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CHAPTER 11
Offering and Disclosure Reform

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Both the US Congress and the US Securities and Exchange Commission (SEC) are seriously considering reform to mandatory disclosure requirements.[1] This chapter examines the law and economics of securities offerings and disclosure requirements. It explains the current disclosure system and analyzes the principles that should govern policymakers as they craft a reformed disclosure regime. It offers a program of interim reforms to improve the existing disclosure system to the benefit of both investors and issuers. It also offers a much simpler, more coherent fundamental reform proposal that would replace the existing fourteen disclosure regimes with three—public, quasi-public, and private, the first two of which would be scaled.

THE BASIC FRAMEWORK OF US DISCLOSURE REQUIREMENTS

The Securities Act of 1933[2] makes it generally illegal to sell securities unless the offering is registered with the SEC.[3] Making a registered offering (often called "going public") is a very expensive proposition and well beyond the means of most small and startup companies. The SEC has estimated that "the average cost of achieving initial regulatory compliance for an initial public offering is $2.5 million, followed by an ongoing compliance cost, once public, of $1.5 million per year."[4] The Act, however, exempts various securities and transactions from this requirement.[5]

The most important exemption is the exemption for private offerings (often called a private placement).[6] This is the means chosen by most businesses, large and small, to raise capital. This is also the reason local business people can start a restaurant or store without registering the securities with the SEC.

Regulation D,[7] adopted in 1982 during the Reagan administration,[8] is the primary means of implementing this exemption, particularly for companies offering stock to investors who are not issuer officers, directors, or other insiders, friends, or family.[9] According to the SEC, Regulation D accounted for $1.3 trillion (62 percent) of private offerings in 2014.[10] Although private offerings do not necessarily have to be in compliance with Regulation D, it 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. Regulation D investments are generally restricted to accredited investors. Generally, accredited investors are financial institutions or affluent individuals with a residence-exclusive net worth of more than $1 million or an income of $200,000 or more ($300,000 joint).[11] Thus, approximately 90 percent of Americans are effectively prevented from investing in Regulation D securities.[12]

The "small issues exemption" was meant to provide an exemption for small firms.[13] This exemption is implemented by Regulation A.[14] Although this exemption is important in principle, it has been, in practice, of virtually no value to small firms due to overregulation (primarily by state regulators). Until 2015, it was almost never used.[15] The 2012 Jumpstart Our Business Startups (JOBS) Act provisions, often called "Regulation A plus," may change this. On April 20, 2015, the SEC adopted final rules,[16] which were effective June 19, 2015, to implement Title IV of the JOBS Act.[17] The SEC's revisions to Regulation A, while a marked improvement over the current rule, nevertheless are cause for serious concern.[18] It is very doubtful that the problems with Regulation A have been solved. In the first year, approximately forty-four Regulation A offerings have been qualified.[19] In contrast, in 2014, there were 2,752 public offerings and 33,429 Regulation D offerings.[20]

Registered companies must file periodic reports. The Form 10-K is an annual report and the Form 10-Q is a quarterly report.[21] In addition, a

Form 8-K must be filed when major events of importance to investors must be reported.[22] Nonfinancial disclosure requirements for public or registered companies (also called reporting or public companies) are provided by SEC Regulation S-K.[23] Regulation S-K imposes approximately 150 different requirements. A PDF of Regulation S-K in small type is 136 pages long. Financial or accounting disclosure requirements are set forth in SEC Regulation S-X.[24] A PDF of Regulation S-X in small type is ninety-six pages long. Regulation S-X, however, incorporates many other requirements by reference.[25]

Registered companies do not all have the same obligations. Companies with a public float of less than $75 million are deemed "smaller reporting companies" and have less onerous disclosure obligations and do not need to comply with the Sarbanes-Oxley Act Section 404(b) internal control reporting requirements.[26] In general, an issuer with an aggregate worldwide common equity market value of $75 million or more (but less than $700 million) that is not a smaller reporting company is an accelerated filer.[27] An accelerated filer must file its 10-Qs within forty days of the close of the quarter and its 10-Ks within seventy-five days of the close of the year. A "large accelerated filer" is, in general, an issuer with an aggregate worldwide common equity market value of $700 million or more.[28] A large accelerated filer must file its 10-Qs within forty days of the close of the quarter and its 10-Ks within sixty days of the close of the year.

Title I of the JOBS Act created a new concept of "emerging growth companies" (EGCs).[29] Generally, a company qualifies as an emerging growth company if it has total annual gross revenues of less than $1 billion during its most recently completed fiscal year and, as of December 8, 2011, had not sold common equity securities under a registration statement. For five years, EGCs are excused from complying with a number of onerous disclosure requirements and from Sarbanes-Oxley Act Section 404(b) internal control reporting requirements. Moreover, they may submit confidential draft registration statements to the SEC for review.[30]

FRAUD

The primary purpose of securities law is to deter and punish fraud.[31] Fraud is the misrepresentation of material facts or the misleading omission of material facts for the purpose of inducing another to act, or to refrain from action, in reliance upon the misrepresentation or omission.[32] Federal law prohibits fraudulent securities transactions.[33] So do state securities laws.[34] State laws governing securities are known as blue sky laws.[35]

Requiring certain written affirmative representations in public disclosure documents deters fraud because proving fraud becomes easier if the public, written representations are later found by a trier of fact to be inconsistent with the facts. Such an approach is analogous to the Statute of Frauds (1677)[36] and Uniform Commercial Code § 2-201,[37] which require certain contracts to be in writing in order to be enforceable. Modern US securities laws go further, requiring the disclosure documents of public companies to not only be in writing but to be publicly available and provided to government regulators.

DISCLOSURE

The second important purpose of securities laws is to foster disclosure by firms that sell securities to investors of material facts about the company needed to make informed investment decisions.[38] Appropriate mandatory disclosure requirements can promote capital formation, the efficient allocation of capital, and the maintenance of a robust, public, and liquid secondary market for securities.[39] Among the reasons disclosure mandates can be effective are: (1) the issuer is in the best position to accurately and cost-effectively produce information about the issuer;[40] (2) information disclosure promotes better allocation of scarce capital resources or has other positive externalities;[41] (3) the cost of capital may decline because investors will demand a lower risk premium;[42] (4) disclosure makes it easier for shareholders to monitor management;[43] and (5) disclosure makes fraud enforcement easier because evidentiary hurdles are more easily overcome.

The baseline for measuring the benefits of mandatory disclosure is not zero disclosure. Firms would disclose considerable information even in the absence of legally mandated disclosure. It is generally in their interest to do so.[44] Even before the New Deal securities laws mandating disclosure were enacted, firms made substantial disclosures and stock exchanges required disclosure by listed firms.[45] Firms conducting private placements today make substantial disclosures notwithstanding the general absence of a legal mandate to do so.[46] The reason is fairly straightforward. In the absence of meaningful disclosure about the business and a commitment, contractual or otherwise, to provide continuing disclosure, few would invest in the business and those that did would demand substantial compensation for the risk they were undertaking by investing in a business with inadequate disclosure.[47] Voluntary disclosure allows firms to reduce their cost of capital; therefore they undertake to disclose information even in the absence of a legal mandate to do so.

