

Testimony of Professor John C. Coates IV
John F. Cogan, Jr. Professor of Law and Economics
Harvard Law School

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Examining Investor Risks in
Capital Raising

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Introduction

Chairman Reed, Ranking Member Crapo, and members of the Subcommittee, I want to thank you for inviting me to testify. Effective and efficient securities regulation is a foundation for economic growth, and I am honored to comment on the topic of protecting investors in the capital-raising process.

In Part I of my remarks, I make three preliminary and general points: (1) the proposals under review all raise the same general trade-off, which is best understood not as economic growth vs. investor protection, but as increasing economic growth by reducing the costs of *capital-raising* vs. reducing economic growth by raising the costs of *capital*; (2) neither I, nor any other witness, nor the SEC, nor any third party, can with any degree of certainty predict whether any proposal on its own, much less in combination, will in fact increase economic growth or reduce it, because the evidence that would allow one to make that prediction with confidence is not available; and (3) the proposals are thus all best viewed as proposals for risky but potentially valuable experiments, and should be treated as such – with an open mind, but also with caution and care. In Part II, I make a general suggestion that could be applied to any of the proposals that are adopted that is in keeping with the need for cautious and careful experimentation. In Part III, I provide responses to specific questions I was asked to address in the invitation to testify, including comments on each of the pending bills.

I. Growth vs. Growth, Uncertainty, and Experiments

While the various proposals being considered have been characterized as promoting jobs and economic growth by reducing regulatory burdens and costs, it is better to

understand them as changing, in similar ways, the balance that existing securities laws and regulations have struck between the transaction *costs of raising capital*, on the one hand, and the combined costs of fraud risk and asymmetric and unverifiable information, on the other hand. Importantly, fraud and asymmetric information not only have effects on fraud victims, but also on the *cost of capital* itself. Investors rationally increase the price they charge for capital if they anticipate fraud risk or do not have or cannot verify relevant information. Anti-fraud laws and disclosure and compliance obligations coupled with enforcement mechanisms reduce the cost of capital.

Each reform bill proposes a different way of achieving growth: lowering offer costs but raising higher capital costs (because of fraud risk and asymmetric information). Whether the proposals will in fact increase job growth depends on how intensively they will lower offer costs, how extensively new offerings will take advantage of the new means of raising capital, how much more often fraud can be expected to occur as a result of the changes, how serious the fraud will be, and how much the reduction in information verifiability will be as a result of the changes.

Thus, the proposals could not only generate front-page scandals, but reduce the very thing they are being promoted to increase: job growth. Suppose, for example, that the incidence of fraud is likely to be higher among issuers that rely on the reforms.¹ If so, and if investors cannot distinguish between new, higher-fraud-risk issuers from the current flow of lower-fraud-risk issuers, the changes may increase the cost of capital for all issuers at a rate in excess of the increase in new offerings facilitated by lower offering costs.² There is rarely a truly free lunch in this world.

The reform proposals all present difficult judgments about what will best increase job growth – and not a simple choice between generating job growth versus protecting investors. The trade-offs are highly uncertain, one by one, and even more uncertain in combination. Specific ways the proposals risk increasing the cost of capital to all entrepreneurs are discussed in Part III below. Between them, the SEC, the PCAOB, and FINRA already have authority to enact all or nearly all of the proposals without a Congressional act. These bills can thus only be understood as experiments in Congressional micromanagement of those agencies, which in general terms have more expertise and resources dedicating to studying the trade-offs than any other group of public officials.

It is true, however, that the agencies would need to get public comments on any of the reforms before adopting them. In the process, they probably would improve the results. But they would take a long time to do that, even in the best of times. And these are times of stress for the financial regulatory agencies as much as for the financial markets. Fewer than one in five of the rules required of the SEC and other financial regulatory agencies under Dodd-Frank have been finalized, and the public is in the middle of commenting on (and the agency staff are still trying to digest comments on) more than 50 pending regulatory proposals from the SEC alone.³ Congress did not give the SEC self-funding authority in Dodd-Frank, and as a result, the SEC is budget-constrained,⁴ and cannot devote the resources that would be ideal to trying to move towards smarter regulation.

(This is a point that those who oppose “active” regulatory agencies often miss – the same procedures and budget constraints that slow or deter regulation also slow and deter deregulation or improved regulation. Congress could fix this by giving the SEC the same

self-funding authority it has given to the Federal Reserve Board, or by requiring the SEC to devote a portion of its budget to deregulatory proposals, or simply by giving the SEC enough funds that it has no excuse for moving slowly on reform proposals. Even if one of these proposals were implemented, however, the Administrative Procedures Act (APA)⁵ would mean that the SEC would move slowly on any reform proposal in any event.)

In addition, finally, the agencies would have also to worry about being sued. In recent years, it has become an almost predictable ritual that any new and controversial rulemaking by the SEC will attract litigation by trade groups that perceive their members as having been disadvantaged by the rule, even for what distant observers would view as “deregulation.” Frequently, the SEC has lost this litigation,⁶ at times on grounds that have been in my view legally dubious.⁷ Knowing that court scrutiny of this kind is likely even when an agency advances a modest but controversial reform would make any regulatory agency rationally reluctant to move quickly, and instead will lead it to act deliberately to pile up as impressive a record as possible to present in the expected litigation.

As a result, given the urgency of the political and economic situation, and given that no more straightforward jobs proposal seem to be acceptable to both parties, it is understandable why these experiments are being proposed now, despite their already being underway SEC studies of several of the proposals, and despite the uncertainties they raise. It would also be understandable if lawmakers ultimately choose to act now, and not wait on agency action. But if it does that, it should do so with the uncertainty about the growth-growth trade-offs presented by the reform experiments in mind.

