example of the kind of EGC for which the Act might grant a 5-year extension -- an R&D heavy firm with very little revenue but (fleetingly) sufficient float to qualify as an accelerated filer. aTyr went public at $14/share, and quickly shot up 85% to $25.87/share within a month. However, as shown below, the company's stock price declined steadily thereafter, reaching $1.02/share as of early last week.[58]

There is nothing wrong with investors betting on a long-shot and losing – this is a necessary predicate for seeding great companies – but a company should not be granted the privilege of using the title of "public company" and enjoying the prestige of trading on a national stock exchange such as NASDAQ while claiming that the burden of an outside, independent audit of its internal controls is too much. Prior to its IPO, aTyr successfully raised more than $170 million in the private markets[59] and $46 million

[57] The company filed a Form D the month prior to the IPO disclosing that it had obtained $76 million in Reg D financing. aTyr Pharma Form D (Apr. 2, 2015) *available at* https://www.sec.gov/Archives/edgar/data/1339970/000133997015000002/xslFormDX01/primary_doc.xml.

[58] Its public float is approximately $30 million, which would allow it to continue avoiding the attestation requirement indefinitely.

[59] *See* The *Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance*, Hearing before the Subcommittee on Capital Markets, Securities, and Investment, Committee on Financial Services, U.S. House of Representatives (July 18, 2017) (testimony of John Blake, CFO, aTyr Pharma) ("aTyr Testimony").

under Reg D in 2017,[60] in each case without having to comply with public company requirements. It chose to become a listed, public company in order to benefit from that status, but it is unwilling to live up to the higher standard that public company status should entail.

Evaluations of the efficacy of Section 404(b) should be based on a rational evaluation of its actual costs and benefits, not on gross, one-sided mischaracterizations. In 2016, aTyr's CFO testified that:

> Section 404(b) requires an external auditor's attestation of a company's internal financial controls that provides ***little-to-no insight into the health of an emerging biotech company*** – but is very costly for a pre-revenue innovator.[61]

I disagree. And I submit that investors who bought aTyr at its peak and lost 95% of their investment might have preferred that the company -- which spent $144 million on R&D from 2013 through March 2018 -- have spent an additional $100,000 each year to obtain an outside auditor's attestation of effectiveness of its internal controls.

III. Helping Angels Lead our Startups Act ("HALOS Act")

In order to evaluate the HALOS Act, we much consider changes in technology and markets over the last few decades. In 2000, I wrote an article that discussed what modern technology meant for securities regulation. The main point in the article, which is directly relevant here, was as follows:

> Technology has undermined the foundations of the U.S. securities regulatory regime. This regime has long relied on distinctions between private and public sales activities; personal and mass communications; local, interstate and international commerce; trade and settlement times; opening and closing prices; individually tailored and impersonal advice; written and spoken communications; and discretionary and nondiscretionary accounts. These distinctions depend on the existence of computational, temporal, and geographic barriers that have been collapsed by technology.[62]

Since I wrote those words, the effect of technology on each of the listed distinctions has been severe, particularly with respect to "private and public sales activities."

The Securities Act's registration exemption for transactions "not involving any public offering" ("nonpublic offering") has been problematic from its inception. What is "public" is not defined in the Act. Courts established a loose set of criteria in evaluating the availability of the

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[60] The company filed a Form D in 2017 disclosing that it had obtained $46 million in Reg D financing. *See* aTyr Pharma Form D (Sep. 15, 2017) *available at* https://www.sec.gov/Archives/edgar/data/1339970/000133997017000001/xslFormDX01/primary_doc.xml.

[61] aTyr Testimony, *supra* (emphasis added). *See also Lawmakers Asked to Broaden*, *supra* ("John Blake, testifying on behalf of the Biotechnology Innovation Organization, told lawmakers that biotech companies that are still developing drugs do not present the same risk that more established or bigger companies have with their financial reporting systems. In his view, they derive little benefit from the auditor attestation requirements for financial reporting controls.").

[62] Mercer Bullard, *Mutual Fund Portfolio Disclosure in the Internet Era*, wallstreetlawyer.com (Sep. 2000) ("*Internet Era*").

exemption that were unpredictable and inefficient. Even after the SEC established a fairly predictable safe harbor under Rule 506, the meaning of "general solicitation and advertising" activities, which were prohibited by the rule, was never particularly clear. Nonetheless, these activities in principle are clearly inconsistent with the statutory nonpublic offering exemption.