As I will discuss in detail, mandatory disclosure laws impose costs, often very substantial costs. These costs do not increase linearly with company size. Offering costs are larger as a percentage of the amount raised for small offerings. They therefore have a disproportionate adverse impact on small firms. Moreover, the benefits of mandated disclosure are also less for small firms because the number of investors and amount of capital at risk is less. Since the costs are disproportionately high and the benefits lower for smaller firms, disclosure should be scaled so that smaller firms incur lower costs.[48]

Disclosure also has a dark side in countries with inadequate property rights protection. In a study examining data from 70,000 firms, the World Bank has found that in developing countries mandatory disclosure is associated with significant exposure to expropriation, corruption, and reduced sales growth.[49]

Nor should it be forgotten that many large businesses and large broker-dealers are quite comfortable with high levels of regulation because regulatory compliance costs constitute a barrier to entry and limit competition from smaller, potentially disruptive competitors; high compliance costs have a disproportionately negative impact on their smaller competitors.[50] Some have been quite forthright about this. Goldman Sachs CEO Lloyd Blankfein, for example, recently said:

> More intense regulatory and technology requirements have raised the barriers to entry higher than at any other time in modern history. This is an expensive business to be in, if you don't have the market share in scale. Consider the numerous business exits that have been announced by our peers as they reassessed their competitive positioning and relative returns.[51]

The securities bar, accounting firms doing compliance work, and regulators all also have a strong pecuniary interest in maintaining complex rules.[52]

The benefits, and to a lesser extent the costs, of mandatory disclosure are notoriously difficult to measure, although the benefits are probably substantially less than commonly thought.[53] This is no doubt partially a function of the fact that the SEC does a very poor job of collecting and publishing relevant data, a deficiency that should be remedied.[54] There is no small degree of truth in the observation of Georgetown law professors Donald Langevoort and Robert Thompson that "[m]ost all of securities regulation is educated guesswork rather than rigorous cost-benefit analysis because we lack the ability to capture the full range of possible costs or benefits with anything remotely resembling precision."[55] The limited empirical literature examining the issue tends to find little, and often no, net benefit.[56] As Yale Law School Professor Roberta Romano has written, "The near total absence of measurable benefits from the federal regulatory apparatus surely undermines blind adherence to the status quo."[57]

On the other hand, the United States securities markets are the largest, deepest capital markets in the world. At over $18 trillion, the 2012 US stock market capitalization was five times the size of China's ($3.7 trillion) and Japan's ($3.7 trillion) and six times that of the United Kingdom ($3 trillion).[58] The US stock market dwarfs the securities markets of most countries.[59] US market capitalization as a percentage of GDP is greater than all major developed countries except for the United Kingdom and Switzerland.[60] US private capital markets are broad and deep compared to other countries.[61] This implies that the US securities regulatory regime is broadly reasonable compared to those in most other countries, although other factors such as property rights protection, taxation (of both domestic and foreign investors), the legal ability or willingness of banks to undertake equity investment, and the degree of corruption should also be considered. An alternative explanation would be that US capital markets are so strong that they can readily absorb the adverse impact of poor regulation.

The core problem with the current US securities regulation system is its negative impact on small startup and emerging growth companies and, therefore, the adverse impact it has on entrepreneurship and the growth potential of the economy.[62] It is quite clear that existing regulations, usually imposed in the name of investor protection,[63] go beyond those necessary to deter fraud and achieve reasonable, limited, scaled disclosure for small firms.[64] Existing rules seriously impede the ability of entrepreneurial firms to raise the capital they need to start, to grow, to innovate, and to create new products and jobs.[65]

INVESTOR PROTECTION EXAMINED

Investor protection is a central part of the SEC's mission.[66] But the term "investor protection" is a very ambiguous term that can cover, at least, four basic ideas. The first is protecting investors from fraud or misrepresentation. This is a fundamental function of government. The second is providing investors with adequate information to make informed investment decisions. Although a legitimate function of the securities laws, this requires policymakers to carefully balance the costs (which are typically underestimated by regulators and policymakers) and the benefits (which are typically overestimated by regulators and policymakers) of mandatory disclosure.[67] The third is protecting investors from investments or business risks that regulators deem imprudent or ill-advised. This is not an appropriate function of government and can be highly counterproductive. The fourth is protecting investor freedom of choice or investor liberty and thereby allowing investors to achieve higher returns and greater liquidity. This primarily requires regulators to exercise restraint or eliminate existing regulatory barriers, both in the regulation of primary offerings by issuers and of secondary market sales by investors to other investors. In practice, this aspect of investor protection is almost entirely ignored by state and federal regulators.

Disclosure requirements have become so voluminous that they obfuscate rather than inform, making it more difficult for investors to find relevant information.[68] Over the past twenty years, the average number of pages in annual reports devoted to footnotes and "Management's Discussion and Analysis" has quadrupled.[69] The number of words in corporate annual 10-Ks has increased from 29,996 in 1997 to 41,911 in 2014.[70] This means that the *average* 10-K is now nearly as lengthy as some famous novels.[71]

Very few investors, whether professional or retail, are willing to wade through lengthy disclosure documents, often running hundreds of pages of dense legalese, available on the SEC EDGAR database[72] or multitudinous state blue sky filings in the forlorn hope that they will find something material to their investment decision that is not available elsewhere in shorter, more focused, more accessible materials. Many of these more accessible materials are, of course, synopses of both the mandated disclosure documents[73] and other voluntarily disclosed information such as shareholder annual reports or materials provided to securities analysts by companies. But the fact that the vast majority of investors rely on these summary materials strongly implies that the legal requirements exceed what investors find material to their investment decisions.

The law should not, even in principle, adopt a regulatory regime that is designed to protect all investors from every conceivable ill. Even in the case of fraud, there needs to be a balancing of costs and benefits. Securities law should deter and punish fraud but, given human nature, it will never entirely eliminate fraud. The only way to be certain that there would be no fraud would be to make business impossible. In other words, the socially optimal level of fraud is not zero.[74] While fraud imposes significant costs on the person who is defrauded, preventing fraud also has significant costs (both to government and to law-abiding firms or investors) and at some point the costs of fraud prevention exceed the benefits, however defined, of preventing fraud.[75] It is up to policymakers to assess this balance and make appropriate judgments in light of the evidence.

About three-fifths of the states conduct what is called "merit review."[76] Under merit review, state regulators decide whether a securities offering is too risky or unfair to be offered within their state, effectively substituting their investment judgment for that of investors. Merit review is wrong in principle. Moreover, it is very unlikely that regulators make better investment decisions than investors. Lastly, merit review is expensive and it delays offerings considerably.[77]

In a free society, it is inappropriate paternalism for the government to prevent people from choosing to invest in companies that they judge to be good investment opportunities or may choose to invest in for reasons other than pecuniary gain (personal relationship or affinity for the mission of the enterprise).[78] Individuals, not government, should be the judge of what is in their own interest. This idea, however, is under sustained assault both by progressives and by those who called themselves "libertarian paternalists."[79] Both progressives and libertarian paternalists rely on the commonsense findings of behavioral economics that people are not always rational, sometimes make poor decisions, and respond to sales pressure or disclosure documents differently.[80] Securities regulators are increasingly looking to this body of literature to inform or justify their actions.[81]

There are at least eight reasons to doubt that government regulators have better investment judgment than private investors investing their own money. First, there is an inability for a central regulatory authority to collect and act on information as quickly and accurately as dispersed private actors.[82] Government has a reputation for being ponderous and slow to act for a reason.[83] In the context of securities regulation, it is highly doubtful that government regulators have a better understanding of business and the markets than those participating in those markets. Second, private investors have strong incentives to be good stewards of their own money, both in the sense of not taking unwarranted risk and in the sense of seeking high returns. In addition, investors may seek to invest for reasons that do not involve pecuniary gain, including support of the persons launching an enterprise or support for a social enterprise that has a dual mission. Government regulators have an entirely different set of incentives. Third, individuals, not government officials, know their own risk tolerance and their own portfolios. Investing in a riskier security[84] can reduce the overall risk of a portfolio if the security in question is negatively correlated or even not highly covariant with price movements of the overall portfolio.[85] Fourth, government officials are people too, and they exhibit the same irrationality and tendency to sometimes make poor decisions as anyone else. There is absolutely no reason to believe that regulators are less subject to the concerns identified by behavioral economics and the "libertarian paternalists" than are others.[86] Moreover, since most securities regulators are lawyers and a legal education provides no training to make investment decisions, there is no particular reason to believe they have any relevant "expertise" that will make their investment decisions objectively better than those investing their own money. Fifth, as public choice economics has demonstrated, government officials are not angels but act in their own self-interest.[87] This too is in keeping with basic common sense. Government officials have an interest in enlarging their agencies, increasing their power, and improving their employment prospects.[88] They are no more benevolent than any other group of people, including issuers and investors, and there is no particular reason to believe that government regulators will act in the interest of investors when those interests conflict with their own interest. The analysis of politics, and the politicians and regulators that conduct politics, should be stripped of its "romance."[89] Sixth, government officials trying to make investments have a notoriously bad track record.[90] Perhaps the most famous example of poor regulator entrepreneurial investment judgment is when securities regulators in Massachusetts barred Massachusetts citizens from investing in Apple Computer during its initial public offering.[91] It was deemed too risky of an investment. Seventh, in their capacity as regulators assessing risk, regulators have an increasingly obvious bad track record. Government regulators in the most recent financial crisis did no better than private actors in understanding risk.[92] Eighth, it is a reasonable hypothesis that government regulators are unduly risk-averse for at least two reasons: Government tends to attract people who are risk averse. They have a lower risk tolerance than those making entrepreneurial investments.[93] Moreover, the incentives for government regulators tend to make them unduly risk-averse. An investment that goes bad may make the headlines and their regulatory judgment may be criticized. An investment that never happens because it does not receive regulatory approval will not make the headlines and the regulators' judgment will not be second-guessed.