II. A General Suggestion

Given that any of these proposals will entail risks of increasing fraud and capital costs, even if modified as I suggest in Part III below, or as suggested by others, it would make sense to include in all of the adopted proposals a sunset provision, such that the proposals would by their terms last for no more than two or three years (or, in the case of S. 1933, seven years). At the end of that testing period, they would remain in place if – but only if – the SEC affirmatively finds that the benefits of continuing the proposals would outweigh their costs. During the testing period, the SEC would be able to complete its currently underway studies, as well as track the use of the new capital-raising options, as well as the extent of fraud that they permit. If the fears of fraud are overblown, and capital has been raised as their backers suggest will be the case, then the cost-benefit analysis should be simple, and the reforms would become permanent. If, however, large amounts of fraud occurs in the test phase, or if even a modest amount of fraud occurs but the reforms do not permit meaningful amounts of new capital-raising, then the agencies might not be able to conclude their benefits outweighed their costs, and the reforms would end.

To be practical, this suggestion might in some cases involve grandfathering market participants, as well as simple and inexpensive notice provisions to allow the agencies to track the use of the reforms, as already reflected in the crowdfunding proposals. The reforms could be tested in this way individually, so that some could remain in place and other not.

The advantage of the sunset approach would be to generate at least some of the information that would be needed to evaluate the reforms, to allow the reforms to be used but only for a modest time before that evaluation is completed, to allow for capital raising in the short-term, while the economy is stressed, and allow for a measured revisiting of the reforms once (we all hope) the economy has returned to a more normal state. Congress could, of course, re-enact the reforms on a permanent basis if it disagrees with the agencies.

III. Specific Responses and Comments

The following remarks respond to comments in the invitation to testify:

1. What factors influence the timing and extent of an issuer's access to the capital markets? How does investor confidence impact markets? What factors contribute to a high degree of investor confidence in the securities markets?

The extent and timing of an issuer's access to capital markets depends on both demand and supply side factors. On the demand side are the number,⁸ wealth,⁹ intelligence,¹⁰ liquidity- and risk-appetites, and confidence of investors, which affects market liquidity,¹¹ as well as the attractiveness of opportunities to spend or invest their money elsewhere. On the supply side, the foremost factors are those that make a given issuer a potentially good investment: the quality of the issuer's management, business plan, and its growth prospects, etc. But other supply side factors are important, include the legal protections afforded investors (including both the laws and the enforcement mechanisms for those laws),¹² the information required or voluntarily disclosed to investors,¹³ including by way of analyst coverage,¹⁴ and the direct offering costs of raising capital from investors.

The largest single direct offering cost for any public offering is usually the cost of hiring underwriters – which almost uniformly charge 7% for initial public offerings in the US, as compared to 4% in the EU.¹⁵ Offering costs also include those that are the focus of the pending reform proposals: legal, compliance and audit costs, both for the offering and on an ongoing basis as a result of laws triggered by capital-raising on the markets, which can be significant, particularly for smaller issuers. As noted, however, a reduction in these costs can be more than offset in an increase in capital costs, if the reduction in direct offering costs decreases investor confidence or the content or reliability of information required by investors.

2. What legal, financial, and practical risks do companies face when offering securities through the Internet or other social media?

In general, the use of the internet and social media do not in my view dramatically change the risks that companies face when offering securities from the risks that are present whenever the public is solicited to invest, except that offers via internet and social media are able to reach a much larger potential investor group more quickly, and without care and expense, their internet-based efforts will be treated (as they should be) as a general solicitation covered by Section 5 of the 1933 Act. I discuss the effects of the internet more particularly below, in the context of commenting on the crowdfunding proposals below.

3. What risks do investors face when investing in publicly held securities?

The economic risks include fraud, expropriation, and loss of investment, risks present in any investment. Many investors also fall prey to the illusion (sometimes reinforced by luck) that they can safely trade in and out of publicly held securities on a frequent basis,

not focusing on the dramatically negative effects that frequent trading by uninformed or poorly informed investors typically have on their total returns over time. The risks are generally lower for publicly held securities, because the investments are liquid, because the issuers are required to make disclosures, reviewed by the SEC staff, because the issuers are subject to greater compliance obligations, and because more public enforcement resources are devoted to public companies than to private companies. Nevertheless, the risks remain.

4. What investor protections (e.g. basic disclosures, liability, etc.) should exist when securities are sold to investors in public or private markets? Should those protections vary with the size of the offering, whether they are public or private, and whether they are offered to mainstream investors or accredited investors?

Investors should receive the most efficient bundle of protections that trades off the marginal cost of capital-raising, which represents the cost of those protections, against the marginal cost of capital, which is determined in part by the value of those protections. The precise configuration of protections is likely to vary across investments, investor dispersion (widely held vs. closely held), firm and offering size, and the nature of the investors. In general terms, the current SEC approach makes sense: generous exemptions and relatively light requirements for securities privately placed with qualified institutional buyers, narrow exemptions and heavier requirements for securities sold to the dispersed and often unsophisticated retail investors. One observation is that in my view the current “accredited investor” test is too weak – too many nominally accredited investors obtain the wealth that qualifies them as such in ways that do not reflect any ability or training to invest wisely (e.g., inheritance, gifts, high salaries for talented young athletes). It would be better if the SEC took more seriously the job of dividing

knowledgeable investors from others, through the use of tests – such as we require for everyone to legally drive, and create incentives for those who cannot or do not have the interest in so qualifying to invest through intermediaries, such as diversified mutual funds.¹⁶ Congress could direct the SEC to do so.

