NSBA
National Small Business Association®

IDEAS FOR IMPROVING SMALL BUSINESSES' ACCESS TO CAPITAL

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23 percent of small business identify lack of adequate capital as one of the three largest problems they face.[2] The purpose of this white paper is to propose and analyze a number of ways to reduce regulatory impediments to small business capital formation while maintaining adequate investor protection.

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Rely More on Statutory Rules than SEC Drafted Rules

It has become clear that the Securities and Exchange Commission (SEC or "the Commission") regards Congressional deadlines in duly enacted statutes to be merely advisory. It took the SEC 15 months, for example, to adopt rules implementing the Title II JOBS Act provision allowing general solicitation in Regulation D filings. Congress had given the SEC 3 months, which was reasonable since it basically involved deleting a paragraph in Regulation D.

Congress required that final regulations implementing Title III of the JOBS Act (relating to crowdfunding) be completed by December 31, 2012. There is little reason to believe that even

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[2] 2013 Mid-Year Economic Report, National Small Business Association, August, 2013. Available at http://www.nsba.biz/wp-content/uploads/2013/08/2013-MY-Report1.pdf .

proposed rules will be out by the end of 2013. Innumerable Dodd-Frank regulatory deadlines have been missed.

Moreover, the SEC has a strong pro-regulation bias and typically has not seriously considered the costs its regulations impose on the private sector. Delays and high compliance costs will substantially reduce the positive impact of any follow-on legislation seeking to improve small businesses' access to capital ("JOBS Act II"). Accordingly, to the extent possible, Congress should draft statutory rules rather than leaving it to the SEC to draft rules.

Finders and Business Brokers Safe Harbor

The finder and business broker issues are related in that they both relate to who should be required to register as a broker-dealer under section 15 of the Securities Exchange Act. Accordingly, they are discussed together.

Proposal: (Part A) Create a statutory exemption for business brokers to the broker-dealer registration requirements consistent with the principles of the SEC *Country Business* no action letter dated November 8, 2006 but extended to include the sale of a controlling interest in the business rather than being limited to the sale of the entire business.
(Part B) Create a statutory exemption to the broker-dealer registration requirements for finders who are not "engaged in the business of effecting transactions in securities for the account of others" or of "buying and selling securities" and, as a integral component of that exemption, provide a bright-line safe harbor such that small finders are not deemed to be engaged in the business of being a securities broker or a dealer.

Analysis:

Introduction of the Problem

Business brokers have a substantial positive economic impact by making the market for closely held small businesses more efficient, by helping entrepreneurs achieve full value for their business when it is sold and by helping aspiring business owners find business opportunities that are appropriate given their skills and financial resources.

Finders play an important role in introducing entrepreneurs to potential investors, thus helping them to raise the capital necessary to launch or grow their businesses. Finders can reduce the cost of raising capital and increase the likelihood of raising needed capital, particularly for entrepreneurs who have a limited number of pre-existing relationships with accredited investors.[3]

The current regulatory ambiguity surrounding finders and business brokers impedes small firms' ability to raise capital and has an adverse impact on economic growth and job creation. They

[3] Title II of the JOBS Act (relating to general solicitation seeking accredited investors in Rule 506 offerings) will probably reduce the importance of finders in the intermediate and long term now that the regulations are promulgated because entrepreneurs will be able to use the internet and publications to seek accredited investors with whom they do not have a pre-existing relationship. In the real world, however, personal relationships (in this case of the finders) will always matter.

make the market less efficient by increasing transactions costs considerably. These costs have a disproportionately adverse effect on small firms trying to raise small amounts of capital.

Section 3(a)(4)(A) of the Securities Exchange Act[4] defines a broker generally as "any person engaged in the business of effecting transactions in securities for the account of others." Section 3(a)(5)(A) of the Securities Exchange Act[5] defines a broker generally as "any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person's own account through a broker or otherwise." Each definition contains a long list of exceptions generally for the benefit of banks.

Section 15 of the Securities Exchange Act requires brokers or dealers to register with the Securities and Exchange Commission ("SEC" or "the Commission").

<u>Bad Actors</u>

Obviously, investor protections are important. But the proposals made here will not harm investor protections. The rhetoric in the debate surrounding private securities offerings is sometimes maddening over-heated. Opponents of adopting more reasonable rules often act as if nearly every entrepreneur is bent on defrauding his or her investors and, conversely, that almost every investor is incapable of making investment decisions.

Accordingly, it should be made clear that the proposed exemption does nothing to change the application of the anti-fraud provisions of federal and state securities laws to registered broker-dealers and to business brokers or finders. A "nothing in this section shall be construed to …" type provision making this point, while unwarranted legally, is probably advisable politically. In addition, there should be affirmative language in the contemplated business broker and finder exemptions that barred those subject to a statutory disqualification from using the exemptions.[6]

<u>Transaction-Based Compensation</u>

The SEC appears to believe that structuring compensation so that it is transaction-based will almost always result in the necessity of registration in the absence of some other specific statutory exemption (e.g. those for banks in section 3 of the Securities Exchange Act). This is both an incorrect reading of the law and bad public policy.