The approximately two-fifths of states that do not undertake merit review[94] rely on antifraud laws and the disclosure of the material facts by issuers but allow investors to make their own decisions, just as federal securities laws rely primarily on disclosure and antifraud enforcement.[95]

While doing little to actually protect investors, the current array of state and federal regulatory excesses imposes costly requirements and restrictions that have a disproportionate negative impact on small and startup firms. Furthermore, although the JOBS Act mitigated the problem, existing rules often, in practice, force these firms to use broker-dealers or venture capital firms to raise capital.[96] Having to hire outside firms raises issuer costs. Being reliant on broker-dealers or venture capital firms to raise capital also increases the likelihood that entrepreneurs will lose control of the company they founded because these firms so often require large fees, a large share of the ownership of the company, or effective control of the firm when raising capital for new, unseasoned issuers. The law should allow entrepreneurs to cost-effectively seek investors without reliance on broker-dealers or venture capital firms.

UNMOORING DISCLOSURE FROM INVESTMENT VALUATION

Title XV of the Dodd–Frank Wall Street Reform and Consumer Protection Act[97] contains three provisions requiring public companies to report in their disclosure documents with respect to conflict minerals, mine safety, and resource extraction. In addition, Title IX Section 953(b) requires disclosure of the ratio between a company's CEO pay and the median pay of all other employees. The primary purpose of these requirements is to further political objectives. They are unrelated to the purpose of the securities laws and the mission of the SEC.

The politically motivated requirements in Title XV distract—or in the case of the proposals for new disclosure requirements, would distract—the SEC from its mission. Moreover, the requirements do nothing to further the securities laws' purpose of protecting shareholders or providing them with information that is material to their investment decisions. Shareholders, when presented with an opportunity to vote on whether to require such disclosure, have almost always voted not to do so.[98]

These Dodd-Frank provisions are part of a continuing trend of using the securities laws to mandate disclosures that are not material to assessing the expected return from investing in a company (that is, its valuation) to further political objectives. For example, there is a major effort under way to pressure the SEC into issuing a rule requiring disclosure of corporate "political spending."[99] The campaign promoting this rulemaking has generated over one million comments to the SEC.[100] The information disclosed in compliance with this rule would not be used by investors to assess the value of their investments, but by activists to pressure corporation management with respect to political issues. Issuance of such a rule has been temporarily barred by Congress.[101]

Legislation has also been introduced in Congress to require both disclosure and a shareholder vote before public corporations can make political expenditures, including independent expenditures, or give money to a trade association for certain purposes. Spending made in contravention of the rules set forth in the legislation would give rise to joint and several liability by a corporation's officers and directors equal to treble the amount spent.[102] The requirements would not apply to private corporations, labor unions, or tax-exempt organizations. There is also a recent petition that asks the SEC to require public companies to disclosure "gender pay ratios."[103]

These requirements impose unwarranted costs on issuers that reduce the return on shareholder investments.[104] The SEC estimates that the conflict minerals, mine safety, resource extraction, and CEO pay ratio requirements combined will have initial compliance costs of approximately $5 billion and ongoing costs of $1.5 billion annually.[105] Furthermore, by adding to already voluminous disclosure requirements, they tend to make it more difficult for investors to find material information in disclosure documents.

THE PRIVATE-PUBLIC DISTINCTION

The securities laws draw a distinction between public and private companies, imposing a wide variety of obligations on public companies that are not imposed on private companies. Originally, this distinction was generally a distinction between firms whose securities were trading on stock exchanges and those whose securities were not. The Securities Acts Amendments of 1964[106] broadened the requirements to register and make periodic disclosures to any company with 500 or more shareholders of record.[107] Thus, the distinction between public and private firms is probably best thought of as between a firm with widely held ownership (public) as opposed to closely held ownership (private).[108] Given the breadth of ownership, the aggregate value of investments made, the fact that management is a more effective producer of information than multiple outside investigators with limited access to the relevant facts absent mandatory disclosure, the agent-principal or collective action problem and various other factors, imposing greater disclosure obligations on larger, widely held firms is appropriate. It is, however, important that even the disclosure and other obligations of public companies be scaled. Compliance costs have a disproportionate adverse impact on small firms, and the benefits are correspondingly less because small firms have fewer investors with less capital at risk.

It is far from clear that the current "holder of record" method of drawing the distinction between public and private firms is the best. The number of beneficial owners, public float, or market capitalization—all metrics used in connection with other securities law provisions—are probably better than the traditional shareholder of record measure.[109] The number of holders of record bears little relationship to any meaningful criteria of when disclosure should be mandated or when disclosure or other requirements should be increased. Its primary virtue is ease of administration.

A SUMMARY OF PRESENT LAW REQUIREMENTS

Post–JOBS Act, there are at least fourteen categories of firms issuing securities. They are

1. private companies using section 4(a)(2);

2–6. private companies using Regulation D Rule 504, Rule 505 (with and without nonaccredited investors), and primarily Rule 506 (with and without nonaccredited investors);[110]

7–8. small issuer Regulation A companies (two tiers);

9–11. crowdfunding companies (three tiers);

12. smaller reporting companies;

13. emerging growth companies; and

14. fully reporting public companies.

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

INTERIM SECURITIES REGULATION REFORM

Fundamental securities regulation reform is necessary, as I will discuss. In the interim, there are steps that should be taken to improve the regulatory environment for small firms seeking access to the capital markets. The major components of an interim reform program are outlined here.

Recommendations Reducing Barriers to Raising Private and Quasi-Public Capital

Regulation A. The original 1933 Securities Act contained the small issue exemption that is the basis for Regulation A. Congress has increased the dollar amount of the exemption over the years.[111] Overly burdensome regulation by state regulators (and, to a lesser extent, by the SEC), combined with the opportunity for issuers to avoid burdensome blue sky laws since 1996[112] via Rule 506 of Regulation D, have rendered Regulation A ineffective—a dead letter that is virtually never used.[113] In 2011, only one Regulation A offering was completed.[114] SEC data show that Regulation A between 2009 and 2012 was used to raise only $73 million. This compares to comparably sized Regulation D offerings of $25 billion and comparably sized public offerings of $840 million.[115] Thus, in the aggregate, over that three-year period, Regulation A accounted for less than three-tenths of 1 percent of the capital raised in offerings of $5 million or less.[116]

Title IV of the JOBS Act demonstrates a clear bipartisan consensus that this is unacceptable and that the section 3(b) small issues exemption needs to be rethought to promote small business capital formation. Title IV has come to be known as Regulation A-plus. It would allow Regulation A offerings of up to $50 million. The SEC promulgated a rule implementing Title IV that was effective June 19, 2015.[117] This regulation would create two tiers, but only the more heavily regulated second tier would be blue sky exempt and even "Tier 2" secondary offerings are not exempt. Smaller "Tier 1" companies remain subject to the expense and delay of blue sky laws. For small businesses to efficiently use Regulation A, legislative changes are needed:

1. Congress should preempt state registration and qualification laws governing all Regulation A company securities. These companies have substantial initial and continuing disclosure obligations. Congress should either define "covered securities" under the National Securities Markets Improvement Act (NSMIA) to include securities sold in transactions exempt pursuant to Regulation A or define qualified purchasers to include all purchasers of securities in transactions exempt under Regulation A, or both. The recent Regulation A-plus rule would do this for "Tier 2" companies' primary offerings.[118]
2. Congress should simplify the statutory small issue exemption. Specifically, amend Securities Act section 3(b)(1) so that "Tier 1" Regulation A offerings have reasonable requirements for offering statements and periodic disclosure and provide that the provisions are self-effectuating without having to wait for the promulgation of SEC regulations. The current rules are nearly as complex as those governing smaller reporting companies.