5. Do secondary market investors face risks different from those who purchase securities primary offerings? How does the availability of information in the secondary market affect liquidity and price?

Yes, the risks are different in secondary and primary offerings. In a primary offering, there is usually no prior market price, and investors must decide on a price on their own, based on their due diligence and information received from the company. In a secondary offering, at least one in a genuinely liquid market, a new investor can rely to an extent on prior market prices to at least simplify the task of price formation. Of course, secondary market prices can be manipulated, particularly if the market is illiquid, and secondary market prices are only as good as the information on which the prior trades were based. More and better information typically increases liquidity and price.

6. How would current legislative proposals affect investors? What changes, if any, should be considered in these proposals?

The proposed reforms fall into four categories: (1) crowdfunding (S.1791 and S.1970); (2) small offerings (S.1544); (3) 1934 Act registration triggers (S.556, S.1824 and S.1941); and (4) initial public offerings (*IPOs*) (S.1933). I address each in turn.

1. Crowdfunding.

The one genuinely new reform proposals on the table relate to crowdfinancing. Modeled on crowdsourced volunteer successes such as Wikipedia, person-to-person lending platforms such as Prosper Marketplace, Inc.,¹⁷ and crowdfunded (but not

financed) schemes for authorship or ownership rights to new music, plays, and discrete products (but not securities or investments), such as Kickstarter,¹⁸ crowdfunding promises to allow for entrepreneurs otherwise unconnected to conventional early-stage financing sources (family, friends, angels) to connect through the internet to “investors” who would be willing to risk small amounts to strangers for the hope of angel-investments-like returns. For fans of the internet, and for entrepreneurs unable to raise capital in other ways, would-be crowdfinanciers make an appealing pitch. Proponents add a dash of anti-Wall-Street and/or Silicon Valley sentiment – crowdfunding will enable the common man to avoid entanglements with the corrupt traditional centers of capital formation – and then point to a handful of experiments in other countries to show that the model can work.

The entirety of the crowdfunding concept suggests nothing to me so much as a catchy, high-risk, and very possibly fraudulent investment scheme. It might work. It might turn out to be a neat new thing. Or it might turn out to be mostly a cheaper, better vehicle for fraud, with negative spillover effects on the current person-to-person lending and crowdfunding project sites. Let me sketch some reasons to be cautious about crowdfunding *per se*, as opposed to crowd-sourced lending or product funding or social entrepreneurship.

From the perspective of the *honest* entrepreneur, what does crowdfunding promise? Given the limits that all crowdfunding proposals currently include – particularly the cap of \$1 million per firm – the fund you can obtain this way will practically only benefit a limited class of entrepreneurs – those working on low-capital-expenditure, low operating-expenditure projects (such as software products) that can be produced with sweat equity,

a laptop, bandwidth, and a coffeemaker. Still, these firms may find the prospect of cheap financing attractive, and the past twenty years have demonstrated repeatedly that such firms can create real value.

Nevertheless, creators of such firms should think carefully before moving to crowdfunding. Without significant investment of time on your part to screen investors, a host of strangers will end up owning a chunk of your company. You will have obligations to them as a fiduciary. Among them may be competitors, gadflies, journalists, cranks, and crooks. They will have rights to get information from your firm. They have standing to sue you. True, their rights are practically useless to them in protecting their legitimate interests as shareholders, but they can cause havoc in your already overworked schedule simply by making demands or filing a complaint. Almost by definition, they will be good at using the Internet to retaliate – with gossip, rumors, exaggerations, or lies -- if you treat them in ways they do not think appropriate. If you succeed, their expectations will soar, and if as is likely you eventually sell more equity – to a venture capital fund, for example – you will likely need to cash out the crowdfunding investors in order to get the venture capitalists to come in. If you ever need them to commit to a lock-up agreement or otherwise facilitate an initial public offering, good luck trying to get them all to agree. (Contrast this with person-to-person lending, where the recipient receives cash in return for a fixed repayment obligation, no different in kind than a credit card, that can generally be paid off at any time.)

From the perspective of investors, crowdfunding should be understood as an act of faith, at least as it would play out under S. 1791. Investors would have no practically effective ways to collect any return on their investment, except to the extent shares could

be sold to some other investor equally or more optimistic or irrational or charitable or profligate, depending on one's point of view.

Under S. 1791, securities regulators will have no ex ante role to play in reviewing disclosures. Ex post fraud liability, even if the heightened standards normally applied under the 1933 Act were applied, would do little to protect against such ordinary corporate transactions as recapitalizations at a low price, low-price mergers with companies controlled by the entrepreneurs, asset sales at a low price, or high compensation reducing to nearly zero any cash flow that the firm were to generate. While such actions might be actionable as breaches of fiduciary duty under corporate law, they would not likely constitute "fraud" in the narrow sense that courts have interpreted Rule 10b-5. As a practical matter, the small amount of money to be invested by any one crowdfinancier would make a private corporate law suit cost-prohibitive, and no self-respecting class action plaintiffs' attorney could be relied upon to know about much less police start-ups that are too small to even be called "microcap."

