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CONGRESSIONAL TESTIMONY

"Private Equity"

Testimony before

The Committee on Banking, Housing and Urban Affairs

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

Summary of Key Points

1. Entrepreneurship is vital to innovation, improved productivity and better products. Entrepreneurship enhances wages, reduces price and improves the international competitiveness of U.S. businesses and workers.
2. Private capital markets are, by far, the primary means that entrepreneurs use to raise the capital necessary to launch and grow their businesses. Private equity, broadly defined, is absolutely vital to the economic future of the United States.
3. Public capital markets are in decline due to regulatory overreach. Firms go public later in their life-cycle and ordinary investors typically do not receive the returns generated by successful start-ups.
4. There is a major effort to apply the policies which have harmed the public market to the private market. If successful, this will have serious adverse consequences for investors, workers and consumers.
5. Private equity funds, narrowly defined, are the primary means of holding failing corporate management to account. They are the primary means by which troubled companies are acquired, management replaced and companies turned around.
6. The "Stop Wall Street Looting Act" (WSLA) would be more aptly named the "Protect Incompetent Management Act." The WSLA would erect a moat and high walls around failing companies so that it would become virtually impossible, and certainly economically unattractive, to take over failing companies and replace their management. While this may be attractive to corporate elites and their lobbyists, it is certainly not in the interests of shareholders, workers or consumers.
7. As drafted, the 100 percent tax in the WSLA on payments to private funds would be imposed on a host of businesses and payments far beyond what the authors of legislation say they intend (to wit, the confiscation of fees paid to private equity funds). There appears to be absolutely no limitation on this tax to private equity funds acquiring targets in the statutory definitions. It is monumentally poorly drafted.

The Importance of Entrepreneurship

Entrepreneurship matters. It fosters discovery and innovation.[1] Entrepreneurs also engage in the creative destruction of existing technologies, economic institutions and business production or

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[1] Israel M. Kirzner, *Competition and Entrepreneurship* (University of Chicago Press: 1973); Israel M. Kirzner, "Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach," *Journal of Economic Literature*, Vol. 35, No. 1 (1997); Randall Holcombe, *Entrepreneurship and Economic Progress* (Routledge: 2006); William J. Baumol, *The Microtheory of Innovative Entrepreneurship* (Princeton University Press: 2010).

management techniques by replacing them with new and better ones.[2] Entrepreneurs bear a high degree of uncertainty and are the source of much of the dynamism in our economy.[3] New, start-up businesses account for much, if not most, of the net job creation in the economy.[4] Entrepreneurs innovate, providing consumers with new or better products. They provide other businesses with innovative, lower cost production methods and are, therefore, one of the key factors in productivity improvement and real income growth.[5] The vast majority of economic gains from innovation and entrepreneurship accrue to the public at large rather than entrepreneurs.[6] Entrepreneurs are central to the dynamism, creativity and flexibility that enables market economies to consistently grow, adapt successfully to changing circumstances and create sustained prosperity.[7] Entrepreneurship promotes the common good, prosperity and a higher standard of living. Among the most important

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[2] See, e.g., Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (1942; Routledge: 1976), pp. 81-86 http://digamo.free.fr/capisoc.pdf; W. Michael Cox and Richard Alm, "Creative Destruction," *Concise Encyclopedia of Economics* (Liberty Fund: 2010) http://www.econlib.org/library/Enc/CreativeDestruction.html; Henry G. Manne, "The Entrepreneur in the Large Corporation," in *The Collected Works of Henry G. Manne*, Vol. 2 (Liberty Fund: 1996).

[3] Frank H. Knight, *Risk, Uncertainty, and Profit* (Houghton Mifflin: 1921) http://www.econlib.org/library/Knight/knRUP.html; Richard J. Cebula, Joshua C. Hall, Franklin G. Mixon Jr. and James E. Payne, *Economic Behavior, Economic Freedom, and Entrepreneurship* (Edward Elgar: 2015).

[4] Magnus Henrekson and Dan Johansson, "Gazelles as Job Creators: A Survey and Interpretation of the Evidence," *Small Business Economics*, Vol. 35 (2010), pp. 227–244 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1092938; Ryan Decker, John Haltiwanger, Ron Jarmin, and Javier Miranda, "The Role of Entrepreneurship in US Job Creation and Economic Dynamism," *Journal of Economic Perspectives*, Vol. 28, No. 3 (Summer 2014), pp. 3–24 http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.28.3.3; Salim Furth, "Research Review: Who Creates Jobs? Start-up Firms and New Businesses," Heritage Foundation Issue Brief No. 3891, April 4, 2013 http://www.heritage.org/research/reports/2013/04/who-creates-jobs-startup-firms-and-new-businesses. In terms of the neo-classical growth model, entrepreneurship is an important factor affecting the rate of technological change and the marginal productivity of capital. See, e.g., Robert M. Solow, *Growth Theory: An Exposition* (Oxford University Press: 2000). Legal institutions, human capital and other factors are also important determinants of economic growth. See N. Gregory Mankiw, David Romer and David N. Weil, "A Contribution to the Empirics of Economic Growth," *The Quarterly Journal of Economics*, Vol. 107, No. 2 (May, 1992), pp. 407-437 https://eml.berkeley.edu/~dromer/papers/MRW_QJE1992.pdf; Robert J. Barro, *Economic Growth*, 2nd edition (MIT Press: 2003).