There is absolutely no mention in the statutory definition of a broker or a dealer of the type or nature of compensation involved. The primary focus of the law is whether the person is "engaged in the business" of "effecting transactions in securities" for the account of others. Ergo, the focus on transaction-based compensation is an unwarranted regulatory creation of the SEC.

[4] 15 USC § 78c(a)(4)(A).
[5] 15 USC § 78c(a)(5)(A).
[6] See Securities Exchange Act section 3(a)(39) [15 USC § 78c(a)(39)]. Obviously, the scope of the unavailability could be narrowed or broadened but dovetailing the unavailability of the exemptions to the statutory disqualification language seems reasonable.

The current SEC analysis is a case of throwing out the small business "baby" with the hedge fund "bath water." SEC staff analysis appears to center on concerns about "conflict of interest."[7] But, in the context of small business trying to raise capital or sell the business, success-based compensation usually creates a commonality of interest between the finder or business broker and their principal rather than a conflict of interest. With success fee compensation, the finder has the same interest as his or her small business principal (finding capital) and the business-broker has the same interest as his or her small business principal (selling the business for the best price). With other forms of compensation, the finder or business broker simply has an interest in getting paid (whether or not he or she performed adequately).

This analysis would be substantially the same if we were talking about real estate brokers, commodities brokers or insurance brokers. As long as it is made clear for whom the broker works (i.e. it is not a case of dual agency), these industries do not regard transaction-based compensation as giving rise to a conflict of interest or as otherwise suspect.

Neither a finder nor a business-broker representing a seller has any fiduciary duty to the buyer. They have a duty of fair and honest dealing, as does the issuer, imposed by other provisions in the securities law[8] and, for that matter, the common law and a host of state statutes. But that constraint creates no conflict of interest.

As a matter of public policy, success-based compensation is generally preferable to other forms of compensation in the context of small firms. Allowing small business owners to pay a finder's fee or business brokerage fee to someone who actually did what they said they would do and either brought capital to a business or helped sell a business is one thing. Forcing business owners into having to pay finders or business brokers whether or not they were successful is another. If the aim of regulation is to prevent misrepresentation, fraud and false dealing, it is preferable to pay people for actually doing what they said they would do rather than forcing business owners into the quandary of guessing whether the person will deliver. Moreover, capital starved small businesses are not generally in a position to pay high-priced consultants who do not deliver. If, in contrast, the business is sold or the capital raised, the small business will have the means to pay.

The effort to channel these activities into either registered broker-dealers (with their attendant large fees) or consultants who bill on a basis other than actual success benefits large issuers and broker-dealers but harms small business seeking to grow. Wall Street is tolerant of large regulatory costs because it creates a major barrier to entry and forces those seeking capital to engage heavily regulated Wall Street firms. The JOBS Act will reduce these barriers to entry (although the SEC is resisting that aim) and a JOBS Act II can do more.

[7] "A Few Observations in the Private Fund Space," Remarks of David W. Blass, April 5, 2013, at the American Bar Association, Trading and Markets Subcommittee, Washington, D.C. "The SEC and SEC staff have long viewed receipt of transaction-based compensation is a hallmark of being a broker. This makes sense to me as the broker regulatory structure is built, at least in large part, around managing the conflict of interest arising from a broker acting as a securities salesman, as compared to an investment adviser which traditionally acts as a fiduciary and which should not have that same type of conflict of interest."

[8] Most notably, section 10 of the Securities Exchange Act (15 USC 78j).

The Current SEC Position on Who Should Register as a Broker-Dealer is Overbroad

The current SEC position on who should be required to register as a broker-dealer is overbroad and significantly exceeds the scope of the statutory registration requirement. The SEC *Guide to Broker-Dealer Registration*[9] illustrates this point.

The *Guide* suggests that those "finding investors," "making referrals," "finding buyers and sellers of businesses," or participating "in important parts of a securities transaction" "may need to register" as brokers. This is significantly beyond the scope of the statutory definition of a broker, to wit, "any person engaged in the business of effecting transactions in securities for the account of others."

The current SEC criteria are so broad that just about anybody involved in the transaction would be required to register as a broker-dealer. The issuer's accountant and attorney, after all, play an "important part" in a securities transaction. Presumably, so too might a finder or business broker. Some might argue that the Kinko's that copied the offering circular played an "important part" in the offering. But the "important part" standard is much broader than the statutory standard. Merely "making referrals" or "finding investors" is not what Congress had in mind when it enacted the Securities Exchange Act and it is not in keeping with the plain meaning of the statute. Making introductions and finding investors does not constitute *effecting securities transactions*.