Unlike crowdfunded products, where a song or other computer-based good can be obtained and its quality verified, investments take time to grow in value, are constantly fluctuating in value, and are inherently based on future – indeed, the standard finance model of the value of a stock is to project future cash flows generated by the firm that has sold that stock. Unlike person-to-person lending, where the borrower has immediate interest or repayment obligations that can be monitored cheaply, the entrepreneur receiving a crowdfinanced investment will have no fixed obligations unless and until the firm is sold or liquidated, before which time many corporate finance transactions can rewrite the terms of the deal on a difficult-to-police basis. While it is possible to imagine

an honest entrepreneur using crowdfunding to generate a firm of great value and then, out of honesty, sharing that value with the initial investors, a well-advised investor would have to recognize that such outcomes will depend almost entirely upon the character of the entrepreneur. While crowdfunding is unlikely to reach the scale to cause any serious systemic financial problems, it would be well to remember that in the last financial bubble, “liar’s loans” were a common way for borrowers to obtain a mortgage – essentially loans based on character. That method of finance did not turn out so well.

In sum, crowdfunding should be recognized as a long shot for both entrepreneurs and investors alike. It might work, in very limited contexts, if the participants have some social or other extra-legal reason to trust one another, and to fulfill that trust. To the extent crowdfunding genuinely is meant to resemble its predecessors in the internet space, the investments would be made by numerous investors (contrary to the usual angel or venture capital model) who nevertheless know and vet each other through an existing and ongoing online community, who can identify each other in a verifiable way (and so weed out sock-puppets and shills) for can communicate with one another about their common investments, rely on each other for information and advice, and would only make small diversified investments with specific safeguards, such as an escrow account into which investments would be placed until a designated project amount was reached – the idea being that no one investor’s money would be used until the project had been “approved” by virtue of a large number of other investors committing their money. And at the end of the day, the investors would make their investments knowing, in effect, not simply that the investments were “risky” or even “highly risky,” but near-charitable donations that might produce a windfall – more akin to a lottery than anything else.

While we can rely to an extent on reputation to substitute for law in some contexts, and crowdfunding intermediaries might be able to develop and impose similar rules of the road on participants, we can also count on some intermediaries to not do that extra work, and to try to generate revenues in the short run on the hopes and dreams of entrepreneurs and investors alike. When they do, and when the conflicts and fraud emerge, the effects will spill over onto the otherwise legitimate crowdfunding intermediaries, and will further spill over onto firms already successfully operating person-to-person lending platforms and crowdfunded product platforms. In some ways, those firms have the most to lose from an ill-considered experiment with crowdfunding.

Moreover, the limits that are currently in S. 1791 are not practically enforceable. While individual investments are limited to \$1,000 per year, and any one firm can only raise \$1 million in a year, there is no mechanism required of issuers, investors, or crowdfunding intermediaries to verify whether the individual has complied with the limit, other than the vague requirement that intermediaries “take reasonable measure to reduce the risk of fraud.” (Even under current rules, requirements that “accredited investor” status be verified are weak at best, with investor self-certification and a short delay sufficing at many online stock-trading platforms.) Even if we did not feel sorry for investors who lied their way into a crowdfunded website, a fraudster could set up multiple fraudulent firms and attract multiple investments of \$1,000 each, greatly exceeding the savings of most typical Americans.¹⁹ When that fraud is uncovered, all web-based financing efforts are likely to lose reputational capital, even the diligent ones that do a good job of screening and monitoring investors and entrepreneurs.

In contrast, the requirements of S. 1970 are more robust, and more likely to prevent reputational spillovers of fraudulent crowdfunding schemes onto legitimate internet based financial firms. By building in express authority for the SEC to condition intermediary status on various forms of investor protection, S. 1970 is a more thoughtful delegation of difficult implementation issues. However, let me caution that – as noted above – the current litigation climate affecting all SEC regulation means that the SEC’s ability to act on its authority cannot be taken for granted. Thus, I would condition any sales under the crowdfunding exemption upon prior SEC rulemaking that is currently in effect, so that if the rules were to be struck down by a court, the exemption too would fall. And, as noted above, I would suggest having any crowdfunding exemption sunset by its terms after two or three years to permit a careful review of how it is being used, before permitting it to continue.

2. Small Offerings.

The effort to reinvigorate Regulation A small offerings represented by S. 1544 strikes me as neither promising nor threatening. It is not particularly threatening (to capital costs or investor protection) because without blanket preemption of state blue-sky laws, it is unlikely to be used. It is not promising for the same reason, and because Regulation D coupled with Rule 144A and innovations such as SecondMarket make the small offering path to capital formation both unattractive for policy reasons (why invite middle class investors to invest with the least protections?) and practical reasons (if a firm cannot raise funds from qualified institutional buyers, how likely is that a firm could do so from unaccredited investors – other than by misleading them?).

If enacted, and particularly if a blanket blue-sky preemption clause were included or added later, it seems to me that moving from \$5 million to \$50 million in one swoop is unnecessarily risky, dramatically so in light of its reduced liability standards relative to conventional public offerings, and even more so if Section 12(g) triggers are raised, as separately proposed. Even though a good case can be made for reducing disclosure, audit and compliance costs for smaller companies selling shares to the public, relative to large existing public companies, this is better addressed by S. 1933, and there is no clear reason to reduce the disclosure and liability standards applicable to any public offering in which hundreds of unaccredited investors are asked to speculate simultaneously on an unproven technology and a control-free cash management system. If S. 1544 is adopted, I would combine the use of a sunset clause suggested above with a more gradual approach to the amount: begin with a \$15 or \$25 million exemption, which would revert to \$5 million if the SEC did not find that the higher threshold met a cost/benefit test, and condition any further increase on a similar subsequent testing phase, sunset, with review and re-approval by the SEC. In addition, caution with this experiment would also suggest adding an all-time fund-raising cap that integrates all offerings under this modified exemption over time, and also integrates it with offerings under Regulation D, rather than simply capping the amount that can be raised in one year. Without those changes, the combination of Regulation A and manipulation of the “record holder” formality under current Section 12(g) could open up a path to complete evasion of public registration requirements, which would not be in keeping with the idea of a “limited” or “small” offering exemption.