3. Congress should eliminate application of the section 12(g)(1) holder of record thresholds for Regulation A securities. Regulation A securities are much less likely to be held in street name through a broker-dealer. Thus, the number of "holders of record" may approach the number of beneficial owners. The current limit of 500 shareholders is too low.[119]

Regulation D. The Securities Act provides an exemption for offerings "not involving any public offering." Regulation D, adopted in 1982, provides a safe harbor such that offerings that are compliant with the requirements of Regulation D are deemed not to involve a public offering.[120]

Regulation D has three parts. Rule 504[121] and Rule 505[122] were meant for use by small firms. Rule 504 allows firms to raise up to $1 million annually.[123] Rule 505 allows firms to raise up to $5 million annually.[124] In practice, 99 percent of capital raised using Regulation D is raised using Rule 506.[125] This is because Rule 506 offerings, in contrast to Rule 504 or Rule 505 offerings, are exempt from state blue sky registration and qualification requirements.[126] Issuers using Rule 506, therefore, do not have to bear the expense and endure the delay of dealing with as many as fifty-two regulators, about three-fifths of whom engage in "merit review" where regulators purport to decide whether an investment is fair or a good investment.[127] Regulation D has become the dominant means of raising capital in the United States, particularly for entrepreneurs. In 2013, approximately $1.3 trillion annually was raised using Regulation D.[128]

Most Regulation D offerings are sold entirely to accredited investors because selling to nonaccredited investors triggers additional disclosure requirements under Regulation D and creates other regulatory risks.[129] In general, an accredited investor is either a financial institution or a natural person who has either income greater than $200,000 ($300,000 joint) or a residence exclusive net worth of $1 million or more.[130] There is a major push by progressive, pro-regulatory organizations and state regulators to increase these thresholds dramatically.[131]

Rule 506 also permits up to thirty-five "sophisticated investors" to purchase Rule 506 offerings. The problem is that the regulatory definition of what constitutes a sophisticated investor is very amorphous. It turns on whether the investor has such "knowledge and experience in financial and business matters" that the investor "is capable of evaluating the merits and risks of the prospective investment."[132] For Regulation D to be an effective avenue for small businesses to raise money:

4. Congress should establish a statutory definition of accredited investor for purposes of Regulation D offerings that (a) sets the income and net worth requirements for natural persons at current levels and (b) establishes specific bright line tests for sophistication.[133]
5. Congress should prevent the promulgation of the Regulation D amendments proposed in July 2013.[134] These rules would substantially increase the regulatory burden for smaller companies seeking to use Regulation D and have no appreciable positive impact.[135] They would require filing three forms instead of one and impose a variety of other burdensome requirements.[136]

Crowdfunding. The story of the investment crowdfunding exemption is an object lesson in how a simple, constructive idea can be twisted by the Washington legislative process into a complex morass. Representative Patrick McHenry introduced his Entrepreneur Access to Capital Act on September 14, 2011.[137] It was three pages long, less than one page if the actual legislative language were pasted into a Word document. It would have allowed issuers to raise up to $5 million and limited investors to make investments equal to the lesser of $10,000 or 10 percent of their annual income.[138] The exemption would have been self-effectuating, requiring no action by the SEC in order to be legally operative. The bill reported out of committee and ultimately passed by the House was fourteen pages long.[139] By the time the Senate was done with it, it had expanded to twenty-six pages.[140] Many of the additions were authorizations for the SEC to promulgate rules or requirements that it do so. The bill was incorporated into the JOBS Act as Title III. Firms may raise no more than $1 million annually using Title III crowdfunding.[141] So it is only an option for the smallest of firms. The PDF of the October 23, 2013, proposed crowdfunding rule was 585 pages long (although double spaced) and sought public comments on well over 300 issues raised by the proposed rule.[142] The PDF of the final rule was 685 pages (229 pages as published in the *Federal Register*).[143]

If Congress decides to work with the current crowdfunding statute rather than start over, there are at least eight changes that should be made if crowdfunding is to achieve its promise as a viable way for small companies to obtain financing. Only two of them relate to disclosure:[144]

6. Congress should eliminate the audit requirements in crowdfunding offerings over $500,000 required by Securities Act section 4A(b)(1)(D)(iii).
7. Congress should reduce the mandatory disclosure requirements on crowdfunding issuers. They are much too burdensome for the very small firms that are permitted to use Title III crowdfunding.

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

Other Improvements. In order to allow extremely small firms to raise capital without complying with complex securities:

8. Congress should amend the Securities Act to create a statutory "micro-offering" safe harbor so that any offering is deemed not to involve a public offering for purposes of section 4(a)(2) if the offering (1) is made only to people with whom an issuer's officers, directors, or 10 percent or more shareholders have a substantial preexisting relationship; (2) involves thirty-five or fewer purchasers; or (3) has an aggregate offering price of less than $500,000 (within a twelve-month period).[145]

Recommendations Reducing Regulatory Burdens on Small Public Companies

Regulation S-K[146] is the key regulation governing nonfinancial statement disclosures of registered (i.e., public) companies. Regulation S-X[147] generally governs public company financial statements in registration statements or periodic reports. These two rules, including the various rules and accounting policies that they incorporate by reference—including those of the SEC, the Public Company Accounting Oversight Board (PCAOB) and the Financial

Accounting Standards Board (FASB)—impose the vast majority of the costs incurred by public companies.

The SEC has estimated that "the average cost of achieving initial regulatory compliance for an initial public offering is $2.5 million, followed by an ongoing compliance cost, once public, of $1.5 million per year."[148] This is probably a significant underestimate for many firms.

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

Although there have been some efforts to scale disclosure requirements, notably the emerging growth company provisions contained in Title I of the JOBS Act and the smaller reporting company rules, public company compliance costs have grown sufficiently high that many smaller firms are "going private."[149] Sarbanes-Oxley (2002),[150] Dodd-Frank (2010),[151] other legislation, and regulatory actions have contributed to these costs. Moreover, US initial public offering (IPO) costs are considerably higher than those abroad.[152] To address the disproportionate costs that small companies face under the securities laws:

Table 1. Initial Public Offering–Related Fees as a Percentage of Offering Size, 1996–2012

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

Source: US Securities and Exchange Commission, Division of Economic and Risk Analysis; "Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act," 79 Fed. Reg. (January 23, 2014): 3978.

Note: Analysis excludes IPOs from non-Canadian foreign issuers and blank-check companies.

9. Congress should preempt blue sky registration and qualification requirements with respect to public companies not listed on national exchanges.
10. Congress should increase the smaller reporting company threshold to $300 million and conform the accelerated filer definition.
11. Congress should make all emerging growth company advantages permanent for smaller reporting companies.
12. Congress should improve the disclosure requirements under Regulation S-K for smaller reporting companies.[153]

FUNDAMENTALS

There is a need to fundamentally rethink the regulation of small company capital formation. A coherent, scaled disclosure regime should be developed and implemented by Congress, with respect to both initial and continuing disclosure, that is integrated across the various exemptions and categories of reporting company such that larger firms with more investors and more capital at risk have greater disclosure obligations. Congress should consider the cost of compliance; the investor protection benefits of the added disclosure; the cost to investors of being denied investment opportunities by investment restrictions; and the cost to the public of lost economic growth, capital formation, innovation, and job creation caused by the regulation of issuers.

It is worth considering a simplified set of exemptions. One possibility is to establish three categories, as shown in table 2.

In such a regime, private companies would have no legally mandated disclosure requirements. Disclosure requirements would be negotiated by the private parties involved, much as they usually are now. A company would be deemed private if it did not engage in general solicitation, was below some specified number of beneficial owners[154] or, perhaps, some measure of non-insider share value (analogous to public float)—call this threshold A—and its shares were not traded on a venture exchange or a national securities exchange.

Public companies could engage in general solicitation and would (1) be above a specified measure of size (threshold B) or (2) have shares traded on a national securities exchange. Disclosure obligations would be scaled based on some measure of size (probably public float). This is the category into which

Table 2. A Proposal for a Reformed Disclosure Regime

Type of Issuer	Type of Solicitation		Size (Public Float/ Number of Beneficial Owners)		Secondary Market Status
Private	Private	and	Below specified threshold A	and	Not national securities exchange and not venture exchange traded
Quasi-public	General	or	Above specified threshold A	and	Not national securities exchange traded (venture exchange trading permitted)
Public (registered)	General	and	Above specified threshold B	or	National securities exchange traded

most companies that are full reporting companies, smaller reporting companies, emerging growth companies, and perhaps some Regulation A-plus companies would fall.