[5] Ralph Landau, "Technology and Capital Formation," in *Technology and Capital Formation*, Dale W. Jorgenson and Ralph Landau, editors (MIT Press: 1989).

[6] Yale economist William Nordhaus has estimated that 98 percent of the economic gains from innovation and entrepreneurship are received by persons other than the innovator. See William D. Nordhaus, "Schumpeterian Profits in the American Economy: Theory and Measurement," NBER Working Paper No. 10433, April 2004 https://www.nber.org/papers/w10433.pdf.

[7] See, Decker *et al*, *supra*; C. Mirjam van Praag and Peter H. Versloot, "What is the Value of Entrepreneurship? A Review of Recent Research," *Small Business Economics*, Volume 29, Issue 4 (December 2007), pp 351-382 https://link.springer.com/content/pdf/10.1007%2Fs11187-007-9074-x.pdf; David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; Deirdre N. McCloskey *Bourgeois Equality: How Ideas, Not Capital or Institutions, Enriched the World* (University of Chicago Press: 2016); Adam Thierer, *Permissionless Innovation: The Continuing Case for Comprehensive Technological Freedom* (Mercatus Center: 2016); David R. Burton, "Building an Opportunity Economy: The State of Small Business and Entrepreneurship," Testimony before the Committee on Small Business, United States House of Representatives, March 4, 2015 https://www.heritage.org/testimony/building-opportunity-economy-the-state-small-business-and-entrepreneurship; George Gilder, "Capitalism is an Information and Learning System," Remarks, November 15, 2018 https://www.heritage.org/markets-and-finance/event/capitalism-information-and-learning-system; Friedrich A. Hayek, "The Use of Knowledge in Society," *The American Economic Review*, Vol. 35, No. 4 (September, 1945), pp. 519-530 https://www.econlib.org/library/Essays/hykKnw.html.

factors impeding entrepreneurship are securities laws that restrict entrepreneurs' access to the capital needed to launch or grow their businesses.[8] After all, without capital to launch a business, other impediments to entrepreneurial success are moot.

Sometimes, an entrepreneur has sufficient capital to launch and grow his or her business from personal savings, including profits from previous entrepreneurial ventures, and retained earnings. Often, however, an entrepreneurial firm will need capital from outside investors or lenders.[9] Other than friends or family, outside investors are typically described as "angel investors" or "venture capitalists."[10] Typically, "angel investors" are individuals who invest at the early "seed stage" while "venture capitalists" are firms or funds that make investments later in the firms' life-cycle after "proof of concept." Firms seeking outside investors are often the most dynamic, high growth companies.[11] In principle, Regulation A and Regulation CF would allow ordinary investors to invest in young firms and for young firms to find a new source of capital. So far, they have been of relatively minor importance largely due to the regulatory and statutory structure of these exemptions. Regulation D and other private offerings remain the most important source of capital for young, dynamic firms.

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[8] Banking laws and practices are a contributing factor. For a short introduction to the problems, see SEC Commissioner Daniel M. Gallagher, "Whatever Happened to Promoting Small Business Capital Formation?," September 17, 2014 http://www.sec.gov/News/Speech/Detail/Speech/1370542976550#.VFfbI8mGklQ.

[9] See, e.g., "2013 State of Entrepreneurship Address: Financing Entrepreneurial Growth," Kauffman Foundation Research Paper, February 5, 2013 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2212743; *The Oxford Handbook of Venture Capital*, Douglas Cumming, Editor (Oxford: 2012).

[10] See Angel Capital Association http://www.angelcapitalassociation.org/ and National Venture Capital Association http://www.nvca.org/. See also Ibrahim, Darian M., "Should Angel-Backed Start-ups Reject Venture Capital?," *Michigan Journal of Private Equity & Venture Capital Law*, Vol. 2, pp. 251-269 http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=2734&context=facpubs; Abraham J.B. Cable, "Fending For Themselves: Why Securities Regulations Should Encourage Angel Groups," *University of Pennsylvania Journal of Business Law*, Vol. 13, No. 1, Fall 2010, pp. 107-172 https://www.law.upenn.edu/journals/jbl/articles/volume13/issue1/Cable13U.Pa.J.Bus.L.107%282010%29.pdf; Darian M. Ibrahim, "The (Not So) Puzzling Behavior of Angel Investors," *Vanderbilt Law Review*, Vol. 61, p. 1405-1452 (2008) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984899; Brent Goldfarb, Gerard Hoberg, David Kirsch and Alexander Triantis, "Does Angel Participation Matter? An Analysis of Early Venture Financing," Angel Capital Association, April 4, 2008 http://www.angelcapitalassociation.org/data/ACEF/ACEFDocuments/Does%20Angel%20Participation%20Matter%20-%20Analysis%20of%20Early%20Venture%20Financing.pdf.

[11] Sampsa Samila and Olav Sorenson, "Venture Capital, Entrepreneurship, and Economic Growth, *Review of Economics and Statistics*, February, 2011, Vol. 93, No. 1, pp. 338-349; Dane Stangler, "High-Growth Firms and the Future of the American Economy, Kauffman Foundation, March 9, 2010 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568246.

The 2012 JOBS Act[12] was a bipartisan achievement of consequence.[13] It substantially improved the laws governing entrepreneurial capital formation.[14] Although the implementation of the JOBS Act by the Commission was unnecessarily heavy-handed, the SEC has made some improvements in the regulatory environment for entrepreneurial capital formation over the past several years. Much more needs to be done by Congress, the Commission and other regulators.