3. 1934 Registration Triggers.

Two of the pending bills propose raising the triggers for 1934 Act registration from the current 500 record holder trigger, one for banks, one for all companies, and, in addition, to exempt employee owners from counting towards the trigger. In my view, these are the riskiest proposals being discussed. Raising the cap to 2,000 record holders would allow *more than half* of all public companies to go “dark.”²⁰ This might be a boon to some companies, which could immediately cut compliance costs. But for investors who have already invested in the suddenly much larger number of firms that could “go dark,” such a radical change would upset legitimate investment expectations, and have spillover effects on liquidity, capital costs, and value of the firms that choose to “remain lit.”²¹ Particularly if combined with permission for private offerings to target the public in general solicitations, as in S. 1544, raising the Section 12(g) limit in this way would effectively gut the securities laws for all but the largest issuers. Such a dramatic change would, if proposed by the SEC, almost certainly generate a great deal of comment and discussion, and rightly result in an extensive public debate. Does it make sense for the Congress to rush in radical deregulation on the hope that it might generate short-term job growth?

If the objection of proponents to public registration under the 1934 Act centers on control systems and compliance costs, the better path is that represented by S. 1933 – and also even more straightforwardly by demanding that the PCAOB use its existing authority to tailor the requirements under Section 404(b) of the Sarbanes-Oxley Act as applied to smaller or newer companies. The objection may, however, be primarily about wanting to keep investors in the dark about executive compensation, corporate

governance, insider trading, proxy manipulation of the kind documented at over-the-counter companies in the SEC's 1963 Special Study,²² conflict of interest transactions, earnings "management," capital expenditures, and other ways in which investors and their money can be misused. Perhaps the reduction of capital-raising costs entailed by such changes is worth trading off against the increased cost of capital for widely held firms generally, on an experimental basis.

But if so, a better case needs to be made than the one thus far presented by advocates, who simply repeat the talking point that the 500 record holder limit is "out of date." Advocates do not ever explain why dispersed investors today are any less in need of strongly enforced disclosure laws, or better capable of protecting themselves without such laws, than they were in 1964. (By contrast, it makes obvious sense that the asset trigger in the 1934 Act would need to be raised, to reflect growth in the economy and average investor wealth.) Ample research shows that dispersed shareholders remain usually unable to easily or cheaply use their existing rights to protect even their most basic rights to elect the boards of directors of the companies in which they invest.

Carving out employee ownership of stock would at least be consistent with SEC exemptions or no-action positions on options and restricted stock units. However, it is unclear why employees are less in need of information and anti-fraud protection than outside investors. While they are in a good position to monitor some aspects of a firm, and equity ownership is clearly an incentive tool for many companies, particularly cash-constrained firms, such as start-ups, few employees have access to or an ability to check the members of the C-suite, and the fact that their investments represent a doubling down on the human capital investment they have in the form of firm-specific knowledge and

relationships built up in their employment has long meant that employee investors are peculiarly exposed to the investment risks represented by employer stock. Some of the current use of employee stock or stock option compensation is generated by tax incentives similar in kind to the mortgage interest deductions – seemingly attractive ideas that are in need of rethinking.

A better case can be made to raise the limits in this fashion for banks, since they are directly regulated by bank regulatory agencies and are required to file call reports and make other disclosures to depositors, which equity investors can also access. However, these disclosures may not be widely known to many bank investors, and if the goal of S. 556 is in fact to permit the continued family or community ownership of community banks without triggering SEC registration, it would be better to develop tailored exemptions for ownership by direct or indirect heirs, or community-based owners geographically proximate to the bank with some long-standing depositor or other relationship to the bank, to increase the odds that the investor has information about and can protect their interest in the issuing bank.

Finally, it should be emphasized that the current use of “record holders” as a trigger for 1934 Act reporting is in fact “out of date,” not because of the number 500, which while arbitrary seems reasonable as a measure of “dispersion” of shareholders, but because of the use of “record holder” as the thing to count. As others have previously testified, the methods of distributing equity have long made the use of record ownership an anachronism. While record holder counts correlate with beneficial owner counts, they do so weakly, and increasingly weakly, over time. Firms that make disclosures to their shareholders already have beneficial owner counts, in order to know how many annual

reports or proxy or information statements to provide to record holders to pass through to beneficial owners, and it has long been a puzzle to outsiders why the SEC not have moved to using beneficial ownership as the relevant metric. To be sure, there are many beneficial owners who object to having their identities known to a company, but it is hard to see why any beneficial owner would object to being counted for disclosure purposes. To be sure, there are fluctuations in beneficial owner counts, and they are probably measured with more noise and greater lags than record holder counts, but the rules could allow firms to rely upon record holder reports of beneficial owners as of a certain date, eliminating such uncertainties for issuers' legal obligations. Alternatively, one could imagine moving to a "public float" trigger measured by reference to value of unaffiliated investments, rather than counts of outside investors, as others have suggested. However, doing so will increase to some extent the arbitrariness of the test, since it will focus less on ownership dispersion – which presumably is the theoretical reason that investors cannot be counted on to demand information on their own – and more on market valuations, which can vary rapidly without regard to the relative power or information needs of investors. Nevertheless, either method of counting would be great improvement over the current trigger, which effectively rewards well-advised firms who carefully structure their investors' investments in order to keep their nominal record holder count down, and punishes older firms like Wa Wa, Inc., which has long done the more straightforward thing and issued stock to employees as holders of record.