It is also the case (contrary to what the SEC currently appears to claim) that the current SEC position is a relatively recent innovation in the SEC position dating most notably from the withdraw of the 1985 *Dominion Resources* no action letter in 2000.[10] For the previous six and half decades, the SEC position was substantially different that the position it has adopted in this century.

The inconsistency of the current SEC position with both the underlying statute and previous SEC practice combined with the lack of clear regulatory standards has introduced significant regulatory uncertainty into the analysis of whether registration is required and what activities unregistered persons may engage in. Most importantly, it impedes small firms' ability to access needed capital both by restricting the availability of finders and business brokers and by causing potential problems when successful small firms later seek venture capital or public financing and encounter counsel raising questions about their prior use of finders (or, to a lesser extent, business brokers).

A Business Broker Exemption

A statutory exemption is needed for business brokers to the broker-dealer registration requirements generally consistent with the principles of the *Country Business* no action letter

[9] Available at http://www.sec.gov/divisions/marketreg/bdguide.htm#II .

[10] See, e.g., the American Bar Association "Report and Recommendations of the Task Force on Private Placement Broker-Dealers," June 20, 2005 for a discussion of previous SEC practice. See also, e.g., "The "Finder's" Exception from Federal Broker--Dealer Registration," John Polanin, Jr., 40 Cath. U.L. Rev. 787 (1991).

dated November 8, 2006 but extended to include the sale of a controlling interest in the business rather than being limited to the sale of the entire business.

Specifically an exemption for business brokers from the section 15 registration requirement should be created provided that:

1. the business broker does not have the power to bind either party in the transaction;
2. the business being sold is a going concern;
3. the business being sold satisfies the size standards for a "small business" pursuant to the small business size regulations issued by the U.S. Small Business Administration;
4. only assets will be advertised or otherwise offered for sale;
5. if the transaction is effected by means of securities, it will be a conveyance of a controlling interest of the business's equity securities to a single purchaser or group of purchasers;
6. the business broker does not advise the two parties whether to issue securities, or otherwise whether to effect the transfer of the business by means of securities, or assess the value of any securities sold (other than by valuing the assets of the business as a going concern);
7. the business broker's compensation will be determined prior to the decision on how to effect the sale of the business and may be a fixed fee, hourly fee, a commission that is based upon the consideration received by the seller (or a combination thereof), regardless of the means used to effect the transaction and will not vary according to the form of conveyance (i.e., securities rather than assets);
8. the business broker will not assist purchasers with obtaining financing, other than providing uncompensated introductions to third-party lenders or help with completing the paperwork associated with loan applications.

This approach is preferable to an approach that requires registration of business brokers. First, it is not clear what the Commission would do with such registrations or how and on what basis it would regulate business brokers in a manner distinct from broker-dealers. Second, such a registration requirement would create needless compliance costs and complexity and these costs would ultimately be borne by small businesses.

A Finder Exemption

In addition, a statutory exemption is needed for finders who are not “engaged in the business” of “effecting transactions in securities for the account of others” or of “buying and selling securities.” As an integral component of that exemption, it is necessary to create a bright-line “small finder” safe harbor such that small finders are not deemed to be engaged in the business of being a securities broker or dealer. Such a bright line safe harbor would eliminate much of the regulatory uncertainty associated with the use of finders.

The safe harbor is meant to ensure that small finders who assist small businesses to find capital from time to time either as an ancillary activity to some other business (e.g. the practice of law, public accounting, insurance brokerage, etc.) or as main street business colleagues or as friends or family members of the business owner are not treated the same for regulatory purposes as a Wall Street investment bank.

Specifically, an exemption should be created for finders from the section 15 registration requirement provided that the finder is not "engaged in the business of effecting transactions in securities for the account of others" and that the exemption provides a safe harbor such that a finder is deemed not to be engaged in the business of effecting transactions in securities for the account of others" if the finder meets one or more of the following criteria:

1. the finder does not receive finder's fees exceeding $300,000 in any year;
2. the finder does not assist an issuer in raising more than $10 million in any year;
3. the finder does not assist any combination of issuers in raising more than $20 million in any year; or
4. the finder does not assist any combination of issuers with respect to more than 15 transactions in any year.

It would be reasonable to prohibit finders from engaging in certain activities to be eligible for this exemption on the grounds that such activities would constitute crossing the line to effecting transactions in securities or providing investment advice (thus triggered investment advisory registration requirements). Among those activities that would be proscribed would be:

1. holding investor funds or securities;
2. providing investment advice or recommending the purchase of securities; and
3. participating materially in negotiations between the issuer and investors.