The Importance of Private Capital Markets to Innovation, Dynamism, Good Wages and Prosperity

Section 4(a)(2) of the Securities Act exempts "transactions by an issuer not involving any public offering."[15] Prior to the JOBS Act, the exemption was in §4(2). This exemption is typically called the "private placement" or "private offering" exemption.

Private offerings are the most important source of capital for American businesses, accounting for *at least* $2.9 trillion in raised capital annually.[16] By comparison, registered (public) offerings raised less than half of that amount ($1.4 trillion).[17] Regulation D is the most important means of raising private capital amounting to approximately $1.7 trillion in 2018.[18] Regulation D is lightly regulated and a tremendous success. The SEC adopted Regulation D in 1982 during the Reagan Administration.[19] It is not an overstatement to say that our economy would not be recognizable without Regulation D. Damaging Regulation D would harm the dynamism of our economy in incalculable ways and have an adverse impact on tens of millions of working men and women and consumers.

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[12] Jumpstart Our Business Startups Act, Public Law 112–106, April 5, 2012, http://www.gpo.gov/fdsys/pkg/PLAW-112publ106/pdf/PLAW-112publ106.pdf.

[13] H.R. 3606 (112th Cong.) passed the House with overwhelming support, 390 to 23: Final Vote Results for Roll Call 110, H.R. 3606, Recorded Vote, March 8, 2012, http://clerk.house.gov/evs/2012/roll110.xml, and passed the Senate by a wide margin, 73 to 26: U.S. Senate Roll Call Votes 112th Congress–2nd Session, H.R. 3606, March 22, 2012, http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=112&session=2&vote=00055.

[14] See, e.g., David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; Thaya Brook Knight, "A Walk Through the JOBS Act of 2012: Deregulation in the Wake of Financial Crisis," Cato Institute Policy Analysis 790, May 3, 2016 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2833877#.

[15] 15 U.S. Code § 77d(a)(2)

[16] SEC "Concept Release on Harmonization of Securities Offering Exemptions," *Federal Register*, Vol. 84, No. 123, June 26, 2019, p. 30466, Table 2 — Overview of Amounts Raised in the Exempt Market in 2018 https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13255.pdf.

[17] SEC "Concept Release on Harmonization of Securities Offering Exemptions," *Federal Register*, Vol. 84, No. 123, June 26, 2019, p. 30465, Figure 1: Capital Raised in Exempt and Registered Capital Markets, 2009-2018 https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13255.pdf.

[18] Ibid., p. 30466, Table 2. See also David R. Burton, "Don't Crush the Ability of Entrepreneurs and Small Businesses to Raise Capital," Heritage Foundation Backgrounder No. 2874, February 5, 2014 https://thf_media.s3.amazonaws.com/2014/pdf/BG2874.pdf.

[19] "Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers of Sales" (Release No. 33-6389), *Federal Register*, No. 47 (March 16, 1982), p. 11251. Regulation D is found at 17 C.F.R. §230.500 through §230.508. See "Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1993 for Transactions Involving Limited O ers of Sales" (Release No. 33-6339), *Federal Register*, No. 46 (August 18, 1981), p. 41791, for the original proposed rule.

The estimates for section 4(a)(2) below are almost certainly substantially lower than the actual amount because the SEC used Thomson Financial's SDC Platinum,[20] which uses information from underwriters, issuer websites, and issuer SEC filings, to quantify section 4(a)(2) raises. It will not capture the amounts raised by typical small businesses throughout the country from family, friends and angel investors. These small business owners raise capital using the section 4(a)(2) exemption – usually without knowing the exemption even exists. Also, while Regulation A and crowdfunding are "exempt offerings" in the sense that they are not "registered offerings" they are not really private offerings either. They are best thought of as quasi-public offerings.

Amounts Raised in the Exempt and Registered Market in 2018 ($ billions)

Offering Type	Amount Raised	Amount Raised (Subcategories)
Registered (Public)	$1,400	
Exempt (Private)	$2,912	
Rule 506(b) of Regulation D		$1,500
Rule 506(c) of Regulation D		$211
Regulation A: Tier 1		$0.061
Regulation A: Tier 2		$0.671
Regulation Crowdfunding		$0.055
Rule 504 of Regulation D		$0.002
Other exempt offerings (section 4(a)(2), Regulation S, and Rule 144A offerings)		$1,200

Source: Securities and Exchange Commission, *Concept Release on Harmonization of Securities Offering Exemptions*

There is no definition in the Securities Act or the Securities Exchange Act or, for that matter, in the securities regulations, of a "public offering" or, conversely, of what is not a public offering. Investors and their attorneys must rely on various court cases, SEC interpretive releases, SEC concept releases, SEC policy statements, SEC staff interpretations, SEC staff legal bulletins, and SEC "no action" letters to make judgments about what will be deemed a public offering. The leading Supreme Court case interpreting this statutory provision is *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). In that 1953 case, the court held that "the applicability of §4(1) [now §4(a)(2)] should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'" This "fend for themselves" formulation is highly suspect in that, whether or not an offering is "public" is analytically unrelated to whether or not the investors in the offering can "fend for themselves." For example, an offering to one utterly unsophisticated person wholly incapable of fending for himself with whom there is a substantial pre-existing relationship is not public in any meaningful sense. (For instance, when the CEO's never-employed son who was a poetry major in college is the sole offeree.) Conversely, an offering limited to those demonstrably able to "fend for themselves" (by whatever measure) conducted on national television and with whom there was no pre-existing relationship is certainly public in the ordinary sense of the term (and the authors of the Securities Act of 1933 undoubtedly intended for it to be treated as such).