4. IPOs.

Last, I address S. 1933, the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011." This bill is the most thoughtful and carefully

structured bill being considered, and (with two caveats, discussed below) raises the fewest risks. While I would shorten the start-up period to four years, rather than five, and couple it with a sunset – after six or seven years, rather than two or three as for the other proposals, in order to let the four-year ramp-up period play out – I believe that the relatively modest reductions in investor protection that it would permit pose the least risk to the current regulatory system while holding out the promise of at least some meaningful non-fraudulent capital formation.

To be sure, I am not sure that the bill will dramatically increase the number or reduce the size of IPOs, as advocates of this reform seek to do, or whether IPOs are as central to job creation as the investment banking community would like to believe. While a case can certainly be made that compliance costs have impeded marginal firms in the last 10 years, the fall-off in IPOs began well before Enron, much less Sarbanes-Oxley, and microcap firms have never been subject to Section 404(b) of that law, yet there has been no resurgence of IPOs by 404(b)-exempt firms, even after the exemption for microcap companies was made permanent. More serious impediments to a renewals of IPOs, it seems to me, is the increased “deretailization” of the equity markets, which in many respects is a good thing, as retail investors have increasingly realized that they are the most likely to make poor investment decisions, and have increasingly come to rely on not on broker-dealers paid to generate value-destroying churn, but on fee-only advisers, particularly advisers to mutual funds and other regulated collective investments, who in turn increasingly invest through private equity funds. Institutions seek not just investments but liquidity depth, making smaller or thinly traded IPOs that might once have attracted a retail investor following unlikely to generate the same interest from the

institutions that now bundle those investors' dollars and invest collectively. Where the institutions are content without that liquidity, they have Regulation D and Rule 144A, which permit issuers to raise a great deal of liquid capital from dispersed institutional investors without going public.

Nevertheless, there probably are at least some firms that would be able to reduce their capital costs by going public, that are nonetheless deterred by the marginally higher offering costs generated by 404(b) and other disclosure requirements. Thus, the bill may do some good. Because the firms would still need to meet all of the other requirements of the 1933 and 1934 Acts, including obtaining audited financial statements (albeit for a reduced period), and because the sponsors would remain subject to the full liability regime of the securities laws, the risks of the deferral of some of the disclosure obligations under the 1934 Act seem appropriately small, and worth taking, particularly because the result is to increase the amount of publicly traded securities, with spillover liquidity benefits for other firms.

I add two caveats. First, I have not had a chance to think carefully about the provisions of the bill that relate to research analysts. They are modestly complex, as they require thinking through the potential conflicts of interest between underwriters, dealers, and firms issuing research, under both the SEC's rules and the rules of FINRA. Analyst coverage is clearly a key linch-pin in developing a liquid market for a prospective public company, but analysts, too, have played a sad role in recent bubbles, particularly in the build-up of telecoms in the late 1990s and early 2000s. The bill proposes to explicitly and clearly take away authority from the SEC and FINRA to regulate analysts in the IPO context, and it is not clear to me – and, since this bill was introduced only 10 calendar

days ago, I suspect it is not clear to anyone other than the sponsors and those who advise them whether this narrowing of regulatory authority makes sense, or is necessary, in its current form, to accomplish the legitimate goal of increasing analyst coverage of newly public firms. Second, I would have thought a more straightforward way to accomplish at least the goal of reducing SOX 404(b) costs would be to command the SEC and the PCAOB to use their authority to better tailor the compliance, audit and attestation requirements for newly public companies. Spurring regulatory innovation is one of the most important tasks Congress has. One way to do it is to deregulate and hope for the best. Another way to do it is to command the agencies to regulate in a more sensible way, with explicit metrics to show that it has worked. For example, Congress could require the agencies to take action within a set period of time to modify the SOX 404(b) requirements, and then report on the effects on compliance costs using surveys of firms. If the costs had not come down, the agencies would be required to go further. While this would take time – and not generate any new jobs before the next election – it would be more likely to produce an efficient trade-off between capital-raising costs and capital costs than the cycle in which we seem to be currently stuck: deregulating, hoping for the best, and then rushing to reregulate after the next scandalous financial collapse.