Modern communications technology has exacerbated the indeterminacy of the concept of "general solicitation." Information no longer needs to be delivered; it can be made instantaneously, electronically accessible to billions by pushing a button. The practicability of immediate, universal access to information renders the idea of a "delivery" requirement somewhat quaint. As I wrote in 2000, "technology has reminded us that [regulatory] distinctions are not real, but rather are metaphors we use to create, interpret and enforce rules."[63] And these "metaphors no longer describe the way we do business."[64]

The declining utility of the concept of general solicitation as a regulatory distinction was never more obvious than when it led, in 2011, to Facebook's cancelling the $500 million U.S. leg of a $1 billion private offering.[65] Facebook reportedly cancelled the offering because a private email solicitation to an accredited investor was leaked to and published by the Wall Street Journal. The SEC has declined to disclose what led to Facebook's cancelling the offering, but the prevailing view is that SEC staff communicated to counsel that the appearance of the solicitation in the Journal could be considered general solicitation or advertising, which would have made the Reg D safe harbor unavailable. At a minimum, it was clear that, under the SEC's somewhat cloudy positions, counsel could reasonably have reached this conclusion on their own.[66] I published an article discussing how this Facebook fiasco illustrated a problem the SEC needed to address, but the SEC took no action.[67]

The SEC's inaction unfortunately led Congress to take a hatchet to the nonpublic offering exemption. The JOBS Act required the SEC to authorize general solicitation and advertising under the nonpublic offering exemption despite the fact that these were inherently incompatible concepts. Congress amended Section 4 to provide that no offers or sales under Rule 506 of Reg D may "be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation." In other words, although general solicitation and advertising are quintessentially "public" in nature, Congress chose to cram the square peg of an essentially public offer into the

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[63] *Internet Era*, *supra.*

[64] *Id.*

[65] *See* Mercer Bullard, *Facebook Fiasco Reveals Flaws in Private Offerings*, Morningstar.com (Feb. 10, 2011).

[66] The Future of Capital Formation, Hearing before the Committee on Oversight and Government Reform, U.S. House of Representatives (May 10, 2011) (testimony of SEC Chairman Mary Schapiro) ("when the media frenzy erupted, [Facebook's] concern was that they might not be able to satisfy the requirement that this was not a general solicitation. And so in light of that, I've asked the staff to come back to me with some recommendations on whether we need to look at the requirements of our exemption. When these exemptions were written, nobody thought about media frenzy being the sort of thing that would tip the balance into whether you were engaged in a general solicitation or truly a private offering. And so we -- we are looking at this issue very closely.").

[67] *See id.*

round hold of the nonpublic offering exemption (under the Orwellian header "Consistency in Interpretation").

The JOBS Act further diluted the public-private distinction by authorizing online crowdfunding, raising the Reg A offering limit from $5 to $50 million and precluding state regulation of large Reg A offerings. Crowdfunding sites now offer a combination of crowdfunding, Reg A and Reg D offerings, each with different disclosures and investor eligibility requirements. Crowdfunding issuers have routinely raised capital under the Reg A, Reg D, crowdfunding, and intrastate exemptions, and through donative funding on Kickstarter and Indiegogo. They promote their offerings on Facebook and Twitter.

This mingling of different offerings and freewheeling public distribution has further undermined nonpublic nature of private offerings. The SEC stated in adopting rules implementing the JOBS Act that it would not permit private Reg D solicitations to be conducted through other public offerings.[68] However, it has permitted crowdfunding offerings that receive more than the $1.07 million annual limit to divert investors who are accredited into a parallel private Reg D offering. In other words, accredited investors are being solicited entirely through the online crowdfunding offering – precisely what the SEC stated that it would not allow.