[20] Ibid p. 30466, at footnote 41.

Although private offerings do not necessarily have to be in compliance with Regulation D, Regulation D provides a regulatory safe harbor such that if an issuer meets the requirements of Regulation D, the issuer will be treated as having made a private offering. Because it is a relatively easy, straight-forward means of ensuring that an offering will be deemed a private placement and because Rule 506 offerings do not need to comply with state blue sky registration and qualification rules, Regulation D Rule 506 offerings have become the most common choice for those raising significant amounts of private capital.

Public Capital Markets are in Decline Due to Regulatory Impediments

The market capitalization of U.S. public companies is on the order of $50 trillion.[21] These markets play a critical role in allocating capital in the U.S. economy, funding growth and funding the retirement of millions of Americans. Unfortunately, being a public company has become increasingly costly because of a vast array of costly regulations and regulatory risk. The number of public companies has declined by almost half over the past quarter century[22] despite the real GDP growing by about 80 percent[23] and the population increasing by about 26 percent.

A large number of poor regulatory decisions over many years have made companies go public later or not at all and many public companies have gone private. Regulators appear to think that they can pile ever-increasing regulatory burdens on firms without any adverse impact. This has an adverse impact on investors because the large gains from entrepreneurship now accrue to relatively wealthy accredited investors operating in private markets and has an adverse impact on young, dynamic and growing companies because they cannot access public capital markets cost-effectively. It also reduces economic growth and economic dynamism to the detriment of the broader public.

The core objective of securities law should be deterring and punishing fraud and fostering reasonable, limited, scaled disclosure by firms for the purpose of providing material information to investors. Statutory provision and regulations that do not meet these objectives should be discarded. Just because somebody somewhere or a small group of investors or non-investors wants free information at the expense of shareholders does not mean regulators should mandate it. And requirements to provide information that has a political purpose unrelated to investors' returns should be particularly suspect.

The Attack on Private Capital Markets

There are proposals to radically restrict access to Regulation D by raising the accredited investor thresholds. There are proposals to impose ESG requirements on private issuers. There is, of course, the "Stop Wall Street Looting Act" which is a direct attack on private equity funds. All of these would increase the cost of raising capital and of operating a business. They would harm the

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[21] Total Market Capitalization of Public U.S. Companies (USD, millions) as of December 31, 2020 https://siblisresearch.com/data/us-stock-market-value/.

[22] See, for example, Les Brorsen, "Looking Behind the Declining Number of Public Companies," *Harvard Law School Forum on Corporate Governance*, May 18, 2017 https://corpgov.law.harvard.edu/2017/05/18/looking-behind-the-declining-number-of-public-companies/; Craig Doidge, G. Andrew Karolyi and René M. Stulz, "The U.S. Listing Gap," NBER Working Paper 21181, May 2015 http://www.nber.org/papers/w21181.

[23] Real Gross Domestic Product, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/GDPC1.

dynamism of the U.S. economy. They would harm innovation. They would reduce productivity and reduce wages. They would cost jobs and reduce opportunity. They would make management of incumbent firms more entrenched and less accountable. They would disproportionately harm small and start-up businesses and lead to greater concentration and less competition.

The Meaning of the term "Private Equity"

The term private equity can mean several different things. It can mean an equity investment in securities that are not a registered, publicly traded securities. In other words, an equity investment in a private offering. It can mean private equity, as in equity investments made by any private fund (including venture capital funds, angel led groups, hedge funds, Small Business Investment Companies (SBICs), Business Development Companies (BDCs), private equity funds (narrowly defined), and a host of other private company investment. Or the term can be used more narrowly for private funds that specialize in acquiring troubled or failing firms or specialize in acquiring firms with a combination of equity and debt but relatively high levels of debt. The later are often called leveraged buy-outs or LBOs.

The Vital Importance of Private Equity Funds, Broadly Defined

As discussed above, private equity funds, broadly defined, are the primary means of raising entrepreneurial capital and absolutely vital to the economic future of the United States. Most successful new companies over the past four decades raised their capital in the private market. They did not do an initial public offering until relatively late in their life cycle (if at all). Neither Congress nor the SEC should do anything to harm this market.[24]

The Importance of Private Equity Funds, Narrowly Defined

Private equity funds, narrowly defined, play a critical economic role as well. They are one of the few remaining practical means of taking over failing public companies, replacing the failed management and turning the company around. But for these funds, the management of public companies would be effectively unassailable and accountable to nobody. Effectively protecting incumbent management from takeovers is undoubtedly attractive to corporate elites and their lobbyists, but it is certainly not in the interests of shareholders, workers or consumers. Congress should not protect failing incumbent managers.

Obviously, not every turnaround attempt is successful. Some fail. But Congress should not adopt legislation that would make it virtually impossible to even try. Doing so would be bad for those that work for these firms since they will all lose their jobs in the absence of a turn around attempt. It would be bad for existing investors since there will be few opportunities to salvage troubled

[24] For a detailed discussion of these issues and citations to supporting data, academic research and proposals for reform, see David R. Burton and Norbert J. Michel, :Proposals to Foster Economic Growth and Capital Formation," March 18th, 2021 https://www.banking.senate.gov/imo/media/doc/David%20Burton%20and%20Norbert%20Michel%20-%202021-3-18.pdf. See also David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf.

companies. It would be bad for customers since the firms from which they buy goods and services will fail.