Endnotes

¹ This assumption is widely believed. For example, one proponent of a crowdfunding exemption states, “Small businesses propose a disproportionate risk of fraud.” C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, Working Paper (Oct. 7, 2011), at 62. But it is surprisingly difficult to find hard evidence to back up this claim. Bradford cites Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 *J. Small & Emerging Bus. L.* 57 (1998) and William K. Sjostrom, Jr., *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, 53 *Fla. L. Rev.* 529 (2001). Fisch relies on an SEC website that does not provide detailed data, and Sjostrom cites Fisch and Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of “Technological Disintermediation” for Unregistered Offerings of Securities*, 2 *J. Small & Emerging Bus. L.* 1 (1998). Langevoort relies on Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* 301 (3d ed. 1995), who rely on Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 *J. Corp. L.* 1, 34-36 (1983), who relies on the SEC’s 1963 “Special Study,” which found that of 107 fraud proceedings in 1961 and 1962, 93% involved issuers not subject to the Securities and Exchange Act of 1934 (1934 Act), i.e., unlisted issuers, and on a 1980 GAO report finding that in the three years ended 1978, in 142 private placements triggered SEC fraud investigations, but the studies do not rigorously compare large and small firm securities offerings. One more recent set of data consistent with the claim is contained in Tables 11, 18 and 25 of Appendix I of the Final Report of the SEC’s Advisory Committee on Smaller Public Companies, dated Mar. 3, 2006, available at www.sec.gov/info/smallbus/acspc/appendi.pdf, which shows that in 2004 and 2005 the percentage of firms with material weaknesses in their financial reporting control systems was over 20% at firms with less than \$75 million in market capitalization, as compared to less than 5% for firms with greater than \$10 billion in market capitalization, the percentage of firms with material weaknesses declines almost monotonically with market capitalization, and also declines (albeit less consistently) with revenues. See also Separate Statement of Mr. Schacht, at 71 Fed. Reg. 11130 (stating “these small firms ... make up the bulk of accounting fraud cases under review by regulators and the courts (one study puts it at 75 percent of the cases from 1998 to 2003),” but not providing any reference). Compare Jonathan M. Karpoff, D. Scott Lee and Gerald S. Martin, *The Cost to Firms of Cooking the Books*, 43 *J. Fin. Quant. Anal.* 581-612 (2008) (Table 2, showing that the incidence of enforcement actions for financial reporting in the period 1978-2002 by firm size, and that the number of actions was similar across firm size deciles, based on all firms in the CRSP database); Natasha Burns and Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 *J. Fin. Econ.* 35-67 (2006) at 55 (larger firms within the S&P 1500 over the period 1995 to 2002 were more likely to announce an accounting restatement).

² The benefits of securities disclosure regulation are articulated and/or evidenced in, among others: Luzi Hail and Christian Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 *J. Acc’g Res.* 485- (2006) (“firms from countries with more extensive disclosure requirements, stronger securities regulation and stricter enforcement mechanisms have a significantly lower cost of capital”); Andrei Shleifer and Daniel Wolfenzon, *Investor protection and equity markets*, 66 *J. Fin. Econ.* 3-27 (2002); Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation around the World*, *Brooklyn Journal of Corporate, Financial, and Commercial Law* 81 (2007-2008); Allen Ferrell, *Mandated disclosure and stock returns: Evidence from the over-the-counter market*. 36 *J. Legal Stud.* 213-51 (2007) (finding that 1964 Securities Acts Amendments reduced volatility and increased returns among OTC firms compared to benchmark NYSE-listed firms); Michael Greenstone, Paul Oyer, and Annette Vissing-Jorgensen, *Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments*, 121 *Q.J. Econ.* 399-46 (2006) (finding that OTC firms subject to new disclosure mandates in the 1964 Securities Act Amendments experienced abnormal returns around the passage of the law); cf. Robert Battalio, Brian Hatch and Tim Loughran, *Who Benefited from the Mandated Disclosures of the 1964 Securities Acts Amendments?*, *J. Corp. Fin.* (forthcoming 2011) (finding no statistical difference in announcement returns for OTS firms moving to NYSE before or after 1964 Securities Acts Amendments and claiming that OTS firms already were disclosing substantial information, but not addressing fact that the SEC “Special Study” that led to the 1964 legislation found that many firms were

not disclosing information, that many of those disclosing information left substantial gaps in the information, that disclosures that were being made were not adequately enforced, given that Rule 10b-5 litigation had not developed at the time; the article also inconsistently dismisses non-differences in NYSE seat prices on the ground that the 1964 legislation was anticipated before its adoption, but treats non-differences in announcement of NYSE-listings before and after the 1964 legislation as showing the legislation provided no benefit to investors in OTC firms).

³ See Davis Polk Regulatory Tracker, Dodd-Frank Progress Report (Dec. 1, 2011), at 4-5.

⁴ In 2011, the SEC was allocated \$115 million less than its budget request, and was able to hire staff for 342 fewer full-time equivalent positions than it sought to do, despite taking in more than its request in fees. Compare U.S. Securities and Exchange Commission, FY 2011 Congressional Justification (Feb. 2010) (www.sec.gov/about/secfy11congbudgjust.pdf, last visited December 11, 2011) at 8-9, with U.S. Securities and Exchange Commission, FY 2012 Congressional Justification (Feb. 2011) (www.sec.gov/about/secfy12congbudgjust.pdf, last visited December 11, 2011), at 9-10.

⁵ 5 U.S.C. § 551 et seq.

⁶ For example, *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) struck down a SEC rule requiring registration of hedge fund advisers under Advisers Act); *Financial Planning Assoc. v. SEC*, No. 04-1242 (D.C. Cir. Mar. 30, 2007) struck down a SEC rule exempting broker-dealers from Advisers Act despite receiving “special compensation” if “incidental” to brokerage; *PAZ Securities, Inc. v. SEC*, No. 05 1467 (D.C. Cir. July 20, 2007) struck down an SEC order affirming expulsion of a NASD-member firm and barring its president from the securities industry for failing to comply with various examination requests; *American Equity Investment Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010) struck down a rule treating a new class of annuities as securities; *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005) struck down a rule mandating proportion of independent directors on mutual fund boards.