The HALOS Act takes the absurdity of public private offerings to a new level. The JOBS Act states that a general solicitation does not make an offering public in nature, as if those are different things. The HALOS Act drops all pretense and simply declares that general solicitations are not general solicitations (under another Orwellian header: "Clarification of General Solicitation"). The Act will allow virtually any type of public entity to advertise and host an event that can be attended by any person for the purpose of any issuer pitching a securities offering. The "HALOS Act" is a wonderful acronym, but the "Angels" are only a small slice of the likely hosts for these very public roadshows. The Act might be more appropriately named the "Shark Tank in Every College Auditorium" Act. After obtaining the credit card they should not be given, students can stroll over to the offering presentation to sign up to buy stock they have no business owning.[69]

Members of Congress should know better than anyone that modern technology and public media has rendered the idea of a private meeting or presentation a quaint artifact of a long-gone era (see, e.g., the Facebook fiasco above). The idea of a truly limited, in-person roadshow in an age when any member of the audience can livestream the presentation around the world is similarly naïve. As I predicted eighteen years ago, the public-private distinction has gone by the wayside, but I did not expect that both Congress and the SEC would install a Guernica-inspired regulatory canvas in its place.

Ironically the HALOS Act's inclusion of "angel investor group" is wholly superfluous. From a practicing lawyer perspective, it will create substantial uncertainty and impose unnecessary compliance costs. If an angel investor group hosts an event, the issuer presenters will have to be

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[68] *See* Crowdfunding, Securities Act Rel. No. 9974 at 392 (Oct. 30, 2015) ("an issuer conducting a concurrent exempt offering for which general solicitation is not permitted will need to be satisfied that purchasers in that offering were not solicited by means of the offering made in reliance on Section 4(a)(6)."). This is known as the "integration doctrine."

[69] Any person can invest in an intrastate offering, in a Reg A+ or crowdfunding offering subject to investment limits, and in a Rule 506(b) offering subject to a financial sophistication standard.

confident that: (1) the Angel host is composed of accredited investors ("AIs") (whatever the term "composed" means), (2) the group's members are "interested in investing in personal capital in early-stage companies (whatever the terms "interested" and "personal capital" mean), (3) the members "hold regular meetings" (whatever "regular" means, including whether "hold" means "attended"), (4) the group has "defined processes and procedures for making investment decisions" (whatever any of that means, including whether the investment decisions reflect the group's pooling of funds), and (5) the group is not "associated with a broker, a dealer, or an investment adviser" (including whether any member may be employed by such a financial services firm and whether, for example, the group may be led by the head of a bank trust officer where all members are the trust officer's clients).

The Angel host will become, itself, a kind of regulated entity that will be at risk of aiding and abetting an illegally unregistered offer of securities if it does not satisfy the definition of "angel investor group." Will the SEC issue guidance on what are sufficiently "defined processes and procedures for making investment decisions"? Or, so soon after creating a separate set of AI verification procedures for Rule 506(c) offerings, will the SEC establish a *another* set of AI verification procedures for Angels? Will the SEC create procedures under which issuers can reasonably verify an Angel's verification procedures? Or its processes and procedures for investment decisions? Or the regularity of its meetings? Or each member's non-affiliation with a broker, dealer or investment adviser? I appreciate the heavenly power of Angels, but do they really want to go there?

Strictly as a matter of practicable compliance, the exercise of defining "angel investor group" is not reasonably worth the confusion doing so will cause. Congress should consider whether, if an angel investor group wants to host a Shark Tank, there is any reason why the group would be unable to find a government entity or instrumentality, post-secondary education institution, or nonprofit. At least all of these terms should be relatively easy to interpret, and hosts should relatively easy to find in virtually any community. Every town of reasonable size has a Chamber of Commerce branch. Every city of reasonable size has a community college branch. Under current SEC positions, presentations could be live-streamed, thereby making them easily accessible to the planet. The Act authorizes the SEC to approve more Shark Tank hosts, and it is not clear on what principled basis the agency could deny a wide swath of organizations admission to this club. It is not a good sign for efficient capital formation when simplistic, populist notions of investing "angels" infest the innards of complex administrative rulemaking.

Rule 506(c) already permits general solicitations and advertising in (public) private offerings. The only real difference the HALOS Act makes is that up to 35 non-accredited investors (the attending college students[70]) can buy stock at a de facto public presentation and issuers can be more

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[70] One member of Congress suggested that the requirement that such investors be sophisticated would prevent college students from investing. *See* House Congressional Record at H261 (Jan. 10, 2017). This is incorrect. There is no, and never has been any, practicable way to enforce this Rule 506 requirement. I am not aware of any enforcement action or private claim *ever* having been brought alleging that a non-accredited investor was not adequately sophisticated. I note that the JOBS Act required that the sophistication of investors be established. *See* JOBS Act Section 302(b). My review of funding portals suggested that this requirement is being honored most often in the breach. The Congressman also fails to note that HALOS Act presentations will undoubtedly be used to market sales under exemptions other than Rule 506. Finally, it appears that the Congressman's position is that the Securities Act's regulation of offers was *never* an appropriate approach to protecting investors.

lax about ensuring that all investors are accredited investors.[71] It is not clear why the last vestige of a quasi-private offering must be eliminated and issuers allowed to invite every one of 300 million Americans to a presentation just so issuers more easily access Angels whose status as accredited investors need not be carefully verified.