Inevitably, adjustments necessary for a failing firm to survive can be painful. But the alternative is either bankruptcy -- because an equity infusion will not be forthcoming and banks or other lenders will stop lending to a failing firm – or government subsidies or bail-outs. It is not desirable to subsidize or bail-out failing firms, including financial institutions. Badly run, unprofitable firms should be allowed to fail. Bail-outs and subsidies make the market markedly less effective at providing goods and services, induce firms to take unwarranted risks, protect incompetent management, raise prices and reduce innovation, increase concentration and harm small competitors and cost taxpayers. Socializing loss and privatizing profit is also unethical.

The Likely Impact of the Proposed "Stop Wall Street Looting Act"

The "Stop Wall Street Looting Act" (WSLA)[25] would be more aptly named the "Protect Incompetent Management Act." The WSLA would erect a moat and high walls around failing companies so that it would become virtually impossible, and certainly economically unattractive, to take over failing companies and replace their management. While this legislation may be attractive to corporate elites and their lobbyists, it is certainly not in the interests of shareholders, workers or consumers. If enacted, WSLA would make it vastly more difficult for troubled firms to find equity investors and make it much more difficult to replace failing management to turn around a company.

Liability for Target Company Debts

The bill would make owners (other than limited partners), officers, directors and other "insiders" of private funds liable for the debts and other liabilities of target companies and prohibits indemnification by the target firm with respect to these liabilities. This provision alone will make it vastly less attractive to acquire an indebted and failing firm.

The definition of private fund is extremely broad. A private fund is generally defined as a company that "would be considered an investment company under section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3) but for the application of paragraph (1) or (7) of subsection (c) of such section 3"[26] and is "not a venture capital fund, as defined in section 275.203(l)–1 of title 17, Code of Federal Regulations." This definition of a venture capital fund goes on for approximately 1,000 words and would exclude many actual venture capital funds either because they acquire debt securities (including convertible bonds or notes), are insufficiently diversified or have more than a de minimis degree of leverage.

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[25] Note: The discussion in this section is based on a draft of the 2021 version of the Stop Wall Street Looting Act, provided by committee staff on October 18th, which is the version expected to be introduced this week. My written testimony had to be submitted by October 19th at 2:00 p.m. It is, of course, possible that the version actually introduced will be different. The 2019 version was introduced as S. 2155 (116th Congress). See also, The Stop Wall Street Looting Act of 2019, Section-by-Section https://www.warren.senate.gov/imo/media/doc/2019.7.17%20Stop%20Wall%20Street%20Looting%20Act%20Section%20by%20Section.pdf.

[26] In general, paragraphs (1) and (7) exclude funds that do not presently propose to make a public offering and are beneficially owned by not more than one hundred persons who are not qualified purchasers.

Fraudulent Transfers

Under current law, 11 U.S. Code §548 provides bankruptcy trustees the authority to police fraudulent transfers. The WSLA extends the lookback period after a change of control from two years to eight years and creates a presumption that any payments to the private fund by the debtor were fraudulent. This too will make acquiring a failing company substantially less attractive.

Confiscatory Taxation

The section-by-section description of the 2019 WSLA says that the bill "Applies a 100% tax on fees paid by target firms to private fund managers, often called "monitoring" or "transaction" fees, effectively ending this form of looting of portfolio companies by managers."[27] The 2021 statutory language amending the Internal Revenue Code, however, does not appear to be limited to just such fees. It states:

> The term 'applicable payment' means **any** amount paid or incurred by an applicable entity (or any person related within the meaning of section 267(b) or 707(b) to such entity) to **any** other person which, at the time such amount is paid or incurred, is an applicable controlling entity. (emphasis added)

An 'applicable entity' is probably *meant* to be a target firm but the statutory language would include just about any firm in the universe.

> The term 'applicable entity' means **any** person—
>
> > "(A) which is engaged in the active conduct of a trade or business, and
> > "(B) with respect to which **any** other person conducts activities in connection with an applicable trade or business. (emphasis added)

The term 'applicable trade or business' means **any** activity conducted on a regular, continuous, and substantial basis that consists of (1) raising or returning capital, and (2) investing in or disposing of specified assets (or identifying specified assets for such investing or disposition) or developing specified assets. Specified assets are securities and real estate "held for rental or investment."

The definition of 'applicable controlling entity' is also very, very broad and will include a host of businesses that presumably are far beyond what the authors of the legislation say they intend. It would include **any** entity which controls the applicable entity and is engaged in an applicable trade or business.

In short, as drafted, this bill would impose a confiscatory 100 percent tax on almost all payments from almost any firm to almost any investment fund indefinitely.[28] There appears to be absolutely

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[27] The Stop Wall Street Looting Act of 2019, Section-by-Section https://www.warren.senate.gov/imo/media/doc/2019.7.17%20Stop%20Wall%20Street%20Looting%20Act%20Section%20by%20Section.pdf.

[28] Once state taxes are considered, the tax rate will exceed 100 percent.

no limitation on this tax to private equity funds acquiring targets in the statutory definitions. It is monumentally poorly drafted.