⁷ The D.C. Circuit’s recent decision striking down the SEC’s “proxy access” rule is a case in point. *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011). Despite the SEC having debated the issue for over a decade, developed an extensive public record before enacting Rule 14a-11, and adopted the rule under the explicit authority and implicit direction of Congress in Section 971 of the Dodd-Frank Act, a panel of the D.C. Circuit struck the rule down as “arbitrary and capricious” on the ground that the twenty-five single-spaced pages devoted to cost-benefit and related analyses in the adopting release was inadequate under the APA and “failed ... adequately to assess the economic effects of a new rule.” The D.C. Circuit failed to acknowledge that there is no currently available scientific or other technique for the SEC to “assess the economic effects” of the rule along the lines that the Court seemed to think legally required – as when the Court held that the SEC “relied upon insufficient empirical data when it concluded that Rule 14a-11 [would] improve board performance and increase shareholder value by facilitating the election of dissident shareholder nominees,” at 1150, or when it held that the SEC had “arbitrarily ignored the effect of the final rule” because the SEC “did not address whether and to what extent Rule 14a-11 will take the place of traditional proxy contests,” at 1153. Instead, the D.C. Circuit substituted its own judgment for that of the SEC in evaluating the existing research relevant to proxy contests, going so far (for example) as to characterize (without explanation) a peer-reviewed article published in the *Journal of Financial Economics* as “relatively unpersuasive.” At 1151. This result was clearly not intended by Congress in adopting the APA, and is clearly inconsistent with decades of precedent under that statute, including a 2005 decision by the same court, *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005), which held at 143 that the SEC need only “determine *as best it can* the economic implications” of a rule to be upheld under the APA.

⁸ Yakov Amihud and Haim Mendelson, *Asset Pricing and the Bid-Ask Spread*, 17 *J. Fin. Econ.* 223-249 (1986) (liquidity increases firm value and lowers its cost of capital).

⁹ Annette Vissing-Jorgensen, *Limited Asset Market Participation and the Elasticity of Intertemporal Substitution*, 110 *J. Pol. Econ.* 825-853 (2002).

¹⁰ Mark Grinblatt, Matti Keloharju, and Juhani Linnainmaa, IQ and Stock Market Participation, 66 J. Fin. 2121-64 (2011).

¹¹ E.g., Pankaj K. Jain and Zabihollah Rezaee, The Sarbanes-Oxley Act of 2002 and Capital Market Behavior, 23 Contemp. Acc'g Res. 629-54 (2006).

¹² La Porta et al., What Works in Securities Laws?, 61 J. Fin. 1-32 (2006), at 20 (in a cross-country study, laws mandating disclosures and public enforcement of those laws “has a large economic effect” making initial public offerings more common); Luzi Hail and Christian Leuz, International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?, 44 J. Acc'g Res. 485- (2006) (“firms from countries with more extensive disclosure requirements, stronger securities regulation and stricter enforcement mechanisms have a significantly lower cost of capital”); Dan S. Dhaliwal, Disclosure Regulations and the Cost of Capital, 45 So. Econ. J. 785 (1979) (adoption of additional disclosure requirements lowered the cost of equity capital for covered firms).

¹³ S. Myers and N. Majluf, Corporate Financing And Investment Decisions When Firms Have Information That Investors Do Not Have, 13 J. Fin. Econ. 187-221 (1984); D.W. Diamond and R.E. Verrecchia, Disclosure, Liquidity and the Cost of Capital, 46 J. Fin. 1325-59 (1991).

¹⁴ Darren T. Roulstone, Analyst Following and Market Liquidity, 20 Contemp. Acc'g Res. 551-78 (2003) (more analyst coverage increases liquidity, which lowers the cost of capital).

¹⁵ Mark Abrahamson, Tim Jenkinson, and Howard Jones, Why Don't Issuers Demand European Fees for IPOs?, 66 J. Fin. 2055-82 (2011). Data from Renaissance Capital shows that the median annual US IPO raised between \$94 and \$157 million in the 2000s (see www.renaissancecapital.com, last visited Dec. 8, 2001). Thus, \$7 million were typically paid to the underwriters in the typical US IPO in recent years. Average underwriter fees were more than twice as high, due to some large issuers (e.g., General Motors) pulling up the average offering size. Total legal, audit, and compliance costs for an IPO, by contrast, are reported to be \$2.5 million. IPO Task Force, Rebuilding the IPO On-Ramp, Presented to the U.S. Treasury (Oct. 20, 2011).

¹⁶ Stephen Choi, Regulating Investors, Not Issuers: A Market-Based Proposal, 88 Cal. L. Rev. 279 (2000).

¹⁷ On person-to-person lending, see Andrew Verstein, The Misregulation of Person-to-Person Lending, 45 U.C. Davis Law Review (forthcoming, 2011), available at <http://ssrn.com/abstract=1823763>.

¹⁸ On crowdfunded projects, see Paul Belleflamme, et al., Working Paper (June 2011), available at <http://ssrn.com/abstract=1578175>.

¹⁹ “A 2010 survey found that 30% of all [American] adults had no savings (excluding retirement savings). ... Forty-nine percent of ... respondents [to another survey] found it difficult merely to pay all of their bills each month.” Bradford, supra note 1, at n. 581.

²⁰ John C. Coates, The Powerful and Pervasive Effects of Ownership on M&A, Working Paper (June 2010), available at <http://ssrn.com/abstract=1544500> (last visited December 12, 2011). In that paper, I find that over a third of all firms in Compustat have fewer than 300 record holders, and that the median number of record holders of such firms in 2007 was 700.

²¹ While some researchers have noted that many firms choose to go “dark” when they are forced to comply with new disclosure requirements, see Brian J. Bushee and Christian Leuz, Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board, 39 J. Acc'g and Econ. 233-264 (2005), few have noted that over a third of public firms large enough to be included in databases such as Compustat have fewer than 300 record holders, and thus can be thought of the reverse of firms that have “gone dark” –

firms that have chosen to “stay lit,” presumably because the lower cost of capital produced by effectively enforced securities laws is worth the lowered cost of compliance that being private would permit.

²² See generally Seligman, *supra* note 1.