Statutory Definition of Accredited Investor

Proposal: Create a statutory definition of accredited investor that prevents the current thresholds for natural persons from being increased. In other words, make the current accredited investor income and net worth standards statutory.

Analysis: The SEC adopted Regulation D in 1982. Regulation D created the concept of an "accredited investor." Accredited investors are permitted to invest in Regulation D offerings. They are, generally, either institutions or natural persons who have an income of more than $200,000 ($300,000 joint) or a residence exclusive net worth of $1 million or more.

Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act[11] ("Dodd-Frank") required the SEC to make the accredited investor net worth qualification to be residence exclusive. Section 413(b) invites the Commission to analyze whether the net worth standard "should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy" and mandates that:

> Not earlier than 4 years after the date of enactment of this Act, and not less frequently than once every 4 years thereafter, the Commission shall undertake a review of the definition, in its entirety, of the term ''accredited investor''

[11] P.L. 111–203, July 21, 2010.

This review, therefore, may be undertaken by the SEC as early as July 21, 2014 and must be undertaken by 2018.

Section 415 of Dodd-Frank required the Government Accountability Office (GAO) to conduct a study of the accredited investor thresholds. This study was released in July, 2013.

Accredited Investor Thresholds Adjusted for Inflation[12]

Accredited Investor Threshold	Existing (1982 –present)	If Adjusted for Inflation (1982 to 2012)
Net Worth	$1,000,000	$2,400,000
Income (Single)	$200,000	$475,000
Income (Joint)	$300,000	$715,000

Source: Author's calculations using BLS data.

The GAO estimates that increasing the accredited investor net worth thresholds to this degree would reduce the number of potential small business investors from 8.5 million to 3.4 million, a reduction of 60 percent. Adjusting the income thresholds would reduce the pool of small business investors from 6.1 million to 1.7 million, or 72 percent. See table below.

Per the GAO: "According to SEC, when the standard was first created, 1.87 percent of households qualified as accredited investors. SEC staff estimate that 9.04 percent of households would have qualified as accredited investors under the net worth standard in 2007; we estimate that removing the primary residence from households' net worth, as required in the Dodd-Frank Act, dropped the percentage to 7.2 percent (based on 2010 data)."[13] The wealthiest seven percent of the public are not poor, uneducated people incapable of paying to secure needed investment advice or of making informed decisions themselves. Nor are they incapable of bearing financial risk. But those arguing to increase the thresholds to, for example the 1982 levels in inflation-adjusted terms, would reduce the pool to about the top two percent of households.

Obviously, this would have a substantial adverse impact on the ability of small firms seeking access to the capital they need to grow their businesses, create jobs, enhance productivity and bring new products to market. But is it fair, in the name of paternalism, to limit investment opportunities to those who are already rich with a net worth exceeding 98 percent of their fellow citizens. Certainly such a policy can be counted on to thwart upward mobility. Making it more difficult for small businesses to raise capital and reducing the ability of investors to invest in companies with tremendous potential is not a worthy policy goal.

The bottom line is this. It is clear that increasing the accredited investor thresholds would have a dramatically adverse impact on small, dynamic, innovative firms seeking capital. There is good reason to believe that the SEC may pursue such a policy and it is advisable to try to stop it.

[12] Bureau of Labor Statistics data shows that the CPI-U index (1982-84=100) for 1982 was 96.5 and for 2012 229.6. The ratio, therefore, is 2.38 representing inflation over the period of 138 percent.

[13] "Alternative Criteria for Qualifying As An Accredited Investor Should Be Considered," GAO, July, 2013, at pp. 9-10 ("GAO Study").

GAO Estimates of Number of Households Eligible for Accredited Investor Status at Various Thresholds for Net Worth and Income (2010) [14]

Income threshold		Net worth threshold	
Existing and hypothetical thresholds	Number of households	Existing and hypothetical thresholds	Number of households
$100,000	21,600,000	$250,000	23,200,000
$200,000 (existing for individuals)	6,100,000	$1,000,000 (existing)	8,500,000
$300,000 (existing for couples)	3,300,000	$1,750,000	4,600,000
$400,000	2,400,000	$2,500,000	3,400,000
$500,000	1,700,000	$3,250,000	2,700,000

Source: GAO

NSMIA Covered Securities

Proposal: Either define NSMIA covered securities to include securities sold in transactions exempt under Rule 504, Rule 505 and Regulation A (in addition to Rule 506) or define qualified purchasers to include all purchasers of securities in transactions exempt under Rule 504, Rule 505 and Regulation A (in addition to Rule 506), or both.

Analysis: The National Securities Markets Improvement Act (NSMIA) of 1996 amended section 18 of the Securities Act (15 USC 77r(a)) to exempt from state securities regulation any covered security.