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

Blue sky laws regarding registration and qualification would be preempted in all cases. State antifraud laws would remain operative.

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

Although it is far from clear that the accredited investor distinction should be retained, some accredited investor limitations measuring wealth, income, or sophistication could be applied to private offerings should policymakers wish to limit those who may invest in private companies. In that case, however, something similar to the current section 4(a)(2) exemption or a statutory exemption for micro issuers should remain. Otherwise, two guys starting a bar would run afoul of the securities laws when they tried to raise money from their family and friends.

Such a regime would constitute a major improvement over the current one. It would be simpler, result in fewer regulatory difficulties and costs, protect investors, and promote capital formation.

CONCLUSION

Because the benefits of mandatory disclosure are so much smaller than usually assumed, policymakers need to adopt a more skeptical posture toward the existing disclosure regime. The costs are significant and have dramatically increased in recent years. The adverse impact on small and startup entrepreneurial firms, innovation, job creation, and economic growth is substantial. Moreover, disclosure requirements have become so voluminous that they defeat their alleged purpose. They obfuscate rather than inform. Finally, disclosure requirements that are not material to security valuation should be repealed.

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

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

In this chapter I have outlined a program of interim reforms to improve the existing disclosure regime and recommended specific changes to Regulation A, crowdfunding, Regulation D, and the regulation of small public companies and of secondary markets that, taken as a whole, would dramatically improve the current regulatory environment. A program of fundamental reform, which I have also outlined, would dramatically simplify the existing disclosure regime to the benefit of both investors and issuers. This proposal would create three disclosure regimes—public, quasi-public, and private—and disclosure under the first two categories would be scaled based on either public float or the number of beneficial shareholders.

NOTES

1. See Disclosure Modernization and Simplification, Title LXXII of the Fixing America's Surface Transportation (FAST) Act, Pub. L. No. 114–94 (December 4, 2015); "Business and Financial Disclosure Required by Regulation S–K Concept Release," 81 Fed. Reg. (April 22, 2016): 23915.
2. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (1933), 15 U.S.C. § 77a et seq. (as amended through Pub. L. No. 112-106 [2012]).
3. See § 5 of the Securities Act of 1933.
4. Proposed Rules, "Crowdfunding," 78 Fed. Reg. (November 5, 2013): 66509.
5. See generally Securities Act §§ 3-4.
6. Section 4(a)(2) of the Securities Act exempts "transactions by an issuer not involving any public offering," 15 U.S.C. § 77d(a)(2). Prior to the Jumpstart our Business Startups Act of 2012 (JOBS Act), Pub. L. No. 112-106, 126 Stat. 306 (2012), the exemption was in §4(2).
7. 17 C.F.R. § 230.500 et seq.; see also US Securities and Exchange Commission, "Regulation D—Rules 504, 505 and 506."
8. See "Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales" (Release No. 33-6389), 47 Fed. Reg. (March 16, 1982): 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 Offers and Sales" (Release No. 33-6339), 46 Fed. Reg. (August 18, 1981): 41791, for the original proposed rule.
9. Insiders, friends, and family will often rely on the private offering exemption (Section 4(a)(2)) without using Regulation D.
10. Bauguess, Gullapalli, and Ivanov, "Capital Raising in the US."

11. See SEC Rule 501(a).
12. Gullapalli, "Accredited Investor Pool."
13. See § 3(b) of the Securities Act of 1933.
14. 17 C.F.R. § 230.251 et seq.; see also US Securities and Exchange Commission, "Regulation A."
15. "Factors That May Affect Trends"; Campbell, "Regulation A."
16. Final Rule, "Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A)," 80 Fed. Reg. (April 20, 2015): 21806–925.
17. Title IV, the Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-106 (2012).
18. Burton, "Regulation A+ Proposed Rule"; and Comments on "Proposed Rule Amendments"; Campbell, "Regulation A and the JOBS Act."
19. Wan, "Progress Report."
20. See Bauguess, Gullapalli, and Ivanov, "Capital Raising in the US," 7.
21. Pursuant to § 13 or 15(d) of the Securities Exchange Act of 1934.
22. Ibid.
23. 17 C.F.R. Part 229.
24. 17 C.F.R. Part 210.
25. Notably the voluminous requirements of the Public Company Accounting Oversight Board (PCAOB) and the Financial Accounting Standards Board (FASB).
26. 17 C.F.R. § 240.12b-2; 17 C.F.R. § 229.10 (Item 10(f)(1)).
27. 17 C.F.R. § 240.12b-2(1).
28. 17 C.F.R. § 240.12b-2(2).
29. Section 2(a)(19) of the Securities Act of 1933 (15 U.S.C. § 77b(a)(19)).
30. Section 6(e) of the Securities Act of 1933 (15 U.S.C. § 77f(e)).
31. A transaction induced by fraud (misrepresentation) is not voluntary or welfare enhancing in that it would not be entered into in the absence of the fraud (or would be entered into at a different price). This principle has been recognized at common law since time immemorial—see, for example, Blackstone, *Commentaries on the Laws of England*, book III, chap. 9—and is recognized by virtually all political theorists. Securities fraud was illegal long before New Deal securities laws or even blue sky laws were enacted (Banner, *Anglo-American Securities Regulation*). See also Easterbrook and Fischel, "Mandatory Disclosure," 669; Walker, "Securities Regulation"; Mahoney, *Wasting a Crisis*.
32. See *Restatement of the Law, Second, Torts, Volume 3* (Philadelphia: American Law Institute, 1977) at § 525 Liability for Fraudulent Misrepresentation; § 526 Conditions under which Misrepresentation Is Fraudulent (Scienter); § 529 Representation Misleading because Incomplete; and §551 Liability for Nondisclosure.
33. See Securities Exchange Act of 1934 § 10(b) [15 U.S.C. § 78j(b)], Regulation of the Use of Manipulative and Deceptive Devices. See also 17 C.F.R. § 240.10b-5, Employment of manipulative and deceptive devices.
34. See, for example, § 501 of the Uniform Securities Act (2002), which reads:

    "General Fraud. It is unlawful for a person, in connection with the offer, sale, or purchase of a security, directly or indirectly:

(1) to employ a device, scheme, or artifice to defraud;
(2) to make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it is made, not misleading; or
(3) to engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person."

35. For a discussion of the history of blue sky laws, see Macey and Miller, "Origin of the Blue Sky Laws"; and Mahoney, "Origins of the Blue Sky Laws."

36. Charles II, "Act for Prevention of Frauds and Perjuryes."

37. Uniform Commercial Code § 2-201. Formal Requirements; Statute of Frauds.

38. For a general introduction, see Posner, "Financial Markets."

39. Prentice, "Economic Value of Securities Regulation"; Black, "Legal and Institutional Preconditions"; Enriques and Gilotta, "Disclosure and Financial Market Regulation."

40. Kahan, "Securities Laws"; Coffee, "Market Failure"; Seligman, "Historical Need," 1.

41. Wurgler, "Financial Markets"; Mclean, Zhang, and Zhao, "Why Does the Law Matter?"; Dye, "Mandatory versus Voluntary Disclosures"; Bushee and Leuz, "Economic Consequences"; Franco, "Why Antifraud Provisions Are Not Enough"; Healy and Palepu, "Information Asymmetry"; Admati and Pfleiderer, "Forcing Firms to Talk."

42. Botosan, "Evidence That Greater Disclosure Lowers the Cost"; Himmelberg, Hubbard, and Love, "Investor Protection."

43. The interests of shareholders and management are often not coincident and may considerably conflict. Corporate managers often will operate firms as much for their own benefit as that of shareholders, and shareholders may have difficulty cost-effectively preventing this. The incongruity of interest is often described as the agent-principal problem or collective action problem and is significant in larger firms where ownership and management of the firm are separate and ownership is widely held. See Jensen and Meckling, "Theory of the Firm"; Mahoney, "Mandatory Disclosure"; Fox, "Retaining Mandatory Securities Disclosure."