Non-Deductibility of Interest

The limitation on the deductibility of interest would make a normal business expense non-deductible and is therefore a substantial move toward the discredited gross income or gross receipts tax.[29] Interest has generally been deductible for purposes of computing taxable income since the advent of the modern income tax.[30] It still *generally* is.[31]

There are two competing conceptions of income in public finance.[32] One is called the Haig-Simons definition of income.[33] The other is sometimes called the Fisher-Ture definition of income[34] although this concept has intellectual antecedents dating back to at least John Stuart Mill in the 19th century.[35] Although not universally the case, the Haig-Simons definition is most often

[29] Andrew Chamberlain and Patrick Fleenor, "Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes," Special Report No. 147, December, 2006 ("it is not possible for lawmakers to craft an economically neutral gross receipts tax") https://files.taxfoundation.org/legacy/docs/sr147.pdf; Nicole Kaeding and Erica Wilt, "Gross Receipts Taxes: Lessons from Previous State Experiences," Fiscal Fact No. 523, August 9, 2016 https://files.taxfoundation.org/20170209073111/TaxFoundation_FF523_0.pdf.

[30] See Revenue Act of 1913, section II.B. ("That in computing net income for the purpose of the normal tax there shall be allowed as deductions: First, the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses; second, all interest paid within the year by a taxable person on indebtedness …")

[31] Internal Revenue Code §163(a) ("There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.").

[32] For a good collection of writing on the subject of measuring and defining income written primarily by authors outside of the field of public finance, see R.H. Parker and G.C. Harcourt, *Readings in the Concept and Measurement of Income* (Cambridge, U.K.: Cambridge University Press, 1969).

[33] Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University of Chicago Press, 1938; Robert Murray Haig, "The Concept of Income – Economic and Legal Aspects," in *The Federal Income Tax*, Robert Murray Haig, Ed., (New York: Columbia University Press, 1921), pp. 1-28 reprinted in *American Economic Association Readings in the Economics of Taxation*, Vol. IX, Richard A. Musgrave and Carl S. Shoup, Eds., (Homewood, IL: Richard D. Irwin, 1959).

[34] Irving Fisher, *Elementary Principles of Economics* (New York: MacMillan, 1910, Chapter III ("A stock of wealth existing at a given instant of time is called capital; a flow of benefits from wealth through a period of time is called income."); Irving Fisher, "Income in Theory and Income Taxation in Practice," *Econometrica* (January 1937); Irving Fisher, "The Double Taxation of Savings," *American Economic Review*, Vol. 29 (March 1939), p. 1; Irving Fisher, "The Unperceived Double Taxation of Income, Answers to Those that Deny Its Existence," 1946, previously unpublished manuscript published in William J. Barber, ed., *The Works of Irving Fisher*, Vol. 12, "Contributions to the Theory and Practice of Public Finance" (London: Pickering and Chatto, 1997); Irving Fisher, "Paradoxes in Taxing Savings," *Econometrica* (April 1942); Irving Fisher and Herbert Fisher, *Constructive Income Taxation* (New York: Harper and Brothers, 1942); Norman B. Ture, "Supply Side Analysis and Public Policy," in David G. Raboy, ed., *Essays in Supply Side Economics* (Washington, DC: The Institute for Research on the Economics of Taxation, 1982), http://iret.org/pub/SupplySideBook.pdf; and Norman B. Ture, "The Inflow Outflow Tax—A Saving-Deferred Neutral Tax System," The Institute for Research on the Economics of Taxation, 1997, http://iret.org/pub/inflow_outflow.pdf .

[35] John Stuart Mill, *The Principles of Political Economy with Some of Their Applications to Social Philosophy* (1848), Book V: On the Influence of Government, Chapter III: Of Direct Taxes, § 5. [An Income Tax] ["all sums saved from income and invested, should be exempt from the tax"]. See also Chapter II: On the General Principles of Taxation https://oll.libertyfund.org/title/mill-the-collected-works-of-john-stuart-mill-volume-iii-principles-of-political-economy-part-ii#lf0223-03_label_1165.

associated with liberal and progressive analysts while The Fisher-Ture definition of income is most often associated with conservative and libertarian analysts.[36] The Haig-Simons definition is what is most commonly seen in modern public finance textbooks. The Haig-Simons definition defines income as the sum of consumption plus changes in net wealth.[37] The Fisher-Ture definition defines income as gross receipts less any outlays or disbursements made to earn current or future income. In both cases, interest income increases income and interest expense reduces income.

A simple example may help better understand the difference between these two conceptions of income. Consider a farmer who bought a tractor for $100,000. The tractor has an expected useful life of ten years. In the first year, the farmer sells crops worth $25,000. Has the farmer made money? Proponents of the Haig-Simons definition of income would say yes, he has income of $15,000 in the first year. This is calculated by saying the tractor has depreciated or declined in value by $10,000,[38] so the farmer has a $10,000 depreciation expense to deduct against his $25,000 of gross receipts. Proponents of the Fisher-Ture definition of income would argue that the farmer has not made money until he has recovered the cost of the tractor. Thus, having spent $100,000 on the tractor and having only $25,000 in income, he has lost $75,000 in the first year. It is important to note that both result in a ten-year net income of $150,000, provided that the farmer *actually* earns $25,000 a year for ten years and then that the tractor is scrapped at the end of the tenth year and has no salvage value. This is because the farmer would have ten years of income at $25,000 per year (i.e. a total of $250,000) and $10,000 of annual depreciation times ten years equals the $100,000 cost of acquiring the tractor. Given the time value of money, however, the two methods are not economically equivalent and at times of high interest rates, this difference can be quite substantial.