15 USC 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.

Oddly, if you look through Regulation D, it is only Rule 506 that explicitly invokes section 4(2). Accordingly, Rule 505 and Rule 504 offerings have not been treated as covered securities by the SEC or the state regulators. It would probably prove interesting to go back to the original 1982 Regulation D proposed rule discussion to see what the SEC regarded as the statutory basis for Rule 504 and Rule 505. Since 502(c) prohibits general solicitation and it applies to all Regulation D offerings, it certainly seems as if the private placement exemption in section 4(2) was the

[14] GAO Study at p. 18.

genesis of all three Regulation D exemptions.[15] The only other candidate would be the small issue exemption under Securities Act section 3(b) that is the basis for Regulation A.

Professor Rutheford B Campbell, Jr. has written a good law review article on this general subject: "The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions," *The Business Lawyer*, Vol. 66, August, 2011. This article also has, so far as the author knows, the best data on Regulation D filings.

Campbell's data shows (p. 926) that 94 percent of all Regulation D filings are Rule 506 offerings. On the face of it this is surprising since the federal regulatory burden is lower on Rule 504 and Rule 505 offerings. Upon further analysis it is not surprising because only Rule 506 offerings are treated as exempt from the 50 state Blue Sky laws (except as to notice filing requirements). Thus, the overall regulatory burden (combined state and federal) is lower on Rule 506 offerings. This is what Campbell is referring to when he talks about the wreck of Regulation D. The original regulatory scheme of incrementally higher regulation of progressively larger offerings has been "wrecked" because Rule 506 has become so much more attractive than other Regulation D offerings after the 1996 enactment of NSMIA.

Regulation D Offerings by Rule (2008-2010)[16]

Rule 504	Rule 505	Rule 506
4.4%	1.6%	94.0%

Source: Professor Rutheford B Campbell, Jr

Regulation A is an exemption for public offerings not exceeding $5 million in any 12-month period. The securities can be offered publicly, using general solicitation and advertising, and, unlike under Regulation D, purchasers do not receive "restricted securities." However, because Regulation A offerings are generally subject to 50 sets of state Blue Sky regulations governing *public* offerings, the Blue Sky compliance burden is high. The other reason that Regulation A is little used is that the substantive federal requirements for Regulation A are, in effect, not that far removed from a full blown registration statement.[17] If an issuer is going to incur that level of cost, it might as well get the benefits of being a true public company. The issue of the substantive federal compliance burden for Regulation A offerings should be addressed, although I do not have much to offer at this point on this issue. Detailed discussions with the relatively few issuers that have navigated the Regulation A process would probably be fruitful.

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[15] So far, the author has not been able to dig up a copy of the original *Federal Register* notice (47 FR 11262, Mar. 16, 1982) that contained the discussion of the original 1982 Regulation D. The National Archives on-line version of the *Federal Register* does not go that far back and neither a Google search nor a search of the SEC web site was fruitful.

[16] Data covers the period September 15, 2008 to October 18, 2010. "The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions," *The Business Lawyer*, Vol. 66, August, 2011, p. 926.

[17] The author freely admits that like just about everybody else, I have never done a Regulation A filing. As the recent GAO study on Regulation A showed, in some years there has been only one Regulation A filing nation-wide. See "Factors That May Affect Trends in Regulation A Offerings," United States Government Accountability Office, July 2012 (GAO-12-839). This study was required by the JOBS Act.

It seems reasonably clear, however, that simply treating Regulation A securities as covered securities would dramatically improve the attractiveness of Regulation A offerings by substantially reducing the Blue Sky compliance burden. Combined with JOBS Act Title IV, this would be potentially a very big positive step.

The simplest way to cure this is to amend 15 USC 77r(b)(4)(E) so that it covers all Regulation D offerings and Regulation A offerings. An alternative is to define "qualified purchaser" under NSMIA to include all purchasers of securities in transactions exempt under Rule 504, Rule 505, Rule 506 and Regulation A. Or both could be done to effectively integrate the qualified purchaser and covered security definitions.

Sophisticated Investors

Proposal: Allow persons to definitively qualify as a sophisticated investor for purposes of Rule 506 by passing an exam.

Analysis: Rule 506(b)(2)(ii)[18] provides 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.

Such a person is typically called a "sophisticated" investor.

Very few issuers take advantage of this provision. The reason is fairly straight-forward. Nobody really knows what the term means and the risk of being jumped by either the SEC, a state regulator or a plaintiff's lawyer for guessing wrong is too high. 88 percent of offerings under $1 million are limited to only accredited investors and 92 percent of offerings between $1 million and $5 million are so limited.[19]

Percentage of Offerings Limited Solely to Accredited Investors[20]

Offerings Under $1 million	Offerings Between $1 million and $5 million
88 percent%	92%

Source: Professor Rutheford B Campbell, Jr

To breath life back into this provision, Congress should direct the SEC to require FINRA to offer an exam allowing persons to definitively qualify as a sophisticated investor for purposes of Rule 506 by passing an exam. In this way, sophisticated (generally young) people who have not yet

[18] 17 CFR 230.506(b)(2)(ii).