The HALOS Act represents the de facto repeal of offering regulation. The question is no longer what communications are permitted without triggering public offering rules. The Act permits public notices that specifically advertise a forum as a securities offering pitch (with only references to a "specific offering of security by" an issuer being prohibited).[72] The Act purports to require that "no specific information regarding an offering of securities by the issuer [be] communicated or distributed by or on behalf of the issuer," and then creates an exception that covers all of the essential specific information that an issuer would want to communicate regarding its offering.[73] The question has become what communications are *not* permitted, as that category has become so narrow as to be more easily defined. The answer is that any communication is permitted to any audience anywhere is the U.S. as long as it is "hosted" by a listed entity.

The HALOS Act is a de facto repeal of Section 5 of the Securities Act, the heart of 85 years of U.S. securities regulation. Admittedly, the HALOS Act rides a horse that probably has long since left the barn, as discussed above, and there is probably no going back. The more practical question is whether Congress will let that horse continue to run wild or establish a new model for promoting fair, efficient markets. Rather than repeatedly asking the SEC to adopt incoherent rules, Congress should, instead, eliminate the regulation of offers and replace it with rules that ensure that, in a world in which all offers are, in effect, allowed to be public, all offering information must be made public.

Congress has created a regulatory regime for unregistered offerings that distinctly favors accredited investors at the expense of retail investors. A $1 million public crowdfunding offering and a $50 million Reg A offering must be accompanied by publicly available filings, while Reg D issuers are allowed to keep their offering documents secret while making public investor presentations. Crowdfunding and Reg A offerings must announce their offerings, while Reg D issuers are permitted to keep them secret. Although Reg D issuers are ostensibly required to file minimal information on Form D, many (if not most) ignore that requirement.[74] The SEC has blithely observed such noncompliance in discussing Reg D offerings but expressed no interest in

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[71] The "more lax" reference here is to the purported difference between the accredited investor requirements under Rules 506(b) and (c). Congress required that 506(c) issuers take reasonable steps to verify" AI status "using methods as determined by the Commission." Prior to the JOBS Act, it was understood that issuers had to take reasonable steps to verify AI status under old Rule 506, but the necessary implication of new Rule 506(c) is that the determination of AI status under the old rule is subject to a lower standard.

[72] *See* HALOS Act Section 3(a)(B).

[73] *See* HALOS Act Section 3(a)(D) (permitting distribution of information including that the issuer will be offering securities, the type and amount of securities to be offered, the amount of securities already spoken for (i.e., "get your order in now, before we run out"), and the intended use of the proceeds).

[74] As discussed below, Congress has tilted the regulation of registered offerings against retail investors as well. This follows Congress's 1996 de facto prohibition against retail investors bringing state securities law claims while leaving that option available to large investors.

doing anything about it. If all offerings are permitted to be public, all public offering information provided to investors should be publicly available.[75]

IV. Encouraging Public Offerings Act of 2018

The Encouraging Public Offerings Act of 2018 ("Confidential Filings Act") would expand two EGC exemptions to cover all filers. Currently, the JOBS Act's roadshow exemption permits EGCs to make private presentations to qualified institutional buyers ("QIBs") and institutional accredited investors ("IAIs") before and after filing a registration statement. The JOBS Act's confidential filing exemption permits EGCs to file a confidential draft registration statement before their IPO. The Act would extend both of these exemptions to all filers. The JOBS Act provided that an EGC must file its at least 21 days before its IPO; the Fast Act reduced that number to 15.

These exemptions exacerbate the incoherent erosion of the distinction between registered and unregistered offerings and further disadvantage of retail investors vis-a-vis large investors. What makes registered offerings different is that communications do not occur in an information vacuum. During the quiet period before a registration statement is filed, no offering-related information may be disseminated. This ensures that when information is disseminated, it is against the disciplining backdrop of a filed, publicly available registration statement. Every other communication, public or private, is made with an eye to that filed document. And every investor, large and small alike, has access to the same filed registration statement as of the issuer's first public marketing of its offering.