44. Romano, *Advantage of Competitive Federalism*; Healy and Palepu, "Information Asymmetry.

45. Easterbrook and Fishel, *Economic Structure of Corporate Law*; Fishman and Hagerty, "Disclosure Decisions"; Stigler, "Public Regulation"; Benson, "Required Disclosure."

46. The Regulation D safe harbor imposes certain additional requirements if the issuer sells securities under Rule 505 or 506(b) to any purchaser that is not an accredited investor. See 17 C.F.R. § 230.502(b).

47. See, for example, O'Hara and Easley, "Information and the Cost of Capital."

48. Lewis, "Future of Capital Formation"; Schwartz, "Law and Economics," 347; Bradford, "Transaction Exemptions." There is also a strong argument that scaling should be a function of the age of the firm so that relatively young firms with limited compliance experience and, typically, limited cash flow and resources should have lesser disclosure requirements than more mature firms. See table 3.3 in Phillips and Zecher, *SEC and the Public Interest*. See also US Securities and Exchange Commission, "Economic Analysis," "Proposed Rule Amendments for Small and Additional Issues Exemptions under Section 3(b) of the Securities Act," 79 Fed. Reg. (January 23, 2014): 3972–93.

49. Liu et al., "Dark Side of Disclosure."

50. Eklund and Desai, "Entry Regulation," 25; Woodward, "Regulatory Capture"; Stigler, "Theory of Economic Regulation."

51. "Regulation Is Good for Goldman."

52. See, for example, Karmel, *Regulation by Prosecution*, 18, where she states:

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

Karmel was an SEC Commissioner from 1977–1980. For a general discussion of these issues, see Rubin and Bailey, "Role of Lawyers"; White, "Legal Complexity."

53. See Enriques and Gilotta, "Disclosure and Financial Market Regulation"; Ben-Shahar and Schneider, "Failure of Mandated Discourse."

54. The lack of data available to policymakers regarding the private capital markets, compliance costs, SEC and other regulator enforcement actions, and the types of securities laws violations that occur in practice is startling. Steps need to be taken to rectify this lack of data so that policymakers can make policy in something other than a largely data-free environment. Specifically, the SEC should collect and publish times series data with respect to the initial offering and continuing regulatory costs incurred by small public and Regulation A companies (including both those whose offerings are declared effective or qualified and those whose offerings are not) and in connection with private placements (primary Regulation D offerings), the amount of capital raised, and the nature of the investors. The SEC should also collect and publish data regarding enforcement actions taken in connection with private, Regulation A, and small public company offerings, disclosure obligations, and secondary market activity. Specifically, the SEC should collect and publish information showing what types of disclosures, misrepresentations, or omissions are the source of enforcement actions; what types of issuers and exemptions give rise to enforcement actions; the frequency and severity of different types of violations (including the amount lost by investors); and whether the primary or the secondary market is the source of most problems.

55. Langevoort and Thompson, "'Publicness.'"

56. de Fontenay, "Do the Securities Laws Matter?"; Daines and Jones, "Truth or Consequences"; Leuz and Wysocki, "Economic Consequences"; Healy and Palepu, "Information Asymmetry"; Zecher, "Economic Perspective"; Easterbrook and Fischel, "Mandatory Disclosure"; Phillips and Zecher, *SEC and the Public Interest*, chap. 3; Kripke, *SEC and Corporate Disclosure*; Benson, *Corporate Financial Disclosure*, and "Corporate Financial Disclosure." For two pioneering economic studies finding no measurable benefit from the Securities Act of 1933, see Stigler, "Public Regulation," and Benson, "Required Disclosure."

57. Romano, "Empowering Investors."

58. See Quandl, 2012 World Bank Market Capitalization Data.

59. Ibid.

60. World Bank, "Market Capitalization of Listed Companies."

61. Broad in the sense that a high number of firms participate in equity markets and deep in the sense that markets are liquid with large numbers of investors investing large amounts of capital.

62. Once the discussion is broadened to financial regulation generally speaking, other major problems also must be considered, including "too big to fail," bank regulation, federal loan guarantees, monetary policy, and the like.

63. There are exceptions. The disclosure requirements with respect to conflict minerals, mine safety, resource extraction, and the ratio between a company's CEO pay and the median pay of all other employees are examples. See Burton, "How Dodd-Frank Mandated Disclosures Harm."

64. See, for example, Romano, "Regulating in the Dark," esp. 89–90, which explains that the Sarbanes-Oxley Act has been particularly costly for small firms; Campbell, "Wreck of Regulation D," which discusses how Regulation D does not work the way it is supposed to for small companies because of state blue sky laws; Campbell, "Regulation A," 77–122, esp. 121–22, which explains that "[f]ederal and state securities laws exacerbate" the already difficult task of small firms trying to raise capital; Campbell, "Regulation A and the JOBS Act"; SEC Commissioner Gallagher, "Whatever Happened to Promoting Small Business?"; Cohn and Yadley, "Capital Offense"; Burton, "Reducing the Burden."

65. For a more complete discussion of the economic importance of entrepreneurship and existing impediments to entrepreneurship, see Burton, "Building an Opportunity Economy."

66. "The mission of the US Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." US Securities and Exchange Commission, "What We Do," retrieved October 31, 2016, https://www.sec.gov/about/whatwedo.shtml#intro. The SEC's statutory charge is: "Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." See § 3(f) of the Securities Exchange Act of 1934 and § 2(b) of the Securities Act of 1933.

67. See, for example, sec. III, "Some Limits and Drawbacks of MD," in Enriques and Gilotta, "Disclosure and Financial Market Regulation."

68. Paredes, "Blinded by the Light"; and, as commissioner, "Remarks at The SEC Speaks." See also, Higgins (Director, Division of Corporation Finance), "Disclosure Effectiveness."

69. Ernst & Young, "Now Is the Time."

70. Monga and Chasan, "109,894-Word Annual Report."

71. For example, Ray Bradbury's *Fahrenheit 451* (46,118 words), F. Scott Fitzgerald's *The Great Gatsby* (47,094), and Stephen Crane's *The Red Badge of Courage* (47,180).

72. The Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system is a free search tool at http://www.sec.gov/edgar/searchedgar/webusers.htm#.U_ZaTmOC2So.

73. Usually, these documents are the federal Forms 10-K, 10-Q, or 8-K.

74. Becker, "Crime and Punishment"; Posner, "Economic Theory."

75. This short discussion abstracts away from many subsidiary issues, including the relative efficacy of civil and criminal penalties, the degree of deterrence that is socially optimal, measurement issues, and the like. For a recent review of some of the issues, see Hylton, "Theory of Penalties."

76. For a dated but detailed look at blue sky laws, see "Report on the Uniformity.' " For a critique of blue sky laws, see Campbell, "Federalism Gone Amuck," 578: "In retrospect, there can be little doubt that the failure of Congress to preempt state authority over the registration of securities was a significant blunder." See also Karmel, "Blue-Sky Merit Regulation." The North American Securities Administrators Association, "Application for Coordinated Review," delineates between merit review and disclosure jurisdictions. There are forty-nine participating jurisdictions, including Puerto Rico, the US Virgin Islands, and the District of Columbia. Of the states, twenty-eight are merit review states, sixteen are disclosure states,

and two (New Jersey and West Virginia) are "disclosure" states that "reserve the right" to make "substantive comments." Four states do not, at this time, participate.

77. Campbell, "Insidious Remnants"; Manne and Mofsky, "What Price Blue Sky"; Maynard, "Future of California's Blue Sky Law"; Sargent, "Future for Blue Sky"; Mofsky and Tollison, "Demerit in Merit Regulation"; Mofsky, *Blue Sky Restrictions*; Bell and Arky, "Blue Sky Restrictions."

78. A discussion of the role of benefit corporations (or benefit LLCs) and social enterprises is beyond the scope of this chapter. However, it is my strong contention that if there is full disclosure and investors understand the dual mission of the enterprise, investors should be free to invest in such enterprises and the founders of such enterprises should be free to sell securities in such enterprises.

79. Jolls, Sunstein, and Thaler, "Behavioral Approach to Law"; Thaler and Sunstein, "Libertarian Paternalism"; Sunstein and Thaler, "Libertarian Paternalism Is Not an Oxymoron"; O'Donoghue and Rabin, "Studying Optimal Paternalism." See also Whitman, "Against the New Paternalism."