[19] "The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions," Rutheford B Campbell, Jr., *The Business Lawyer*, Vol. 66, August, 2011, p. 930.

[20] Ibid.

become accredited would be able to qualify and issuers would be able to make their Regulation D securities available to them without incurring regulatory risk.

This exam could easily be based on the investment knowledge part of the Series 7 exam (the General Securities Representative Qualification Examination) administered to aspiring stock brokers. The relevant parts are part F2 "Evaluates Customers' Other Security Holdings, Financial Situation and Needs, Financial Status, Tax Status, and Investment Objectives" and part F4 "Provides Customers with Information on Investments and Makes Suitable Recommendations").

Private Placement Safe Harbor

Proposal: Amend the Securities Act to create a safe harbor so that any offering (within a 12 month period):

> (1) to people with whom the issuer (or its officers and directors) has a substantial pre-existing relationship;
> (2) involving 35 or fewer other persons; or
> (3) of less than $500,000

is deemed not to involve a public offering for purposes of section 4(a)(2).

These figures are far from set in stone.

Analysis: Section 4(a)(2) of the Securities Act exempts "transactions by an issuer not involving any public offering." It has always puzzled me that there is no definition of a public offering or, conversely, of what is not a public offering (i.e. a private placement) in the Securities Act or, for that matter, in the securities regulations.

Thus, in principle, a few guys forming a small little business (e.g. a local restaurant) who are a little too public in seeking investors (for example, telling a local reporter about their plans when they run into him at the local high school football game or standing up at the local Kiwanas or Rotary Club seeking partners) can run afoul of the securities laws.[21] In practice, the SEC has not been bad about this although some state regulators probably have been.

Nevertheless, you never know what will happen in the future and it seems that creating a bright line, per se safe harbor for very small offerings should be done. If you are raising a small amount of money from a few people most of whom you know already, you should not have to hire a securities lawyer and do a private placement offering memorandum or risk being chased by the SEC, or more likely, being successfully sued by disgruntled investors if the business fails or does not have the hoped for returns.

[21] Assuming they do not have a substantial pre-existing relationship with everyone in the room. Now, however, if they comply with the investor verification procedures and do a compliant Rule 506 offering (e.g. by selling only to accredited investors), they could save their situation. Odds are, however, they will have not even heard of Rule 506 and not have the vaguest idea that their actions would be a violation of the securities laws.

Small Cap Internal Control Reporting and Assessment Requirements

Proposal: Eliminate the internal control reporting and assessment requirements of Sarbanes-Oxley section 404(b) for companies with market capitalizations of $300 million or less.

Analysis: The bi-partisan "AGREE Act" bill proposed eliminating the application of this provision to small cap public companies. There is no doubt that section 404(b) imposes a huge cost on small public companies and has, in the real world, almost no positive impact. This provision is, based on anecdotal evidence, one of the big reasons small public companies are "going private."

In these companies, a small executive team of a very few persons controls the company. If they want to abscond with company funds, a loose-leaf binder on the shelf is not going to stop them. Yet these loose-leaf binders with internal control assessments cost a quarter of million dollars or more to produce. It is really the accountants and management consultants full employment provision.

Eliminate Restrictions on Credit Union Lending to Small Businesses

Proposal: Repeal the restrictions on credit union lending to small businesses.

Analysis: Section 107A of the Federal Credit Union Act (12 USC 1757a) imposes a limit on credit union business lending (which is almost exclusively small business lending). The limit is equal to 1.75 times the section 216 net worth requirement of 7 percent. Thus, no more than 12 ¼ percent of loans can be to small businesses. There is no reason to believe that small business loans involve any more risk than consumer loans.

Concern that Internal Revenue Code section 501(c)(14) affords an advantage to credit unions is reasonable. Unfair competition by tax-exempt organizations against businesses is commonplace. But that Internal Revenue Code provision has a long history and whatever advantage is accorded to credit unions is equally applicable to any loan so it does not logically justify a provision affirmatively discriminating against small businesses.

This is particularly the case since banks are notoriously slow to lend to small businesses.[22] The interest of the small business community, and the public interest in economic growth and prosperity, is to reduce artificial barriers to capital access for small, growing firms.

An alternative to repealing the restrictions would be to increase the cap or, as some bills have proposed, allow the regulators to increase the cap to as high as 27 ½ percent for well capitalized credit unions.[23]

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[22] See, e.g., "Small Business Lending in the United States, 2012," Victoria Williams, U.S. Small Business Administration, Office of Advocacy, Office of Economic Research, July 2013. See also, NSBA 2013 Mid-Year Economic Report available at http://www.nsba.biz/wp-content/uploads/2013/08/2013-MY-Report.pdf .