The EGC exemption destroyed the key elements of this model. It permits issuers to make unregulated presentations without the disciplining effect of a filed registration statement as context, with a filed registration statement becoming available only 21 days prior to an EGC's IPO.[76] This model facilitates the communication of fraudulent or inaccurate information prior to the filing of a registration statement, provides large investors with a distinct informational advantage over retail investors, and provides inadequate time for investors to evaluate an EGCs registration statement.

The company discussed above, aTyr Pharma, illustrates how the confidential filing process can be abused. The company filed its first draft registration statement on December 22, 2014, and continued to file undisclosed amendments for more than 4 months before filing a public registration statement – only one month before its IPO. Prior to that filing, the SEC had objected to aTry's representations in confidential filings regarding the valuation of its stock, but this issue was still unresolved as of the first public filing. The SEC rejected additional disclosure initially proposed by aTyr to address the valuation issue,[77] and ***corrective disclosure was not included in its registration statement until 9 days before the IPO***.[78] The SEC also allowed aTyr to disclose its expected offering price range to the SEC staff 23

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[75] *See SEC's Power to Revive IPO Market*, *supra* ("In the UK, all private companies are forced to publish accounts.").
[76] The JOBS Act actually required that the registration statement be filed at least 21 days prior to the issuer's first roadshow. However, the SEC interpreted test-the-waters presentations not to be communications roadshows, although that is exactly what they are. It thereby amended the JOBS Act to permit the initial filing of a public registration statement a mere 21 days prior to the issuer's IPO.

[77] Letter from Maggie Wong, Goodwin Procter LLP, to SEC (Apr. 17, 2015) ("April 17 Letter") *available at* https://www.sec.gov/Archives/edgar/data/1339970/000119312515136534/filename1.htm

[78] aTyr Pharma Prospectus (Apr. 27, 2015) ("April 27 Prospectus") *available at* https://www.sec.gov/Archives/edgar/data/1339970/000119312515148013/d819057ds1a.htm. A redlined comparison of the originally filed section of the prospectus to the amended version is provided at Appendix A to this testimony.

days prior to the IPO[79] while still continuing to withhold that information from an amended registration statement filed 9 days prior to the IPO.[80] Thus, while retail investors had 9 days to evaluate aTyr's final amended prospectus, QIBs and IAIs had likely been receiving presentations on aTyr for weeks, if not months. Even those large investors had only 9 days to compare the information in the final amended prospectus to information they had previously received.

The Facebook IPO illustrates how retail investors are routinely disadvantaged by discriminatory treatment and the lack of fair access to information. Facebook amended its registration statement just 9 days before its IPO to include adverse information not previously disclosed.[81] While investment bankers cut their earnings forecasts[82] and reportedly communicated the new information to their large clients, retail clients were left in the dark.[83] Facebook's stock price crashed after the offering, which led to the filing of more than 40 lawsuits.

The Confidential Filings Act codifies[84] retail investors' informational disadvantage by increasing the number of issuers who may provide information to large investors when no registration statement has been made available to retail investors. The aTyr and Facebook IPOs make it clear that the SEC is quite willing to grant effectiveness even after material new information has been added to a registration statement only nine days before an IPO, perhaps even the day before an IPO. The Act engenders a policy of discrimination against and disadvantaging of retail investors that directly contradicts the core goal of registered offering regulation: ensuring access to, and the integrity of, information about public offerings and public companies.

V. Consumer Financial Choice and Capital Markets Protection Act of 2017

The Consumer Financial Choice and Capital Markets Protection Act of 2017 ("MMF Act") would permit money market funds ("MMFs") to maintain a stable net asset value of $1.00 per share and exempt such funds from imposing the liquidity fee imposed by Rule 2a-7 under the Investment Company Act. This part of the Act is intended the reverse the effect of amendments to Rule 2a-7 that the SEC adopted in response the Financial Crisis. The Act also prohibits such funds from

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[79] *See* April 17 Letter, *supra*.

[80] *See* April 27 Prospectus, *supra*. The expected range was never disclosed to the public.