80. Jolls, Sunstein, and Thaler, "Behavioral Approach to Law"; Korobkin and Ulen, "Law and Behavioral Science."

81. See, for example, Stein, "Remarks before the Consumer Federation"; Elan, "Annotated Bibliography"; US Securities and Exchange Commission Investor Advisory Committee, minutes of May 17, 2010 meeting.

82. Hayek, "Pretence of Knowledge"; *Individualism and Economic Order*; "Use of Knowledge in Society"; and "Economics and Knowledge."

83. Schuck, *Why Government Fails So Often*; Winston, *Government Failure*; Peirce, *Bureaucratic Failure*.

84. A "riskier security" is here defined as a security with a high degree of unique risk (as opposed to market or systemic risk).

85. This is often called a negative beta or low beta investment. For a discussion of these issues, see, for example, Brealey, Meyers, and Allen, "Introduction to Risk" or most introductory finance textbooks.

86. Choi and Pritchard, "Behavioral Economics and the SEC."

87. Tullock, Seldon, and Brady, *Government Failure*.

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

89. Shughart, "Public Choice"; Buchanan, *Collected Works of James M. Buchanan*, 46, from a lecture originally given at the Institute for Advanced Studies in Vienna, Austria in 1979. Buchanan stated: "My primary title for this lecture, 'Politics without Romance,' was chosen for its descriptive accuracy. Public choice theory has been the avenue through which a romantic and illusory set of notions about the workings of governments and the behavior of persons who govern has been replaced by a set of notions that embody more skepticism about what governments can do and what governors will do, notions that are surely more consistent with the political reality that we may all observe about us. I have often said that public choice offers a 'theory of governmental failure' that is fully comparable to the 'theory of market failure' that emerged from the theoretical welfare economics of the 1930s and 1940s."

90. Folsom and Folsom, *Uncle Sam Can't*; Pack and Saggi, in "Case for Industrial Policy," 1, write: "Overall, there appears to be little empirical support for an activist government policy even though market failures exist that can, in principle, justify the use of industrial policy."

91. Rustin and Lynch, "Apple Computer Set."

92. For example, in February 2008, then Federal Reserve Board Chairman Ben Bernanke said, "Among the largest banks, the capital ratios remain good and I don't anticipate any serious problems of that sort among the large, internationally active banks that make up a very substantial part of our banking system." See "Fed Chairman." Only seven months later, the Emergency Economic Stabilization Act of 2008 established the Troubled Asset Relief Program (TARP), with Bernanke's support, to bail out the big banks.

93. Roszkowski and Grable, "Evidence of Lower Risk Tolerance."

94. See the discussion at note 77 and North American Securities Administrators Association, "Application for Coordinated Review of Regulation A Offering."

95. There is, however, a creeping introduction of a type of merit review into federal securities laws. Notably, Title III of the JOBS Act limits investments to a specified percentage of income or net worth and the new Regulation A-plus rules do the same. It does not take too much imagination to envision a federal regulatory regime that has specified diversification or other requirements for most investors that would seriously limit investors' options and that most entrepreneurs starting a business with their own funds would fail. Indeed, the Financial Industry Regulatory Authority (FINRA) Rule 2111 relating to suitability requirements already imposes the broad outlines of such a system for transactions recommended by a broker-dealer. The Department of Labor's fiduciary standards under the Employee Retirement Income Security Act (ERISA) raise similar issues.

96. Examples would include the SEC's continued limitations on paying finders (or private placement brokers) who bring capital to a small business, limits on peer-to-peer lending, the unduly restrictive rules governing Regulation D general solicitation, and the crowdfunding rules that quite probably make non-broker-dealer funding portals uneconomic. Moreover, the sheer complexity of SEC and FINRA regulation of broker-dealers acts to limit competition and to create a cartel, resulting in higher broker-dealer fees than would obtain in a genuinely competitive market. The Financial Crimes Enforcement Network (FinCEN) proposed rules applying the Anti-Money Laundering/Know Your Customer (AML/KYC) rules to funding portals, even though they are prohibited from holding customer funds and the financial institutions holding the funds must do AML due diligence, are a further example. See "Amendments to the Definition of Broker or Dealer in Securities," 81 Fed. Reg. (April 4, 2016): 19086–94.

97. Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

98. The Conference Board, "Corporate Political Spending"; and Welsh and Passoff, "Proxy Preview 2016," 64–65.

99. Michaels, "Democrats Pressure SEC"; and "SEC Action on Corporate Political Spending Disclosure," letter signed by ninety-four senators and representatives.

100. "Petition for Rulemaking on Disclosure by Public Companies of Corporate Resources Used for Political Activities," File No. 4-637-2, April 15, 2014; and "Comments on Rulemaking Petition: Petition to Require Public Companies to Disclose to Shareholders the Use of Corporate Resources for Political Activities," File No. 4-637, https://www.sec.gov/comments/4-637/4-637.shtml.

101. Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, H.R. 2029, 114th Cong. (December 18, 2015), Section 707, Title VII, Division O: "None of the funds made available by any division of this Act shall be used by the Securities and Exchange Commission to finalize, issue, or implement any rule, regulation, or order regarding the disclosure of political contributions, contributions to tax exempt organizations, or dues paid to trade associations." This act governs spending through FY 2016, which ended September 30, 2016.

102. The Shareholder Protection Act of 2015, S. 214, H. R. 446, 114th Cong.

103. "Request for rulemaking to require public companies to disclose gender pay ratios on an annual basis, or in the alternative, to provide guidance to companies regarding voluntary reporting on pay equity to their investors," submitted by PAX Ellevate Management LLC, File No.4-696, February 1, 2016.

104. For example, the US Chamber of Commerce estimates, based on survey data, that the CEO pay-disclosure-rule compliance costs $711 million annually, substantially more than the SEC estimate. See Brannon, "Egregious Costs of the SEC's Pay-Ratio." The SEC estimated that the initial cost of compliance with the conflict minerals rule "is between approximately $3 billion to $4 billion, while the annual cost of ongoing compliance will be between $207 million and $609 million." See "Conflict Minerals," Final Rule, 77 Fed. Reg. (September 12, 2012): 56351.

105. Burton, "How Dodd-Frank Mandated Disclosures Harm."

106. The Securities Acts Amendments of 1964, Pub. L. No. 467, 78 Stat. 565 (August 20, 1964). See also Phillips and Shipman, "Analysis of the Securities Acts Amendments."

107. See section 12(g) of the Securities Exchange Act. The 2012 JOBS Act liberalized this rule by allowing a firm to have up to 2,000 accredited investors before having to register. In addition, under the JOBS Act, investors who bought securities pursuant to the Title III crowdfunding exemption are not counted toward the section 12(g) limit. It is also important to note that "holder of record" is not the same as beneficial owner. Most investors hold their stock under "street name" so that all of the stock held by various customers of a particular broker-dealer is held on the records of the company as one holder of record—the broker-dealer. In addition, many investors may combine to form and invest in a special-purpose vehicle that in turn actually invests in the company. The special-purpose vehicle counts as only one shareholder of record. The regulations do not require the issuer to "look-through" the special-purpose vehicle investor. In addition, mutual funds, closed-end funds, or private equity funds are, in effect, entities that represent the investment of many individual investors, yet they too would constitute just one holder of record.

108. Regulation A and crowdfunding securities are public in the sense they may be sold to all investors and the securities are not restricted securities (in the case of crowdfunding, after one year). They are not public in the sense that the issuer is not subject to the requirements of a reporting company. The term quasi-public is meant to encompass these types of companies and companies that would be in a similar situation under alternative regulatory regimes.

109. For a discussion of these issues, see Langevoort and Thompson, " 'Publicness.' "

110. Rule 502(b) imposes significantly greater disclosure requirement on issuers that sell to non-accredited investors in both Rule 505 and Rule 506(b) offerings.

111. Securities Act of 1933 section 3(b); 15 U.S.C. § 77c(b). It was originally $100,000 and was increased to $300,000 in 1945, to $500,000 in 1970, to $2 million in 1978, and to $5 million in 1980. The JOBS Act in 2012 created section 3(b)(2), which allows certain Regulation A offerings to raise as much as $50 million. This is so-called Regulation A-plus.