[23] See, e.g., H. R. 1688, 113th Congress, 112 sponsors.

Peer-to-Peer Lending

Proposal: Permit Peer-to-Peer Lending portals to provide loans to small businesses without filing a registration statement.

Analysis: The key substantive point here is that a loan is a loan not a security. And whether that loan is from a bank, a credit union, a non bank lender or an individual via a P2P lending portal should not matter.

Prosper and Lending Club have web platforms allowing consumers to lend money to multiple individuals and enabling consumers to borrow directly from other consumers. This enables lending consumers to achieve a higher rate of return than by depositing money in banks while still having a diversification of risk. It enables borrowing consumers to get better rates than they can at banks. The lending consumer can choose the amount of credit risk they want to take and the returns are commensurately higher for lending to borrowers with lower credit ratings.

Originally, Prosper and Lending Club also lent to small businesses. In 2008, the SEC jumped both Prosper and Lending Club. As the SEC put it:

> The notes offered by Prosper are investments. Lenders expect a profit on their investments in the form of interest, which is at a rate generally higher than that available from depository accounts at financial institutions.[24]

As a result of the SEC action, Prosper and Lending Club now must file a revised registration statement (prospectus) every few weeks or so. See their web sites[25] or EDGAR. Thus, the regulatory burden on this business is very high. The regulatory burden has caused all of the European companies in this business to exit the U.S. market and none have entered it (so far as the author knows) even though P2P lending is a thriving business in Europe. At this point, Prosper and Lending Club are probably reasonably comfortable with the situation. The high compliance burden, which they have learned to deal with, is a major barrier to entry for potential competitors.

The GAO has issued a report on this entitled 'Person-To-Person Lending: New Regulatory Challenges Could Emerge as the Industry Grows' which was released on July 7, 2011. This report is valuable in that it explains in detail the regulatory morass that P2P lending currently faces. Its proposed solutions generally lack merit in that they would not really solve the problem.

The mere fact that somebody expects a return should not trigger SEC involvement let alone the requirement to file a registration statement. If that were the test, *any* business would be caught up in securities regulation and so would every lender, no matter how small, and so for that matter

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[24] See, Order Instituting Cease-And-Desist Proceedings Pursuant to Section 8a of the Securities Act Of 1933 Against Prosper Marketplace, Inc., Release No. 8984 / November 24, 2008. There is also a consent decree for Lending Club. Both Propser's and Lending Club's 10-Ks from the relevant period go into detail.

[25] See https://www.lendingclub.com/info/sec_filings.action and http://www.prosper.com/prospectus/ . In the case of Prosper, they appear to be filing an addendum nearly every business day.

would any real estate, commodities or other investor. Undertaking to make a consumer or small business loan should not trigger Securities Act registration requirements.

P2P lending represents a way to make financial intermediation for consumer and small business loans much more efficient to the benefit of consumers, small business owners and small lenders. There is a very strong need to cut down the regulatory weeds and allow the potential efficiencies of internet lending and borrowing to take place.

A straight forward solution to this is to either amend section 3 of the Securities Act so that loans from individuals to small businesses or other individuals accomplished through a web portal are exempt securities or amend section 4 so that the lending transactions that are accomplished through a web portal are exempt (or both). The Securities Act, after all, exempts bank lending.

It is also important that the regulatory and oversight responsibility for this industry (primarily policing fraud) be vested in one agency. One possibility is, the Consumer Financial Protection Bureau (CFPB). Others would include the Federal Trade Commission (FTC) or the Treasury. The banking and securities regulators are the wrong place. P2P is too different from what they are used to and they will be inclined to impose regulations as burdensome as they do on banks or investment banks. One thing is certain. The current regulatory environment for P2P lending is a mess.

Regulation A

Proposal: (Part A) Simplify the statutory small issue exemption.
(Part B) Permit but not require Reg. A offering statements to be placed on EDGAR.

Analysis: The author does not have fully developed ideas about how to reduce the regulatory burden on Regulation A filings. Input from readers would be appreciated. Regulation A offering costs are high enough that Regulation A was effectively a dead letter. The JOBS Act may change that but I suspect it will not have the desired effect unless either the covered securities issue discussed above is addressed or the substantive compliance burden is reduced. If the compliance costs remain too high and blue sky laws remain applicable, most issuers will probably continue to either use Regulation D or go public. Congress enacted the small issue exemption under Securities Act section 3(b) for good reason. There is a need to bring it back to life.