[81] Steve Schaefer, *Morgan Stanley Cut Facebook Outlook Just Before IPO*, Forbes (May 22, 2012) ("a May 9 updated SEC filing that indicated the social network has seen more users migrate to mobile devices, a channel which has proven difficult to monetize to date") *available at* https://www.forbes.com/sites/steveschaefer/2012/05/22/report-morgan-stanley-cut-facebook-estimates-just-before-ipo/#4847e9b5554c. The Facebook IPO occurred on May 18.

[82] *Id.*

[83] Alistair Barr, *Morgan Stanley Cut Facebook Estimates Just Before IPO*, Reuters (May 22, 2012) ("Institutions and major clients generally enjoy quick access to investment bank research, while retail clients in many cases only get it later. It is unclear whether Morgan Stanley only told its top clients about the revised view or spread the word more broadly. The company declined to comment when asked who was told about the research.") *available at* https://www.reuters.com/article/us-facebook-forecasts/insight-morgan-stanley-cut-facebook-estimates-just-before-ipo-idUSBRE84L06920120522. Morgan Stanley subsequently was sued in connection with the Facebook IPO and settled for $5 million.

[84] The SEC previously extended confidential filing privileges to all issuers.

directly receiving federal assistance, such as the programs implemented by banking regulators in the wake of the Financial Crisis, as discussed further below.

I testified before Congress in opposition to money market fund reforms before they were adopted by the SEC.[85] My views have not changed, but circumstances have. Dozens of money market funds have closed, hundreds of billions of dollars of credit that had been extended to businesses have been diverted to the U.S. government, and institutional investors looking to find a short-term home for their cash have been forced to reevaluate their longstanding preference for money market funds.

A 2017 Fed study found that the rules resulted in a massive shift of assets from prime and municipal bond money market funds to government funds, with an increasing share of the latter going into agency debt.[86] From January 2015 to February 2017, assets in prime/muni funds declined $1,315 billion (-65%) and assets in government funds rose by $1,191 billion (115%).[87] The following chart from that study illustrates this transformational shift.

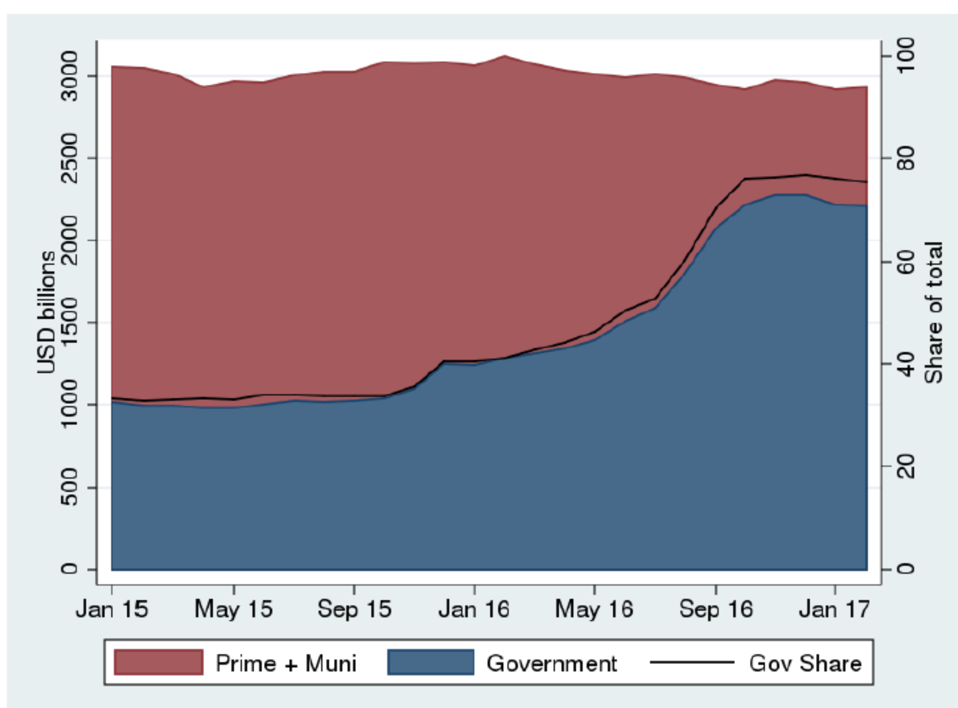
Figure 1: MMF Total Net Assets by Fund Category: Government vs. Prime & Muni.
Solid black line: share of government MMFs in percentages (right y-axis).[88]

[85] Hearing before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (June 24, 2011).