Using the Haig-Simons definition of income, interest income either increases net wealth or funds consumption. Conversely, interest payments either reduce net wealth or reduce consumption. Using the Fisher-Ture definition of income, interest income is a gross receipt and should be

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[36] The reason for this is that the Haig-Simons definition implies a higher effective marginal tax rate on capital income which appeals to some progressives. The fact is, however, that graduated tax rates can be applied to a Fisher-Ture tax base and any distributional outcome sought can be obtained. For any given level of tax revenue, the Fisher-Ture tax base has a lower excess burden or deadweight loss. This is because factor incomes are taxed once and equally by a Fisher-Ture tax base and capital income is taxed twice under Haig-Simons. Fisher-Ture is less distortionary and has a lower excess burden.

[37] Simons' exact words were "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period in question." Simons, *Personal Income Taxation*), p. 50. Haig's formulation was "[i]ncome is the money value of the net accretion in economic power between two points in time." Haig, "The Concept of Income,' p. 27.

[38] This assumes that the tractor declines in value evenly over time and that straight-line depreciation method is used. Other methods are possible (e.g. double declining balance, sum of the years digits, production units, etc.). Economists often use geometric decay since it can be mathematically more tractable in certain models. For information on tax depreciation, see, "How to Depreciate Property," Internal Revenue Service, Publication 946 (2020) https://www.irs.gov/publications/p946. See also Charles R. Hulten, "The Measurement of Capital," in *Fifty Years of Economic Measurement: The Jubilee of the Conference on Research in Income and Wealth*, Ernst R. Berndt and Jack E. Triplett, eds. (Chicago: The University of Chicago Press for the National Bureau of Economic Research, 1990), pp. 119-152. Charles R. Hulten, "Getting Depreciation (Almost) Right," March, 2008 https://www.econ.umd.edu/sites/www.econ.umd.edu/files/pubs/Getting%20Economic%20Depreciation%20Almost%20Right.pdf.

included in income.[39] Similarly, interest expense should be deductible as a cost of acquiring capital.

Accounting conceptions of income lead to the same conclusion. Interest received is considered income and interest paid is considered an expense under generally accepted accounting principles (GAAP).[40] Both the Financial Accounting Standards Board (FASB)[41] and the Securities and Exchange Commission[42] require that interest income and expense be reflected on financial statements.[43]

Compensation Restrictions

In principle, I have no issue with well-considered restrictions on bonuses and other payments to management that drove their company into the dirt. The restrictions need to be carefully drafted to ensure that they do not impede the ability to hire new management in a turn around situation.

Carried Interest

The carried interest provisions in the bill are complex and generally counterproductive. There is, however, a need to draw the line between capital and labor income. But it need not be this complex. Raising the capital gains tax rate on true investments is both economically destructive and will reduce federal revenues.

Voluminous Disclosure Requirements

The Title V disclosure requirements are so voluminous that private fund disclosure would be a close cousin to public fund disclosure and be just as burdensome. This is probably the point. But, as discussed above, the private capital market is vital to the economic future of this country and we should be loath to damage it. Doing so will harm millions of ordinary people.

Private Equity Issues that Need to be Addressed

The SEC Division of Examinations has identified a number of issues relating to private equity funds, narrowly defined, that need to be addressed. There appears, however, to be an adequate statutory and regulatory framework to address the issues through examinations and enforcement.[44]

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[39] If the interest income is saved or invested, then there will be a countervailing deduction. If it is used to fund consumption, then there will be no countervailing deduction.

[40] See, for example, FASB's Accounting Standards Codification 835-20-20; *U.S. Mater GAAP Guide*, 2017 (Riverwoods, IL: CCH, 2016) Topic 835, Interest, p. 8137; Joanne M. Flood, *Wiley GAAP: Interpretation and Application of Generally Accepted Accounting Principles*, 2019 (Hoboken, NJ: John Wiley & Sons, 2019), chapter 55, p. 1070. Certain interest expense must be capitalized.

[41] Financial Accounting Standards Board https://www.fasb.org/home.

[42] The SEC is the primary regulator of companies that issue securities and their periodic financial disclosures. See Securities and Exchange Commission https://www.sec.gov/. See also David R. Burton, "Reforming the Securities and Exchange Commission," Heritage Foundation Backgrounder No. 3378, January 30, 2019 https://www.heritage.org/sites/default/files/2019-01/BG3378.pdf.

[43] See Securities and Exchange Commission Regulation S-X.

[44] "SEC Risk Alert, Observations from Examinations of Investment Advisers Managing Private Funds," Securities and Exchange Commission, June 23, 2020 https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.