Permitting but not requiring Regulation A offering statement to be placed on EDGAR is an idea that was included in the recommendations of the Government-Business Forum on Small Business Capital Formation that makes sense. It would make it easier for potential investors to obtain information about Regulation A offerings and increase the likelihood of issuers finding investors.

Know Your Customer Rules

Proposal: Amend the Bank Secrecy Act to make it clear that federal "Know Your Customer" do not apply to finders, business brokers or crowdfunding web portals that do not hold customer funds.

Analysis: SEC staff has expressed some concern about finders, crowdfunding portals and money laundering. This is incredibly ill-advised. Federal "Know Your Customer" rules are voluminous and complex.[26] FINRA is also clearly thinking about this.[27] These rules impose a tremendous compliance burden on financial institutions – running to the many billions of dollars. Applying these rules to finders or business brokers would effectively render any contemplated exemption a nullity because the administrative burden would be so high.

Finders would by their nature not hold customer funds and the contemplated exemption would contain an explicit prohibition against finders doing. Title III of the JOBS Act prohibits crowdfunding portals from holding customer funds. Accordingly, it is exceedingly doubtful that anything would be gained from requiring "Know Your Customer" compliance from finders or crowdfunding portals. Requiring crowdfunding portals to comply with these rules will kill crowdfunding portals except by broker-dealers.

Investor or issuer funds are, in contrast, held in a financial institution and subject to the stringent federal "Know Your Customer" rules and anti money laundering (AML) provisions. Furthermore, foreign financial institutions that enter the U.S. financial system and U.S. financial institutions that deal with foreign financial institutions are subject to U.S. "Know Your Customer" rules as well as the increasingly robust international "Know Your Customer" and AML regimes promoted by the OECD Financial Action Task Force.[28]

Data Collection and Publication

Proposal: Improve SEC collection of data on private placements and Regulation A offerings and ensure the data is published regularly without materially increasing the administrative burden on issuers.

Analysis: There is an incredible dearth of real data on private securities offerings. The SEC publishes nothing on a periodic or consistent basis. The agency did put out one article.[29]

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[26] See, e.g., Internal Revenue Service Rev. Proc 2000-12, "Application Procedures for Qualified Intermediary Status Under Section 1441; Internal Revenue Service Notice 2013-43 "Revised Timeline and Other Guidance Regarding the Implementation of FATCA;" section 326 of the Patriot Act amending the Bank Secrecy Act; 31 C.F.R. § 103.121; FINRA Rule 2090 (Regulatory Notice 11-25, May 2011); etc.

[27] See FINRA Regulatory Notice 12-34 (FINRA Requests Comment on Proposed Regulation of Crowdfunding Activities)

[28] See, e.g., "International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation - the FATF Recommendations," February 16, 2012, available at www.fatf-gafi.org/recommendations .

[29] Vlad IVanov and Scott Bauguess, "Capital Raising in the U.S.: The Significance of Unregistered Offerings Using the Regulation D Exemption," February 2012.

Professor Campbell has developed some very good information as well.[30] The public did not even know how many Regulation A offerings were done until the GAO study came out in July 2012.[31] But that is about it. Compare that to what is available in other fields and the contrast is amazing. Tax has the Statistics of Income and the IRS Databook. In other policy areas, there are the Bureau of Labor Statistics, the Bureau of Economic Analysis (National Income Product Accounts, Trade), the Federal Reserve (Flow of Funds, etc.), FDIC (banking), the Census Bureau (poverty, population characteristics, etc.) and so on. With respect to the public markets, the private sector puts out good data based on EDGAR filings. But in the area of private offerings of securities, there is almost nothing.

The SEC doesn't even keep (or at least release) data about its enforcement actions in this area. This would enable policy-makers to get a handle on where the true problems with fraud were. In addition, amending Form D to allow firms to report on their compliance costs (appropriately defined) would help as well.

It is hard for policy-makers to make appropriate policy decisions in a virtual factual vacuum.

More thought needs to go into this but the problem is real.

GAO Studies

The following studies by the Government Accountability Office (GAO) may be helpful:

1. Examine whether bank regulators inappropriately treat small business loans as disproportionately risky, thereby discouraging bank lending to small firms. Generally, bank regulators deny this but small business owners frequently report this as a reason given by bankers for not lending.
2. Determine the typical compliance costs incurred by issuers in various Regulation D filings and Regulation A filings.
3. Determine the typical compliance costs incurred by private placement issuers because of blue sky laws.
4. Determine the typical compliance costs incurred by small capitalization public companies.
5. Determine and quantify what are the primary sources of fraud in private placements and what percentage of offerings involve fraud.

[30] "The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions," Rutheford B Campbell, Jr., *The Business Lawyer*, Vol. 66, August, 2011, p. 930.
[31] "Factors That May Affect Trends in Regulation A Offerings," United States Government Accountability Office, July 2012 (GAO-12-839).