[86] *See* Marco Cipriano and Gabriele La Spada, Investors' Appetite for Money-Like Assets: The Money Market Fund Industry after the 2014 Regulatory Reform, Staff Report No. 816 (June 2017; revised June 2018) ("Fed MMF Report") *available at* https://ssrn.com/abstract=2989552.

[87] *Id.* at 5.

[88] Fed MMF Report, *supra*, at 7.



However, since 2017 this shift may have run its course. From March 2017 through April 2018, prime funds government money market assets have increased from 2,210 to 2,284 billion (13%) and prime fund assets have increased from $587 to $685 billion (17%).[89] Nonetheless, the MMF rules had a marked effect on the allocation of capital (notably one of reallocating a substantial amount of capital from private enterprise to federal government funding) and billions of dollars in lost income to investors.[90] Rising interest rates may lead to greater prime MMF gains in the future at the expense of both government funds, bank deposits and bank savings accounts, but also to substantially higher foregone income to investors.

The distortion in the market for short-term cash investments is, of course, mirrored by a distortion in the market for short-term debt. The prime-to-government debt shift has substantially reduced the role of MMFs in providing businesses with access to short-term borrowing.[91] It is ironic that, in light of the MMF rules' disruption to short-term funding markets, that Chairman

[89] Money Market Fund Statistics, U.S. Securities and Exchange Commission (Mar. 16, 2017 & May 17, 2018). These findings are generally consistent with Chairman Clayton's October 5, 2017, letter to House Subcommittee on Markets, Securities, and Investment Ranking Member Maloney (see page 2) ("2017 Letter").

[90] For example, the total would be $8.75 billion assuming a 25 basis point spread between prime and government MMF yields from 2015 through June 2018 and $1.1 trillion in assets. As interest rates rise, the losses will be substantially higher.

[91] While there is no question that municipal bond assets in MMFs have decreased dramatically, I am not persuaded that the MMF reforms have had long-term adverse consequences in the municipal bond market as a whole. *See* U.S. Money Market Reform: Assessing the Impact, Blackrock (June 2018); Money Market Reform and Municipal Issuers, Vanguard (December 2017).

Clayton has expressed concern that permitting floating NAV MMFs "could be disruptive to the short-term funding markets."[92]

The counterargument that the MMF rules are needed to reduce systemic risk has never had a sound factual basis. Since the inception of modern money market funds, more than 3,000 banks have failed, often with disastrous consequences for depositors and other bank creditors and huge bills for taxpayers. In contrast, only two money market funds have failed. One was a very small institutional MMF that broke a dollar in the 1980s. The Reserve Fund's failure triggered a mass exodus from MMFs that posed a systemic threat, but, unlike thousands of bank failures, these near-MMF failures resulted in *zero losses* to taxpayers and non-Reserve Fund shareholders. Rather, the U.S. government enjoyed a billion-dollar windfall in the form of insurance premiums for coverage on which not one claim was ever made.

Notwithstanding such adverse effects, I have four primary concerns regarding the bill that lead me to recommend against its enactment. First, I am not aware of there having been a thorough empirical analysis of the likely effect of the MMF Act. Just as the original rules were adopted with an inadequate understanding of their effect, Congress should not rush turn back the clock without know the effect of doing so. Instead, I recommend that Congress instruct the SEC to conduct such an analysis. I disagree Chairman Clayton view that "it's too early to say we're wrong." I have no doubt that the SEC *was* wrong, but now that circumstances have changed, I am not certain that reverting to the old system would be right.

Second, I do not have faith in the SEC's ability to manage money market fund risk. In January 2008, I drafted a petition to the SEC asking it to take steps to address what I viewed as a growing risk that a money market fund would break a dollar and specifically cited the risks created by the SEC's longstanding policy of granting last-minute, ad hoc, verbal exemptive relief to address the hundreds of prior instances in which a money market fund had flirted with failure.[93] In response to the petition, the SEC did nothing and, unfortunately, my prediction proved prescient. The SEC failed to take action when the risks presented by the Reserve Fund became very apparent well before it failed, and the SEC's fumbling of the process of granting ad hoc exemptive relief contributed to the Fund's failure (and helped its executives subsequently escape liability).