There are many issues that need to be addressed to improve private equity, broadly defined. A partial list would include:[45]

1. Establish a fundamentally reformed, simplified and rationalized securities disclosure system with three basic categories of firm (private firms, quasi-public or venture firms and public firms), reasonable, scaled disclosure requirements and specified secondary markets.
2. Enact legislation permitting finders and private placement brokers substantially along the lines of the "Unlocking Capital for Small Businesses Act."
3. Congress should require the Division of Economic and Risk Analysis at the SEC to conduct a study mapping and reporting accredited investor data by state and county but permitting the use of core-based statistical areas or metropolitan statistical areas if data masking by the Census Bureau or the IRS Statistics of Income effectively requires their use.
4. Congress should amend the Securities Act section 4 by adding a new subsection (f) to create a safe harbor under section 4(a)(2) for micro-offerings. Alternatively, Congress should create a new exemption for micro-offerings under section 4(a) of the Securities Act by enacting a new section 4(a)(8).
5. Congress should provide that a natural person is an accredited investor for purposes of Regulation D who has:
    (1) passed a test demonstrating the requisite knowledge, such as the General Securities Representative Examination (Series 7), the Securities Analysis Examination (Series 86), or the Uniform Investment Adviser Law Examination (Series 65) or a newly created accredited investor examination testing for substantive investment knowledge;
    (2) met relevant educational requirements, such as an advanced degree in finance, accounting, business, economics or entrepreneurship; or
    (3) acquired relevant professional certification, accreditation, or licensure, such as being a certified public accountant, chartered financial analyst, certified financial planner, registered representative or registered investment advisor representative.
6. Self-certification should be allowed for all Rule 506 offerings and obtaining an investor self-certification should be deemed to constitute taking "reasonable steps to verify that purchasers of the securities are accredited investors" as required by the JOBS Act for Rule 506(c) offerings.
7. The statutory crowdfunding offering limit should be conformed to the new limit in Regulation CF. Clarify funding portal liability for the misstatements of issuers. Clarify that the term "issuer" does not include any person who is a broker or funding portal except with respect to securities of the entity (or its parents, subsidiaries, affiliates or other related parties) operating the broker or funding portal. Congress should make it clear that funding portals need not comply with AML rules because they may not hold customer funds. Allow

[45] For a detailed discussion of each of these proposals and citations to supporting data, academic research and draft statutory language, see David R. Burton and Norbert J. Michel, :Proposals to Foster Economic Growth and Capital Formation," March 18th, 2021 https://www.banking.senate.gov/imo/media/doc/David%20Burton%20and%20Norbert%20Michel%20-%202021-3-18.pdf.

curation by funding portals by repeal restrictions on investment advice. Alternatively, allow "impersonal investment advice" by funding portals.

8. Amend Section 1361(c) of the Internal Revenue Code to disregard crowdfunding and Regulation A shareholders for purposes of the 100 shareholder limit for Subchapter S corporations.
9. Preempt blue sky registration and qualification requirements for all primary and secondary Regulation A offerings.
10. Require an annual SEC and one-time GAO study that collects and reports data from state regulators on the fees or taxes they collect from issuers. These studies should collect data from at least the years 2017-2020 and classify the fees and taxes collected from issuers by offering type.
11. Codify and broaden the exemption from the section 12(g) holder-of-record limitations for Regulation A securities. Eliminate the income and net worth limitations imposed by Regulation A (although not by Securities Act section 3(b)).
12. Exempt P2P lending from federal and state securities laws. Amend Title III of the JOBS Act to create a category of crowdfunding security called a "crowdfunding debt security" or "peer-to-peer debt security" with lesser continuing reporting obligations. Congress could adopt an alternative regulatory regime for P2P lending.
13. Exempt business brokers from the broker-dealer registration requirements. Alternatively, register and reasonably regulate business brokers.
14. Congress should require the SEC to publish better data on securities offerings, securities markets and securities law enforcement and to publish an annual data book of time series data on these matters (as outlined below). The Division of Economic and Risk Analysis (DERA) should publish annual data on:
    (1) the number of offerings and offering amounts by type (including type of issuer[46], type of security[47] and exemption used[48]);
    (2) ongoing and offering compliance costs by size and type of firm and by exemption used or registered status (e.g. emerging growth company, smaller reporting company, fully reporting company) including both offering costs and the cost of ongoing compliance;
    (3) enforcement (by the SEC, state regulators and SROs), including the type and number of violations,[49] the type and number of violators and the amount of money involved;

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[46] By industry; by measures of size such as gross revenues, assets or employees; by age (i.e. years in existence); reporting status; and so on.

[47] Common stock, preferred stock, bond, (and whether the bond or preferred stock is convertible into common stock), other classes of security, whether options or warrants were attached; and so on.

[48] Regulation D (Rule 504 and 506 (including 506(b) and 506(c)); Regulation A (Tier 1 and Tier 2); Crowdfunding (Tiers 1, 2 & 3); non-Regulation D section 4(a)(2) offerings, Rule 144A and other exemptions.

[49] Civil or Criminal (referrals, convictions, settlements); with respect to broker-dealers (Breach of Fiduciary Duty, Suitability violations, Negligence, Failure to Supervise, Misrepresentation, Fraud, Breach of Contract, Omission of Facts, Violation of Blue Sky Laws, Unauthorized Trading, Manipulation, Churning); issuer violations by type of violation (e.g. fraud, non-compliance with Regulation S-K, Regulation S-X, failure to file an 8-K, Regulation A, Regulation CF, etc.) and type of issuer ((private issuer, Regulation A issuer, crowdfunding issuer, reporting company, investment company, registered investor advisor, broker-dealer, registered representative, etc.).

(4) basic market statistics such as market capitalization by type of issuer and type of security; the number of reporting companies, Regulation A issuers, crowdfunding issuers and the like; trading volumes by exchange or ATS; and
(5) market participants, including the number and, if relevant, size of broker-dealers, registered representatives, exchanges, alternative trading systems, investment companies, registered investment advisors and other information.

This data should be presented in time series over multiple years (including prior years to the extent possible) so that trends can be determined.