112. See section 102 of the National Securities Markets Improvement Act of 1996 (Pub. L. No. 1040-290, October 11, 1996) incorporating the Capital Markets Efficiency Act of 1996 as section 18(b)(4)(E) of the Securities Act (15 U.S.C. § 77r(b)(4)(E)), which treats as covered securities those securities not involving a public offering under Securities Act section 4(a)(2). Rules 504 and 505 were promulgated under Securities Act section 3(b) and therefore transactions using these rules are not blue sky exempt.

113. See, for example, Campbell, "Regulation A"; Cohn and Yadley, "Capital Offense"; "Factors That May Affect Trends."

114. See "Factors That May Affect Trends," 9.
115. "Proposed Rule Amendments for Small and Additional Issues Exemptions under Section 3(b) of the Securities Act," 3928.
116. Roughly $73 million out of $25,840 million. If section 4(a)(2) private offerings made without use of the Regulation D safe harbor were considered, the percentage would be substantially lower still.
117. "Amendments for Small and Additional Issues Exemptions under the Securities Act."
118. Massachusetts and Montana challenged the authority of the SEC to preempt state law. Lynch, "Two States Sue U.S. SEC." On June 14, 2016, the US Court of Appeals for the District of Columbia Circuit ruled against the states and for the SEC. To the author's knowledge, the state regulators have not indicated whether they will file a Petition for a Writ of Certiorari with the US Supreme Court.
119. Securities Exchange Act section 12(g)(1). For a more detailed discussion, see Burton, Comments on "Proposed Rule Amendments."
120. See "Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers of Sales" (Release No. 33-6389), 11251. Regulation D is found at 17 C.F.R. § 230.500 through §230.508.
121. 17 C.F.R. § 230.504. See also US Securities and Exchange Commission, "Rule 504 of Regulation D," retrieved October 31, 2016, https://www.sec.gov/answers/rule504.htm.
122. 17 C.F.R. § 230.505. See also US Securities and Exchange Commission, "Rule 505 of Regulation D," retrieved October 31, 2016, https://www.sec.gov/answers/rule505.htm.
123. Rule 504 offerings are exempt from the additional disclosure requirements for sales to non-accredited investors. See Rule 504(b)(1). General solicitation is permitted only in certain specified circumstances.
124. Rule 505 allows up to thirty-five nonaccredited investors but investments by nonaccredited investors trigger additional disclosure requirements under Rule 502(b).
125. See Bauguess, Gullapalli, and Ivanov, "Capital Raising in the US," 12.
126. This has been true since the passage of the National Securities Markets Improvement Act (NSMIA) of 1996, which amended section 18 of the Securities Act (15 U.S.C. § 77r) to exempt from state securities regulation any "covered security." 15 U.S.C. § 77r(b)(4)(E) provides that "[a] security is a covered security with respect to a transaction that is exempt from registration under this subchapter pursuant to . . . commission rules or regulations issued under section 77d(2) of this title, except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under section 77d(2) of this title that are in effect on September 1, 1996." Section 77d(2) is a reference to section 4(2) of the Securities Act (now section 4(a)(2)), to wit, transactions by an issuer not involving any public offering. Only Rule 506 of Regulation D relied on this provision. See US Securities and Exchange Commission, "Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales," 11251. Rule 505 and Rule 504 rely instead on section 3(b) of the Securities Act. See 17 C.F.R. § 230.504(a) and 17 C.F.R. § 230.505(a). Accordingly, Rule 504 and Rule 505 offerings are not treated as covered securities by the SEC or the state regulators.
127. The fifty-two regulators are the fifty states, the District of Columbia, and the SEC.
128. Bauguess, Gullapalli, and Ivanov, "Capital Raising in the US"; Burton, "Don't Crush the Ability."
129. See Rule 502(b).

130. 17 C.F.R. § 230.501(a) (SEC Rule 501).

131. For details, see Burton, "Don't Crush the Ability."

132. Rule 501(e) excludes all accredited investors from the calculation of the number of purchasers. Rule 506(b)(2)(ii) requires that "each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description." The shorthand for this requirement is that he must be a "sophisticated investor."

133. The Fair Investment Opportunities for Professional Experts Act (H.R. 2187, 114th Cong.), which passed the House by a vote of 347–48 on February 1, 2016, would take steps in this direction by statutorily setting the thresholds at current level and indexing them prospectively, by treating certain financial professionals as sophisticated, and by allowing the SEC with FINRA to broaden the definition.

134. The Private Placement Improvement Act of 2016 (H.R. 4852, 114th Cong.) would prevent promulgation of these rules. This bill was reported out of the House Financial Services Committee on June 16, 2016. For proposed rules, see Release No. 33-9416; Release No. 34-69960; Release No. IC-30595; File No. S7-06-13; RIN 3235-AL46, "Amendments to Regulation D, Form D and Rule 156," 78 Fed. Reg. (July 24, 2013): 44806–55 and Release No. 33-9458; Release No. 34-70538; Release No. IC-30737; File No. S7-06-13; RIN 3235-AL46; "Amendments to Regulation D, Form D and Rule 156; Re-Opening of Comment Period," 78 Fed. Reg. (October 3, 2013): 61222.

135. See Burton, Comments to the SEC on "Amendments to Regulation D."

136. However, filing a simple closing Form D indicating the amount actually raised is justified by the need to have improved information about this critical market.

137. Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (2011–2012).

138. It also excluded crowdfunding investors from the holders of record count, preempted blue sky laws, and entitled issuers to rely on investor self-certification as to income level.

139. H.R. 2930, 112th Cong. (November 3, 2011).

140. Senate Amendment to Title III of H.R. 3606 (March 22, 2012).

141. Securities Act section 4(a)(6).

142. There were 284 actual requests for comment, but many of them are multipart requests. US Securities and Exchange Commission Proposed Rules, "Crowdfunding," October 23, 2013. For the Federal Register version of these proposed rules, see 78 Fed. Reg. (November 5, 2013): 66428–601; citations to the Crowdfunding proposed rules discussed in the text are to this version.

143. Crowdfunding, Final Rule, 80 Fed. Reg. (November 16, 2015): 71388.

144. The other proposed changes are: (1) permit funding portals to be compensated based on the amount raised by the issuer; (2) make it clear that funding portals are not issuers and not subject to the issuer liability provisions; (3) repeal the restriction on providing investment advice entirely or, alternatively, explicitly permit "impersonal investment advice," making it clear that a portal may bar an issuer from its platform if the portal deems an offering to be of inadequate quality without fear of liability to issuers or investors and that this would not constitute providing prohibited investment advice; (4) reduce the administrative and compliance burden on funding portals; (5) allow intermediaries to rely on good faith efforts by third-party certifiers for purposes of complying with the investment limitation in section

(4)(a)(6)(B); and (6) amend the Bank Secrecy Act to make it clear that federal AML/KYC rules do not apply to finders, business brokers, or crowdfunding web portals since they are prohibited by law from holding customer funds. FinCEN has proposed rules to make funding portals subject to the AML/KYC rules. See "Amendments to the Definition of Broker or Dealer in Securities."

145. The Micro Offering Safe Harbor Act, H.R. 4850, 114th Cong. (2015–2016) is designed to address this issue. The version as originally introduced would do so. The amended version reported out of the House Financial Services on June 16, 2016, is very narrow and will have only a limited impact. Burton, "Starting a Small Business."

146. 17 C.F.R. Part 229.

147. 17 C.F.R. Part 210.

148. Proposed Rules, "Crowdfunding," 78 Fed. Reg. (November 5, 2013): 66509.

149. See, for example, Committee on Capital Market Regulation, "Interim Report"; Kamar, Karaca-Mandic, and Talley, "Going-Private Decisions"; Bartlett, "Going Private but Staying Public."

150. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

151. Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

152. See, for example, Meoli et al., "Cost of Going Public."

153. See Burton, "Reducing the Burden."

154. There would be a need to have reasonable, administrable look-through rules if beneficial ownership were to replace the holder of record threshold. However, in the contemplated regulatory regime, the impact of the step-up from private to quasi-public status would not be so discontinuous as the step-up from private to public today, therefore this break point would be of less importance.

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