Third, I am concerned that banking regulators would seize upon another money market fund failure (albeit highly unlikely) as an excuse to impose new regulations on all funds that could cripple America's mutual fund sector. Our mutual fund industry is one of the country's crown jewels, boasting some of the world's greatest businesses. They provide Americans with a low cost access to diversified portfolios of securities that have created enormous wealth for investors and funding for our capital markets. However, banking regulators have demonstrated that they do not

[92] 2017 Letter, *supra* , at 2.

[93] Petition from Fund Democracy, Consumer Federation of America, National Association of Personal Financial Planners, Financial Planning Association, AFL-CIO and Consumer Action to SEC (Jan. 16, 2008). The petition also asked the SEC to require frequent disclosure of money market portfolios, a measure it ultimately adopted *after the Financial Crisis.*

understand that this success is attributable to managed risk-taking,[94] preferring instead the model of socialization of risk and government subsidies that lie at the heart of the banking industry and that became, as a result of the Dodd-Frank Act, an overriding guiding principle in America's financial regulatory policy. Banking regulators' inability to recognized much less embrace risk-taking as a critical and necessary foundation of a capitalist democracy is the result of our Balkanized regulatory structure, which continues to put the U.S. at a significant disadvantage to other modern economies. Unfortunately, Congress has shown little interest in addressing this foundational weakness in our financial system. The threat of a repeat of banking regulators' partly turf-driven overreaction to the Reserve Fund failure therefore continues to be very real. It is not clear that this risk is worth taking.

Finally, Congress has stripped banking regulators of powers necessary for them to take appropriate emergency action in the event of another severe liquidity event.[95] Section 1101 of the Dodd-Frank Act severely restricted banking regulators' authority under Section 13(3) of the Federal Reserve Act to extend credit to non-banking institutions, and legislation has been proposed that would impose further restrictions.[96] The MMF Act would broadly prohibit funds that rely on it from receiving any federal assistance. For all of banking regulators' post-crisis excesses, their mid-crisis management was essential to surviving the Financial Crisis. Their actions froze the run on money market funds, stabilized the industry, and actually generated substantial profits for the government while costing taxpayers nothing.[97] It is easy to forget that what might in peaceful times appear to be bureaucratic overreach may be the difference between preventing the collapse of our financial system and saving it from disaster. While it may have been prudent for Ulysses to lash himself to the mast under the circumstances, it would not have made sense to do so when the ship was headed for the rocks. With Congress having significantly hamstrung our ability to mitigate the effects of a future money market fund failure, and the MMF Act's broad prohibition against federal assistance, and considering the other factors cited above, I cannot support its rush to re-create that risk.

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[94] This is particularly true with respect to money market funds. *See generally* Melanie Fein, Shooting the Messenger: The Fed and Money Market Funds (2012). Banking regulators analysis of systemic risk posed by Metropolitan Life also showed an inadequate understanding of insurance.

[95] At the time of the Financial Crisis, the Fed has authority to extend credit to nonbanking institutions under Section 13(3) of the Federal Reserve Act. In connection with the money market fund crisis, it relied on Section 13(3) to establish the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF") and the Commercial Paper Funding Facility (CPFF"). *See* Marc Labonte, Federal Reserve: Emergency Lending, Congressional Research Service at 26 – 27 (January 6, 2011)("CRS Report"). Section 1101 severely restricted the Fed's authority under Section 13(3). *See id.* at 10 – 11 (describing restrictions); *see generally Alexander Mehra, Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis*, 13 U. Pa. J. Bus. L. 221 (2010); Eric Posner, What Legal Authority Does the Fed Need During a Liquidity Crisis? 101 Minn. L. Rev. 1529, 1532 (2017) ("Unfortunately, in the Dodd-Frank Act, Congress moved in the opposite direction, weakening rather than strengthening [the Fed's] LLR ["Lender of Last Resort"]" function). Ironically, the Fed blamed limitations on its legal authority for not bailing out Lehman Bros., and it was Lehman debt that caused the Reserve Fund to break a dollar.

[96] *See, e.g.*, H.R. 4302 (2017).

[97] The money market insurance program generated $1 billion in premiums and no claims, the AMLF "experienced no losses and earned income of $0.5 billion over the life of the program," and the CPFF "earned income of $6.1 billion over the life of the program and suffered no losses." CRS Report, *supra*, at 26 – 27.